16 August 2005

Hon. Han Duck-soo
Deputy Prime Minister and Minister of Finance and Economy
Chair, APEC Finance Ministers’ Meeting
Republic of Korea

Dear Deputy Prime Minister Han:

On behalf of ABAC, we are pleased to provide the attached report on business perspectives of financial sector reform, key elements of which will be presented at our dialogue with Ministers at the 12th APEC Finance Ministers’ Meeting to be held September 8-9 in Jeju. Our report incorporates ABAC’s views and recommendations on issues drawn from the Finance Ministers' agenda and summarises our work and recommendations on strengthening and deepening financial systems, along with related capacity building initiatives.

ABAC values the deepened relationship with APEC Finance Ministers through our participation in the APEC Finance Ministers' processes throughout the year and we express our sincere gratitude for your personal efforts in seeking to arrange a special dialogue with Ministers. We welcome the participation of senior finance ministry officials, including the Chair of the Technical Working Group, in our ABAC meetings. During this year we have met with the Second Minister of Finance of Malaysia and with senior officials from the Ministries of Finance of Mexico and China.

In our dialogue with Finance Ministers we intend to address and provide recommendations on what we see as three critical issues. These are: (1) The need for a robust and ambitious outcome to the liberalization of financial services in the Doha Development Round to stimulate quality foreign direct investment flows; (2) The financial implications and challenges of ageing societies in our region; and (3) Mechanisms for financing the massive infrastructure requirements of the region.

Based on our June 13-14 visit to Geneva and the inertia that now marks WTO negotiations, it is our view that much greater effort is needed if the Doha Round is to succeed. We strongly encourage Finance Ministers to engage in this process. Critically, much of that effort ought to be directed at improving the quality and range of offers in the various modes of financial services. We have developed the attached check-list of best practices in financial services liberalization, which we would encourage economies to use as a tool in developing their own offers and in evaluating those of other economies. At the same time, in order to ensure the full benefits of financial service liberalization to economies in terms of investment flows, we have developed a priority list of barriers to foreign direct investment in the financial services sector, the removal of which would offer the most benefit to host economies and corporate investors, along with suggested policy responses.

Major demographic changes coupled with growing infrastructure needs give urgency to (1) the development of private pension systems to help governments address the retirement and health needs of their ageing populations, and (2) the development of domestic bond markets to match long-term private savings needed to support pension obligations with long-term infrastructure investments. Under appropriate prudential policies relating to quality and investment diversification, pension funds should be regarded as a valuable source of infrastructure financing. There needs to be a major effort, in conjunction with the private sector, to restore private financing of infrastructure by encouraging
public private partnerships. Because the development of domestic bond markets is integral to this process, we recommend that Ministers adopt an action plan process to promote bond markets, including collective initiatives and voluntary action plans by individual developing economies. We propose that in 2006, APEC adopt general principles to guide bond market development in the region's emerging markets. ABAC would be pleased to develop these principles with PECC and in coordination with interested expert groups, including regional development banks.

Our report also covers ongoing issues that need to be addressed to ensure the growth and stability of financial systems that underpin economic development. ABAC remains concerned about the limited action by the international community on the issue of volatile short-term capital movements and the impact of hedge funds. We have commissioned a study of possible transitional mechanisms that could be used by vulnerable economies to help avert major shocks. Convergence to international accounting standards, as embodied in the International Financial Reporting Standard (IFRS), may also help to facilitate more efficient and stable capital flows by improving competitiveness in offshore markets and in attracting international capital into domestic markets.

There is a continuing need to deepen and broaden financial systems, to improve their governance – in both the public and private sectors – and to improve security while at the same time maintaining efficiency in transactions. ABAC supports these objectives with well-defined capacity building initiatives aimed at improving the quality of human and institutional resources. We seek Ministers' endorsement of these initiatives, and we request that APEC economies adequately fund the participation of regulators and policy makers in quality training initiatives to ensure widespread knowledge and implementation of best international standards and practices. In our view, the adoption of good policy frameworks and international standards and practices will be of limited value unless the human resource base is of the highest quality in terms of expertise, knowledge and ethics.

We respectfully request that as Chair of the Finance Ministers meeting, you transmit this letter and the attached report and recommendations to your APEC Ministerial colleagues in preparation for our dialogue in September. We look forward to discussing the three major issues we have identified in our report with Ministers in September and to endorsement of the recommendations contained in our report.

Yours sincerely,

Jae-Hyun Hyun
ABAC Chair
(Korea)

Yasuo Kanzaki
ABAC FWG Co-Chair
(Japan)

Jeffrey Koo
ABAC FWG Co-Chair
(Chinese Taipei)

Twatchai Yongkiittikul
ABAC FWG Co-Chair
(Thailand)

Mark Johnson
ABAC Finance Working Group (FWG) Chair
(Australia)

Azman Hashim
ABAC FWG Co-Chair
(Malaysia)

Gary Benanav
ABAC FWG Co-Chair
(USA)
Introduction

The global economic outlook is generally favourable, but risks have increased over recent months. These include: rising and volatile oil prices; increasing imbalances between major economic groupings; tightening interest rates; and, rising premiums on lower quality loans. Following a period of very high growth, the current outlook is for firm, albeit slower growth. Adjusting to a more moderate growth path is welcome, providing there is a relatively smooth adjustment in employment and investment levels.

ABAC considers that a smooth adjustment is not assured and that longer-term growth is put at risk so long as major imbalances persist and deepen. While markets will ultimately force adjustments, this may not be a smooth and politically acceptable process. In our view Ministers have a shared responsibility to consider, as a matter of urgency, ways to coordinate policies to achieve a smooth adjustment by addressing major imbalances.

The key judgements in this report are set against this outlook and address emerging and long-term challenges faced by APEC economies into the next decade. Earlier this year we observed that the next decade will see significant developments in financial sector convergence, its supporting information and communications technology, improved financial engineering capacities, increased competition, and financial system liberalisation. These developments have the potential to provide immense gains for APEC economies.

But finance industry structures and regulatory arrangements will need to keep pace with such changes to promote the smooth and efficient functioning of markets and the consequent economic growth and employment opportunities. This will require increased collaboration, regionally and globally, to ensure the adoption of best standards and practices in regulatory arrangements. In proposing a far reaching agenda to APEC in the context of meeting the Bogor goals we have urged that APEC economies:

- give priority to liberalising financial services in the WTO Doha Round;

- engage in developing and implementing world-class financial standards and regulatory practices to promote financial system stability;

- increase vigilance and deepen regional cooperation and coordination among APEC economies to secure stable financial systems and develop comprehensive capacity building initiatives;
- mobilise local and overseas capital to link long-term savings and investments by developing robust capital markets which will support the retirement income and health needs of ageing communities; and,

- develop public-private partnerships for the development of reliable infrastructure financing vehicles.

Our review of key issues and recommendations are as follows:

1. **Foreign Investment in financial services: Action required in the WTO Doha Round**

Much greater effort is needed to promote the liberalisation of financial services in the Doha Round. The benefits from liberalisation undertaken unilaterally or multilaterally have been well demonstrated across many economies. Financial services liberalisation underpins and facilitates strong economic activity, investment and employment growth. It creates greater choice for savers and investors and rewards entrepreneurship. Greater competition in financial services provides for more robust financial systems.

In the study commissioned by ABAC in 2004, comprehensive liberalisation of services, covering banking, insurance, asset management, payment systems (including credit cards), brokerage and securities, provided the greatest benefits to economies. ABAC is concerned that the Doha negotiations may perpetuate the current imbalance between financial services sectors, something that will undermine the economic synergies between sectors.

ABAC strongly encourages APEC economies to make high quality offers on financial services in the WTO Doha Round (which would make permanent and rationalise unilateral action to liberalise their financial services sectors) to promote economic growth, business and employment and competition. We believe that APEC Finance Ministers should pursue these objectives with other Ministerial colleagues involved in the WTO Doha Round.

High quality offers should i) advance the momentum in the negotiations, ii) create a stable and predictable competitive environment, and iii) promote broad liberalisation to establish the best conditions for new business opportunities for local and overseas firms. We propose for Ministers’ consideration the attached checklist which defines best practices for liberalization of the major sub-sectors of financial systems. The checklist, which ABAC presented to negotiators and WTO officials in June in Geneva, was developed by ABAC as a tool for economies to use in developing or evaluating financial services liberalization offers either multilaterally or bilaterally.

ABAC recognises that some developing economies may need to pursue transitional policies toward full liberalisation, step by step. They would be encouraged in those policies by improved market opening and liberalisation in developed economies and by support from developed economies in improving and strengthening institutional capacities. Transitional policies should promote and be integral to the process of liberalisation. Publicly available information on policy developments which economies intend to pursue would add confidence to the process of reform.

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1 Professor J. Kimball Dietrich: insert name of study – Benefits of Financial Market Liberalisation
Recommendations:

➢ To underscore the importance of, and build confidence in the financial services liberalisation process, APEC Finance Ministers should advocate that WTO members should:

  o encourage the adoption of the best practices in ABAC’s checklist for the WTO Doha negotiations and the use of the checklist as a central reference in assessing the quality of their own offers and those of other members of the WTO, with a view to upgrading offers;

  o give priority to developing and implementing effective initiatives to build institutional capacities in both the public and private financial sectors in developing economies, and involve the private sector and international and regional agencies in those initiatives;

  o pursue the following key priorities in the WTO Doha Round in relation to the liberalisation of financial services:
    ▪ comprehensive liberalisation of all major financial sectors
    ▪ national treatment;
    ▪ allow investors to choose the form of establishment;
    ▪ no "economic need tests" or geographic or product-specific restrictions;
    ▪ temporary entry of natural persons; and
    ▪ transparency in rules and rule making, promptness in licensing and clear explanation of reasons behind decisions on the granting of licences.

2. Foreign Direct Investment and the regulatory environment

Maintaining global competitiveness in the region is an issue of concern. FDI in the financial services sector can help improve the competitiveness of the host economy and have positive benefits for consumers, providing capital, technology, new product lines, managerial knowledge, enhanced skills and the restructuring of inefficient enterprises. These benefits were demonstrated in the Dietrich report we commissioned last year and supported by recent reports by the World Bank, among others.

In response to these findings, ABAC provides Ministers with a business perspective on the conditions that stimulate investor interest in an economy and a checklist template of barriers to FDI in the financial sector, the removal of which business considers would be of most benefit to the host economy and the corporate investor.

These papers are attached to this report. In addition to important conditions providing for commercial presence, investor considerations principally rest with the legal and regulatory framework of the potential host economy; the technical infrastructure; education of the workforce; and the transparency and openness of the market.
Recommendations

- ABAC encourages Ministers to use the attached FDI checklist and suggested policy responses as guides to action to remove impediments to FDI in financial services.
- ABAC strongly encourages Ministers to consider ways of addressing the following priority impediments and to work with ABAC to build institutional capacities to make the investment environment more attractive and workable for all concerned:
  - Restrictive conditions of market entry and operation;
  - Issues of National Treatment and MFN;
  - Restrictions on financial services, including asset management;
  - Issues of transparency, predictability and openness in legal and regulatory regimes;
  - Inadequate regulatory and legal infrastructure;
  - Capital controls;
  - Governance issues;
  - Inadequate property rights protection; and
  - Restrictions on the movement on natural persons.

3. Meeting the challenges of ageing communities

The demographic changes facing APEC pose economic, social and financial challenges in meeting rising health care and pension costs as societies age. The turning point, where the number of retirees and dependants is greater than the number of workers, begins for developed economies within the next five years, and within a generation for most developing economies in APEC. Costs can be financed through a combination of public financing and mandatory private contributions and supplemented by voluntary tax-advantaged private savings. In the case of the poorest in some economies, provision is made for direct resource transfers. Requirements for financing pensions and health costs highlights the role of the financial services sector in helping to mitigate and manage such risks for societies at large. ABAC has studied possible options for addressing these challenges (see attached paper) and offers the following thoughts to Ministers.

Pay-as-you-go government pension systems (even as a partial solution) will severely constrain economic growth as the burden to pay for pensions is shifted to a shrinking percentage of workers in an ageing population. The faster economies move to include a pre-funded private pension option and health coverage as part of their retirement and health schemes, the less strain on budgets as populations age.

For demographically older societies, the insurance and asset management industries offer individual and group products to help older workers and retirees meet their financial needs. The sectors can also play a key role in managing pension assets (including public pensions, where these are opened up to private management). The sector helps to pool stable, long-term sources of capital which can be used to support needed investments in infrastructure. Life insurers must match their long-term liabilities with assets, and so they look for long-term investment prospects.

Asset management and asset allocation strategies (whether by public pension funds or private investments) will contribute to achieving higher rates of return and diversifying risk and will assist in meeting economies’ asset accumulation needs. Cross-border investment is essential in sound asset management; it provides for diversification, risk minimisation and best returns. Overly restrictive investment rules can lower returns and reduce solvency. Ideally, within well-
supervised limits, insurers and pension funds should be able to invest their portfolios in a mix of quality domestic and non-domestic assets, taking proper account of both risk and return factors.

A successful privatized pension system must rely upon transparent and reliable regulation during both the accumulation phase and the payout phase. There is no single model for either phase. However, there are examples that could serve as useful models in certain APEC economies. The OECD, UNCITRAL, and the World Bank have developed guidelines for designing and implementing effective private pension systems. While there are many variations in schemes, some principles are fundamental. These cover the design of private pension funds, protecting the rights of members and beneficiaries, regulation and supervision, and more broadly the regulation of finance and capital markets. ABAC recognizes that developing pension schemes and the appropriate investment strategies involves skill and commitment and dedicated resources. This is an area of public policy in which ABAC members have skills and experience and we stand ready to support APEC through public-private sector capacity building initiatives.

Recommendations

- demographic trends require that APEC economies give priority to reviewing pension and health care systems to meet the pressures of ageing communities;

- policies should involve private pension accumulation schemes to reduce reliance on public schemes and should aim to facilitate more rapid accumulation of capital in sound assets (including improved investment climates, financial services liberalization and increased domestic transparency of regulation);

- policies and regulations should be sufficiently flexible to permit the full range of investment options – in long-term domestic infrastructure as well as cross-border activities – yet accord the appropriate supervision of these activities;

- key principles outlined in OECD guidelines on private pensions, covering the rights of members and beneficiaries, regulation and supervision and governance, should be considered as economies develop private pension systems; and

- that the APEC Finance Ministers' processes and ABAC work to jointly develop appropriate capacity building initiatives to support the development of private pension arrangements in APEC's emerging economies.

4. Promoting public private partnerships to finance regional infrastructure

ABAC believes that encouraging private sector involvement in infrastructure financing is one of the most pertinent challenges facing the region today. The public sector cannot meet the current and projected infrastructure investment needs. Since 1997, private sector involvement has been much lower than previously expected or needed. In the 1990s, private sector finance accounted for 20 to 25% of infrastructure funding in developing economies. Between 1990-2002, private funding amounted to $805 billion; including $190 billion placed in East Asia. Financing peaked in 1997, but since the Asian financial crisis it has fallen dramatically and the recovery rate has been slow. Estimates point to the private sector now providing 5% of current needs in the
Asian region. In 2002, finance from this source was $US 47 billion – the lowest level since 1994 and was concentrated in telecommunications and energy.

Infrastructure requirements for electricity, water, sanitation, telecommunications and transport over the next 5 years, both in new funding and in maintenance expenses, are estimated to be in the order of $162 billion annually, with 80% going to China. To put this need in context, the sum required is just over 6% annually of the region’s GDP. Estimates at the January 17, 2005 infrastructure summit in Jakarta projected Indonesia’s requirements for private sector finance for infrastructure over the next five years at $80 to $90 billion, with an expected one-third of the total needs being met from the budget and $10 billion from multilateral lenders. ABAC has reviewed developments and impediments to infrastructure financing (see attached paper) and offers the following views to Ministers.

Surveys of private sector participants in infrastructure projects in the Asian region point to policy uncertainty and high investor risks in the region as the key deterrents to private investment. Commitments by economies to reforms in legal and finance institutions, risk mitigation on pricing and the setting and adjustment of tariffs, improvements in auditing and accountability, and the removal of impediments to capital mobility are all seen as important reforms to encourage renewed private participation.

Experience points to the importance of financing packages to suit individual projects. Flexible financing can accommodate specific risks, maturity requirements, the structuring of revenue streams and adjustment to financing requirements at different stages of a project. Depending on the characteristics of a particular project, financing can involve equity financing and equity funds, overseas and local bank financing, and financing through bond market issues. In the early 90’s bond market financing was the fastest growing source of private finance with flows increasing from $2.3 billion in ‘93 to $45.8 billion in ‘96. The development of long-term contractual savings institutions (insurance companies, pension and superannuation funds) in the region would be highly important institutional changes that would allow the linking of long-term savings with infrastructure financing needs.

Recommendations:

- APEC economies confront the infrastructure financing gap in developing economies in the region as a major priority in economic and social management and in the maintenance of financial system stability;
- Economies requiring infrastructure financing undertake comprehensive reforms to eliminate the gap by adopting the following measures:
  - cooperate with the private sector to create an environment for infrastructure investment which would be conducive to encouraging flexible private participation in project design, operation and financing, and reflect the realities of individual projects and their objectives;
  - build on the guidelines and modalities developed in UNCITRAL and other international and regional organisations concerned with the development of private sector participation and work with ABAC to develop a capacity building initiative to

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2 An excellent reference is the recent publication by the World Bank, the ADB and Japan Bank for International Cooperation “Connecting East Asia: A new framework for Infrastructure”.

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review and improve on guidelines to deal with risk evaluation and measurement in public private partnership model clauses;

- liberalise financial systems to allow local and overseas participation in the growth of pensions and superannuation systems and products, under appropriate supervisory arrangements (refer to the recommendations in the accompanying paper on ageing economies and asset allocation strategies); and

- deepen and strengthen capital markets and implement ABAC/PECC recommendations to promote regional bond markets.

5. Enabling expanded private sector activity in the region’s bond markets

During their meeting with ABAC and PECC in September 2003, the APEC Finance Ministers called for private sector inputs on how to promote private sector activity in the region’s bond markets, to accelerate the development of domestic and regional bond markets. In response, ABAC and PECC convened a private sector-led conference in May 2004 in Taipei. Participants identified necessary conditions to enable expanded private sector investment and issuance, domestic and cross-border, in these markets, and proposed a number of objectives that APEC economies must pursue to provide these conditions. ABAC endorsed these proposals to the APEC Finance Ministers in 2004, and recommended that member economies make self-assessments based on these objectives. Australia, Japan and Korea undertook self-assessments in response to this recommendation.

In June 2005, ABAC, PECC and the ADB Institute convened a follow-up conference in Tokyo, involving both public and private sectors. Assessments reveal that while some developing economies have made significant progress in meeting most of the objectives to provide an enabling environment for private sector investment and issuance in bond markets, many are still in the early stages of development, especially with respect to corporate bond markets. Participants noted that current bond market initiatives are entering a critical stage as these move toward more technical issues, requiring greater private sector involvement. Participants also noted the multiplicity of initiatives by various regional groups, which call for efforts to ensure consistency among each other and with APEC’s vision of free and open trade and investment.

**Recommendations:**

- APEC economies should pursue objectives proposed by the 2004 Taipei bond market conference to enable expanded private sector domestic and cross-border investment and issuance in local-currency bond markets, giving priority to the key objectives identified in the 2005 Tokyo conference, as described in the published conference report (*Developing Bond Markets in APEC: Toward Greater Public-Private Sector Regional Partnership*).

- APEC Finance Ministers should pursue these objectives through an action plan process for bond market development, including the development of voluntary action plans by developing economies and of collective initiatives to facilitate cross-border investment and issuance in bond markets, with the involvement of the private sector.

APEC Finance Ministers should develop, for adoption in 2006, general principles for bond market development cooperation to guide and promote consistency among various bond market development activities, in cooperation with the private sector and with the assistance of regional development banks.
6. Strengthening and deepening the region's financial systems

i) ameliorating the impact of volatile capital flows

ABAC advised Ministers last year that notwithstanding the benefits of capital flows, concerns remain about the vulnerability of some economies to volatile short-term flows and the activities of hedge funds. We reviewed the work of the Financial Stability Forum and the BIS and recommended that economies implement measures recommended by those groups, including importantly strengthening domestic economic frameworks and financial systems to withstand external shocks and that economies require major international agencies to improve surveillance and monitoring of volatile capital flows and the activities of hedge funds.

It is disappointing that monitoring and surveillance remain undeveloped generally and that the Manila Framework, created in part to undertake monitoring in the region, has been disbanded. ABAC has commissioned a study to review policy responses in various economies and to assess the feasibility and practicability of measures, including "circuit breakers" that vulnerable economies might consider invoking as transitional policies until domestic markets become sufficiently deep and liquid to handle volatile flows. The results and recommendations from this important study will be transmitted to Finance Ministers and to Leaders in November this year.

Recommendations

- vulnerable APEC economies should take action to deepen and strengthen domestic financial markets;
- APEC should:
  - request international agencies to improve monitoring and surveillance of volatile capital flows and the activities of hedge funds and to provide more public and transparent data on flows;
  - note that ABAC is undertaking a study with PECC on policy responses to this issue, including possible transitional mechanisms that could be employed by vulnerable economies.

ii) budget discipline as a means of enhancing exchange rate stability

Business notes the critical contribution that sound budget management makes to economic and exchange rate stability – irrespective of whether rates are fixed or flexible. Where rates are fixed, fiscal discipline is particularly important as any serious inflationary bias in fiscal policy may well lead to interest rate adjustments and could ultimately cause major adjustments to exchange rates. In this scenario (and before an exchange rate adjustment), fiscal and monetary policy would be running in different directions.

From a business perspective, and for the community broadly, major adjustments of this kind can be highly disruptive. Fiscal discipline is essential to macroeconomic stability, to the health of the investment climate and to shaping foreign perceptions about an economy's credit-worthiness, which can impact significantly on capital flows. While there is no consensus to the form of commitment to fiscal discipline, economies should commit to measures which embody a number of characteristics, namely: certainty; transparency; credibility and sustainability.
Recommendations

- acknowledge business concerns to see economies maintain fiscal discipline, especially in economies with fixed exchange rate regimes, and
- encourage the incorporation of certainty, transparency, credibility and sustainability into fiscal policies.

iii) Convergence to international accounting standards

Under the leadership of the International Accounting Standards Board, the International Financial Reporting Standard (IFRS) is recognised increasingly as the global accounting standard. IFRS becomes effective this year. Business notes the difficulties involved for economies in changing reporting standards but considers that convergence to a common standard by regional economies will benefit those economies by facilitating direct comparison between domestic and foreign company financial statements. In so doing, it will facilitate acceptance of their financial statements in overseas capital markets and improve their ability to compete offshore and to attract international capital into their own domestic market.

Recommendation

- APEC economies should implement urgently, in consultation with their business communities and other stakeholders, measures to converge practices as early as practicable to the IFRS; measures could well include training programs by public agencies and private business groups in the implementation of IFRS and awareness raising programs.

7. Supportive capacity building initiatives

Strengthening and deepening regional financial systems involves not only reforms to liberalise financial markets and promoting investment and competition, but also a commitment to implement best international standards and practices of supervision and regulation in financial sectors and to improve governance in both public and private financial institutions. These measures complement liberalisation and competition and create the conditions for system stability and economic growth. ABAC strongly supports capacity building aimed at meeting these objectives – by raising the skills base and knowledge of regulatory supervisors and of members of private financial institutions; specifically by:

- supporting the implementation of Basel 2 in the banking system;
- promoting the development of domestic and regional bond markets;
- training APEC regulators in supervision of the life insurance and pensions sectors;
- improving security in financial systems to counter money laundering and terrorist financing activities;
- promoting good governance in financial systems; and
- promoting remittances through formal financial sectors under appropriate supervisory arrangements.
The activities of the joint ABAC and PECC Advisory Group on APEC Financial System Capacity Building are variously supported by the World Bank, the IMF, the ADB, BISD and the AFDC. More recently, ABAC has cooperated with the ABA, the Chilean Bankers' Association, the ADBI and SEACEN in promoting specific symposiums and training programs. Some training is sponsored at the economy specific level (for example by the Australian APEC Study Centre at Monash University), others involve academic and professional support organised through PECC. Ministers should be aware that the network of support groups is widening and, as a consequence, more effective partnerships are developing between the private sector and public sector agencies.

Current and planned major public/private sector initiatives are described in Appendix I to this report.

**Recommendations**

- support ABAC capacity building initiatives by:
  - direct involvement where appropriate by APEC Finance Ministers and officials in training initiatives and relevant symposiums;
  - ensuring adequate funding is available to meet the costs of the involvement of regulators and policy officials from emerging APEC economies so that they can participate in relevant symposiums and training programs;
  - endorsing the current program of work as outlined in the Appendix to this report

**9. Conclusion**

The APEC region faces significant challenges in the coming years to maintain and enhance the necessary financial system stability and growth that underpin economic performance and development. Rapidly ageing societies, coupled with growing infrastructure needs, will strain budgets and require fresh policy responses, including the development of public/private partnerships to address these needs. We cannot overemphasize the importance of APEC economies establishing the right policy and investment climates that will stimulate the mobilization of private sector savings and a sustained increase in private sector investment in the region. Removing major impediments to foreign direct investment and liberalizing the major financial services sub-sectors through a robust outcome to the Doha Round negotiations will be critical to this endeavour. Developing strong institutional and human resource capabilities in the financial services sector, most particularly in the area of regulatory supervision, will be a vital element of the success of these policies. ABAC is honoured to be able to continue to contribute to your policy deliberations on these important matters.
ATTACHMENTS:

- Check List: Developing a Benchmarking Tool: Advancing Financial Services Liberalisation in the WTO Doha Round
- Check List of Impediments to FDI in the Financial Services Sector and Recommended Policy Responses
- ABAC Paper - Ageing Economies and Asset Management/Asset Allocation Strategies
- ABAC Paper – Infrastructure and Financing Arrangements
- Report and Recommendations of the Tokyo Conference on developing regional Bond Markets
Specific Capacity Building Initiatives

a) A conference jointly sponsored by ABAC, PECC, ADBI on developing bond markets, held in Tokyo, on 21/22nd June; the recommendations are included under 5 of this report

b) ABAC supported an APEC symposium on anti-corruption and transparency held in Seoul, 1/2nd September – recommendations to Ministers will/have been provided to Ministers

c) ABAC/PECC/ABA is to sponsor a major symposium in Melbourne on 19th October 2005 in conjunction with the Annual Meeting of the Asian Bankers' Association; the symposium is aimed at promoting good corporate governance and transparency in APEC financial institutions

d) ABAC and PECC sponsored with the SEACEN (South East Asia Central Bankers Training Institute) a public/private dialogue involving regulators and bankers and International organisations which considered cross-border issues arising from the Implementation of Basel 2, and emerging new banking regulatory supervisory issues

e) ABAC participated in the APEC Policy Dialogue on remittances held in Bangkok on 26/27th May; ABAC endorses the objective of encouraging remittance payments into the formal payments system to improve security over those flows and to reduce costs to people remitting funds

f) ABAC is developing with the Asia Pacific Group and international financial agencies a training program which would involve private sector experts in training regulatory officials from emerging markets in the supervision of laws and regulations to counter money laundering and terrorist funding

g) ABAC participated in the PECC Finance Forum held as part of PECC’s 16th Council Meeting, in Seoul, 5/7th September.
CHECKLIST

FINANCIAL SERVICES LIBERALIZATION: GOALS AND BEST PRACTICES

For use by economies in assessing and evaluating the quality of financial services offers in the Doha negotiations.
## GOALS

The offer should create new market-opening and investment opportunities. To what degree does it satisfy the following goals?

1. Improves upon 1997 commitments (where applicable)
2. Creates new business opportunities through the lifting of restrictions
3. Creates conditions that will attract new capital
4. Addresses market access, national treatment and transparency of domestic regulation measures in a comprehensive manner (as elaborated in the best practices which follow).

## BEST PRACTICES

A high-quality offer in the banking sector should contain the elements enumerated below.

### ESTABLISHMENT

1. Permits investor to choose the form of establishment – whether as a branch, joint venture or wholly-owned subsidiary – that makes the most business sense.
2. Contains no “economic needs tests” or other geographic or product-specific restrictions.
3. Grandfathers existing investments in operations and activities.

### TEMPORARY ENTRY OF NATURAL PERSONS

Facilitates the temporary entry of key financial services personnel required for managerial, technological, system or risk management purposes (add other categories as may be required by applicable investments).

### NATIONAL TREATMENT

1. Provides assured national treatment for asset management activities provided by financial services firms.
2. Avoids discriminatory international markets as domestic companies.
3. Should treat locally established affiliates of foreign banks on the same basis as domestic companies for regulatory and other purposes. Where differences in such treatment exist, they should not create conditions of competition more favorable to domestic service or service suppliers than for like service or service suppliers of other WTO Members.
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<th><strong>ADDITIONAL COMMITMENTS</strong></th>
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<td><strong>TRANSPARENCY</strong></td>
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<td>1) Commits to improved transparency overall.</td>
<td>a) Publication in national gazette.</td>
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<td>2) Spells out procedures for providing interested parties with notice of proposed rulemaking and opportunities for comment on proposed new rules.</td>
<td>b) Standard procedures for submitting public comments.</td>
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<td>3) Gives interested parties a reasonable amount of time to comment on, understand and take steps to comply before new or revised regulations take effect.</td>
<td>Clearly defines a standard “reasonable amount of time”.</td>
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<td>4) Commits to current and proposed regulations being easily accessible in writing and on the Internet.</td>
<td>E-government procedures.</td>
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<td>5) Commits to a clear and accessible licensing process, including creation of a system for answering inquiries about regulatory requirements, interpretation, exceptions that are easily accessible and responsive to the public.</td>
<td>a) Creates an enquiry point for licensing and application matters.</td>
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<td>6) Commits to providing justifications for denials of licenses or applications based strictly on factors explicitly identified in the pertinent regulations.</td>
<td>b) E-government procedures.</td>
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<td>7) Commits to the making of prompt licensing decisions and provides a timely, nondiscriminatory appeals process available for applicants whose applications are denied.</td>
<td>c) Employees are evaluated on accountability to the public.</td>
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<td>8) Commits to provide clear and reliable information about an economy’s financial services laws and practices.</td>
<td>Justifications are provided in writing and within a fixed timeframe, known to all.</td>
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<td>a) Spells out appeals process, sequence and timeframes.</td>
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<td>b) E-government procedures.</td>
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<td>a) E-government procedures.</td>
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<td>b) Regular interchanges between regulatory and supervisory bodies and private sector through public forums or other mechanism.</td>
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</table>
**GOALS**

The offer should create new market-opening and investment opportunities.
To what degree does it satisfy the following goals?

<p>| | |</p>
<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>1)</td>
<td>Improves upon 1997 commitments (where applicable)</td>
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<tr>
<td>2)</td>
<td>Creates new business opportunities through the lifting of restrictions</td>
</tr>
<tr>
<td>3)</td>
<td>Creates conditions that will attract new capital</td>
</tr>
<tr>
<td>4)</td>
<td>Addresses market access, national treatment and transparency of domestic regulation measures in a comprehensive manner (as elaborated in the best practices which follow).</td>
</tr>
</tbody>
</table>

**BEST PRACTICES**

A high-quality offer in the insurance sector should contain the elements enumerated below.

**MARKET ACCESS**

1) Contains no “economic needs tests” or other geographic or product-specific restrictions.
2) Grandfathers existing investments in operations and activities.

Reinsurance: marine and transportation insurance allowed cross border (Mode 1).

Reinsurance: Access to marine and transportation insurance and intermediation on cross border basis (Mode 1 for each).

Life and non-life reinsurance:

a) Elimination of mandatory cessions 
b) Elimination of restrictions for cessions to foreign reinsurance companies 
c) Elimination of right-of-first refusal privileges 
d) Elimination of discriminatory collateralization and localization of assets 
e) Abolition of reinsurance monopolies 
f) Guarantee of freedom of form for reinsurance contracts

**ESTABLISHMENT**

1) Permits investor to choose the form of establishment – whether as a branch, joint venture or wholly-owned subsidiary – that makes the most business sense. 
2) Provides full regard for relationship between parent and subsidiary.
3) Allows use of home company name in host economy. 
4) Does not permit denial of form of establishment on the basis of the legal entity in the home market. 
5) Permits freedom to determine percentage of foreign equity shares in joint ventures. 
6) Provides for staged elimination of foreign equity limitations (if any) with minimum 51% ownership during staging period.

Compulsory lines: Fully bound by national treatment and market access, as defined by GATS

Monopolies: Best endeavors to eliminate insurance monopolies and exclusive services providers

**TEMPORARY ENTRY OF NATURAL PERSONS**

1) Avoids nationality / residence requirements irrespective of nationality 
2) Provides freedom to foreign insurance company to select its own representatives in host economy 
3) Provides for temporary visa or work permits for short periods of stay
### NATIONAL TREATMENT

1) Provides the ability to compete for insurance coverage otherwise provided by state-owned or state affiliated enterprises.
2) Provides full national treatment with respect to capital, solvency, subject to prudential carve out (must explain reasons for less favorable treatment under prudential carve out)
3) Insurance mediation: monetary transfer obligations limited to what is necessary to assume legal responsibilities in host economies.

### TRANSPARENCY

1) Regulations to be made publicly available
2) Prior comment on new and revised regulations
3) Reasonable time interval prior to new regulations entering into force
4) Written explanations provided for rejected or accepting proposals
5) Written statement to insurance applicant outlining necessary documentation
6) Ability to provide information to the public on creditworthiness of a company
7) No restrictions on availability of financial services information to insurance suppliers
8) Availability of rules and procedures with respect to identification of financially troubled institutions
9) New tax measures affecting insurance enter into force only after their notification to the WTO on a semi-annual basis

### SOLVENCY AND PRUDENTIAL FOCUS

1) New products, rates and services for other than personal or compulsory lines not subject to file and approval requirements
2) Regulations aimed at allowing the market to determine which products and rates are to be applied
3) Written explanation required of products that require file and approval procedures
4) “Deemer” method for use in file and approval procedures
5) No limits on the number or frequency of new products by an insurance supplier
6) No restriction on dividend payments, provided that solvency provisions are met
7) Encouragement of use of international “best practices” standards in accounting and auditing activities

### INSURANCE MONOPOLIES

1) Monopolies generally prohibited from offering products outside monopoly designations, with provision that they not abuse monopoly position where authorized
2) Insurance suppliers with monopoly rights will keep separate accounts regarding monopoly and non-monopoly activities

### INSURANCE REGULATOR

Must be an independent government entity.

### PENSIONS

1) When private pensions are allowed, provide immediate obligations for full market access/national treatment to those providing private pensions in the market
2) Private pension fund managers designated to manage public or private pensions in host economy
3) Freedom to select form of commercial presence
4) Ability to offer range of product / investment options.
**GOALS**

The offer should create new market-opening and investment opportunities. 
To what degree does it satisfy the following goals?

1. Improves upon 1997 commitments (where applicable)
2. Creates new business opportunities through the lifting of restrictions
3. Creates conditions that will attract new capital
4. Addresses market access, national treatment and transparency of domestic regulation measures in a comprehensive manner (as elaborated in the best practices which follow).

**BEST PRACTICES**

A high-quality offer in the banking sector should contain the elements enumerated below.

**ESTABLISHMENT**

1. Removes barriers to establishment by foreign investors in the financial sector and allows wholly-owned subsidiaries.
2. Allows establishment in the form of branches or other forms of presence.
3. Commits to permitting locally established affiliates of foreign asset management firms to use the services of affiliates outside the host economy to provide asset management services to domestic clients in the host economy.
4. Commits to removing prohibitions on foreign firms from managing pension assets, including public assets, on the same basis as domestic firms.
5. Contains no “economic needs tests” or other geographic or product-specific restrictions.
6. Commits to grandfather existing investments in operations and activities.
7. Ensures market access for the full range of asset management services.
8. Permits the dissemination and processing of financial information necessary to provide clients with necessary services.
9. Commits to support the provision and transfer of financial information, financial data processing, and the provision of advisory and software related services.

**CROSS BORDER**

1. Permits foreign asset management firms to provide services on a cross border (Mode 1) basis.
2. Commits to support financial services provided cross border without requirement of local establishment (Mode 3) and also permits by consumption abroad (Mode 2).

**TEMPORARY ENTRY OF NATURAL PERSONS**

1. Facilitates the temporary entry of key financial services personnel required for managerial, technological, system or risk management purposes (add other categories as may be required by applicable investments).
2. Removes requirements for a minimum number of senior or key personnel to be resident or located in the economy.
### NATIONAL TREATMENT

1) Provides assured national treatment for the full range of asset management activities provided by financial services firms.
2) Locally established affiliates of foreign asset management firms should have the same access to domestic and international markets as domestic companies.
3) Locally established affiliates of foreign asset management firms should be treated for regulatory and other purposes on the same basis as domestic companies. Where differences in such treatment exist, they should not create conditions of competition more favorable to domestic service or service suppliers than for like service or service suppliers of other WTO Members.

### ADDITIONAL COMMITMENTS

<table>
<thead>
<tr>
<th>TRANSPARENCY</th>
<th>EXAMPLES</th>
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<tbody>
<tr>
<td>1) Commits to improved transparency overall.</td>
<td>a) Publication in national gazette.</td>
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<tr>
<td>2) Spells out procedures for providing interested parties with notice of proposed rulemaking and opportunities for comment on proposed new rules.</td>
<td>b) Standard procedures for submitting public comments.</td>
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<tr>
<td>3) Gives interested parties a reasonable amount of time to comment on, understand and take steps to comply before new or revised regulations take effect.</td>
<td>Clearly defines a standard “reasonable amount of time”.</td>
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<tr>
<td>4) Commits to current and proposed regulations being easily accessible in writing and on the Internet.</td>
<td>E-government procedures.</td>
</tr>
<tr>
<td>5) Commits to a clear and accessible licensing process, including creation of a system for answering inquiries about regulatory requirements, interpretation, exceptions that are easily accessible and responsive to the public.</td>
<td>a) Creates an enquiry point for licensing and application matters.</td>
</tr>
<tr>
<td>6) Commits to providing justifications for denials of licenses or applications based strictly on factors explicitly identified in the pertinent regulations.</td>
<td>b) E-government procedures.</td>
</tr>
<tr>
<td>7) Commits to the making of prompt licensing decisions and provides a timely, nondiscriminatory appeals process available for applicants whose applications are denied.</td>
<td>c) Employees are evaluated on accountability to the public.</td>
</tr>
<tr>
<td>8) Commits to provide clear and reliable information about an economy’s financial services laws and practices.</td>
<td>Justifications are provided in writing and within a fixed timeframe, known to all.</td>
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</table>

### TRANSPARENCY EXAMPLES

- a) Publication in national gazette.
- b) Standard procedures for submitting public comments.
- Clearly defines a standard “reasonable amount of time”.

### E-GOVERNMENT PROCEDURES

- a) Creates an enquiry point for licensing and application matters.
- b) E-government procedures.
- c) Employees are evaluated on accountability to the public.

### JUSTIFICATIONS

- a) Spells out appeals process, sequence and timeframes.
- b) E-government procedures.
- Justifications are provided in writing and within a fixed timeframe, known to all.

### REGULAR INTERCHANGES

- a) E-government procedures.
- b) Regular interchanges between regulatory and supervisory bodies and private sector through public forums or other mechanism.
Barriers and Impediments to Foreign Direct Investment (FDI): Checklist and Recommended Policy Response

The World Bank and others, including private sector groups, have provided advice on the optimal investment environment. The following guiding principles seem to be used by many multinational corporations to evaluate direct investment opportunities. These are divided into two main groups: (1) The basic requirements, meaning those that a potential investor will want to see met before going any further; and (2) Specific requirements, those that inhibit the willingness of an investor to seriously consider an investment or inhibit the ability of the investor to operate efficiently and effectively in a market. The over-arching message is that governments must take steps towards greater financial sector openness in conjunction with broader structural reform policies in order for both entities, the investor and the host economy, to fully realize the benefits of FDI.

1. Basic Requirements

- **Stable and sensible economic policies.** Business needs confidence that the host economy will be managed in a competent and predictable way and that the rules of the game will not change mid-way through.

- **Low political risk.** Capital tends to flow toward environments with low political risk. An investor's ability to rely upon the integrity of the host government, and its ability to maintain local law and order, are both essential to any long-term investment.

- **A well educated labor force and availability of necessary inputs to an operation, including access to technology.** While the investor brings capital, often new technologies and management to the table, the quality of the local work force and the availability of in-country materials are also important for success. As financial services become increasingly IT-enabled, access to communications infrastructure and the Internet become critical.

- **The size, value and potential for growth of the host economy's domestic market, especially the purchasing power of its consumers.** Companies will not invest in areas where there is little potential to make a profit. Note: some markets are small but attractive because they are high value.

- **Reliable infrastructure.** The ability to complete transactions, get products and services to market, resolve disputes, and enter into contracts depends upon the presence of reliable telecommunications services, transportation services, power generation, office support services, a competent financial system, legal and judicial services, and other basics. Investments cannot yield reliable returns without them.

- **A stable currency, especially protection from currency devaluation or manipulation.** Investments are often made in a foreign currency, usually dollars or yen, but the local products are sold in the local currency. While businesses recognize they need to adopt good mechanisms and management regimes to hedge against currency fluctuations, businesses are wary of economies with a history of currency devaluations and artificial currency manipulations. For example, they will be unwilling to make an investment in dollars if they suspect that local assets (valued in the local currency) will be devalued, and they will lose part (or possibly all) of the original dollar-based investment.

- **Stable and well-functioning market system.** Private property and the freedom to make contracts are essential components as are financial disclosures based on sensible accounting
practices. Investors and creditors are rewarded for their good decisions and not shielded by government from the consequences of bad decisions.

- **Ongoing program of regulatory reform and efficiency.** Increased regulatory uniformity among economies should lower regulatory costs for market participants and the governments.

2. **Specific Requirements**

- **Market access and non-discrimination.** Investors will gauge the degree to which foreign governments will interfere with the company’s ability to enter the market and compete fairly with domestic or other foreign providers. In some cases joint ventures are a condition of market entry. These can increase the risk to the investor if the regulatory framework is not transparent, is discriminatory and the local partner is not well established. The freer the market, the more attractive it becomes as an investment opportunity.

- **Sensible capital requirements and the ability to manage assets.** Investors will look favorably on economies that adhere to international best practices for paid up capital and capital reserves requirements, and where foreign and local investors are treated in the same way. They also look favorably on markets where they have the ability to manage assets on a global basis (for example, in the ability to invest funds where the return is likely to be greatest, rather than being forced to invest all funds domestically).

- **Policies that encourage the development of strong and stable capital markets.** Investors need to be able to borrow and invest locally as they wish with competitive sources of capital.

- **Provision for the remittance of dividends, interest, and royalties.** Investors are reluctant to place significant investments in economies that do not allow the repatriation of profits.

- **Property rights and the protection against the unfair seizure of or nationalization of assets.** Investors will not put their resources into economies that confiscate them. The importance of government protection of property and asset rights cannot be overstated. Property, includes real assets as well as intangible assets like patents and copyrights.

- **A good corporate governance ethic, supported by the host economy** to ensure that the owners of a company and all its stakeholders get their fair share.

- **Potential for the provision of services beyond the geographic area of establishment.** A business will not necessarily locate in a particular economy or geographic region of a particular economy solely to operate there. Companies value the ability to source from an operating unit in one market to serve nearby external markets, or geographic regions in an economy.

- **A transparent and open legal and regulatory regime and good regulatory supervision.** Companies seek markets with fair and consistently enforced business laws, sensible and well-designed regulatory regimes, which do not impose undue burdens and impede the ability of the company to grow and create more opportunities. At the same time, they want to be sure that their investment is subject to sensible and predictable regulatory supervision consistent with international best practices.

- **Favorable taxation and tax incentives.** While tax incentives geared to attract initial investments are important, governments have to think long term. The final investment decision is usually based on how an economy’s taxation will affect the normal operating environment.

- **Temporary entry of natural persons.** Companies want to have the ability to move in professionals from other areas or regions on a temporary basis as needed.
### Checklist of Barriers and Impediments to FDI in the Financial Services Sector and Recommended Policy Response

<table>
<thead>
<tr>
<th>Barrier/Impediment</th>
<th>Issues/Concerns</th>
<th>Recommended Policy Response</th>
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<tbody>
<tr>
<td><strong>Restrictive conditions of market entry and operation:</strong></td>
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<tr>
<td>- inhibits the willingness or ability of investors to</td>
<td>- foreign equity caps</td>
<td>- phase out foreign equity caps</td>
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<tr>
<td>bring in full range of capital, skills and technology</td>
<td>- joint venture requirements including ownership and control issues</td>
<td>- phase out joint venture requirements as condition of market access</td>
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<td>and the efficiencies of management and new product</td>
<td>- limits on range of products</td>
<td>- remove limits on range of products offered (subject to appropriate supervisory</td>
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<td>lines</td>
<td>- limits on ability to operate in an integrated national market</td>
<td>mechanisms)</td>
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<td>- increases risk to potential investor</td>
<td>- onerous capital requirements</td>
<td>- permit comprehensive market access in all regions of an economy</td>
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<tr>
<td>- benefits of new capital, skills, technology and</td>
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<td>- permit foreign majority ownership</td>
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<td>products only available to a portion of the market</td>
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<td>- establish a strong regulatory system (thereby making establishment and operating</td>
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<td>where establishment or trade is restricted to certain</td>
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<td>restrictions unnecessary)</td>
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<tr>
<td>geographic regions</td>
<td></td>
<td><strong>Strengthen Local Industry</strong></td>
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<tr>
<td>- SMEs in restricted regions unable to profit from</td>
<td></td>
<td>- support and encourage capacity building in regulatory supervision</td>
</tr>
<tr>
<td>competitive benefit of new services</td>
<td></td>
<td>- encourage local providers to participate in Basel 2 capacity building workshops (capital</td>
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<tr>
<td>- Incentive reduced for host government to upgrade</td>
<td></td>
<td>adequacy, risk assessment and management, operational risk and financial disclosure);</td>
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<tr>
<td>prudential standards to internationally accepted</td>
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<td>and other financial sector capacity building programs such as those promoted by the</td>
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<td>requirements (foreign investors generally subject to</td>
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<td>IAIS, World Bank, ADB, IMF, PECC and APEC.</td>
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<td>high standards of prudential supervision in their</td>
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<td>home economy)</td>
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<td>Issues/Concerns</td>
<td>Recommended Policy Response</td>
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</table>
| Lack of National Treatment and MFN                     | - discrimination between local and foreign providers, including differing capital requirements  
- differential requirements on 3rd country providers  
- discriminatory tax  
- restrictions on financial service providers; banks, insurers, asset managers  
- restrictions on assets for investment  
- restrictions on personnel  
- procedures for right of redress and/or appeal  
- license application and award procedures  
- inconsistent and discriminatory treatment of business entities | - equal treatment for foreign and local providers  
- improve operational risk through capacity building (e.g. Basel 2)  
- remove discrimination between foreign service providers in terms of market access and operations  
- clear, published processes for legal and regulatory decisions and right of appeal  
- clear published process for regulatory policy formulation and stakeholder consultation |
| Restrictions on Asset Management                       | - restrictions on personnel  
- inability to get best return on investment  
- increases risk  
- inability to match liabilities with assets  
- procedures for right of redress and/or appeal  
- license application and award procedures  
- inconsistent and discriminatory treatment of business entities  
- poor prudential supervision  
- enforcement of binding contracts  
- lack of expertise  
- inadequate solvency and creditor rights  
- weak property protection rights and enforcement | - allow cross border investment  
- allow fund management from overseas  
- provide for commercial presence of overseas service suppliers  
- capacity building in internationally recognized best practices for financial sector regulation  
- strengthened economic and legal infrastructure, including bankruptcy laws and regulations |
| Lack of transparency, predictability and openness in legal and regulatory regimes | - procedures for right of redress and/or appeal  
- license application and award procedures  
- inconsistent and discriminatory treatment of business entities  
- poor prudential supervision  
- enforcement of binding contracts  
- lack of expertise  
- inadequate solvency and creditor rights  
- weak property protection rights and enforcement | - clear, published processes for legal and regulatory decisions and right of appeal  
- clear published process for regulatory policy formulation and stakeholder consultation |
| Weak regulatory and legal infrastructure                | - poor prudential supervision  
- enforcement of binding contracts  
- lack of expertise  
- inadequate solvency and creditor rights  
- weak property protection rights and enforcement | - capacity building in internationally recognized best practices for financial sector regulation  
- strengthened economic and legal infrastructure, including bankruptcy laws and regulations |
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<th>Recommended Policy Response</th>
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<tr>
<td><strong>Capital controls</strong></td>
<td>- potential to increase cost of capital to investor and consumer&lt;br&gt;- inhibits ability of investor to source and place capital appropriately and efficiently&lt;br&gt;- difficulty in hedging risk&lt;br&gt;- inhibits willingness of investor to participate in the market&lt;br&gt;- future exchange rate vulnerabilities without clear exit strategy</td>
<td>- repatriation of profits, dividends, remittances&lt;br&gt;- inability to source capital and place investments on a global basis &lt;br&gt;- phase out capital controls&lt;br&gt;- strengthen capital markets infrastructure&lt;br&gt;- regulatory reform&lt;br&gt;- phase in flexible exchange rate arrangements</td>
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<tr>
<td><strong>Weak governance</strong></td>
<td>- increases threat of corruption&lt;br&gt;- reduces market efficiency&lt;br&gt;- promotes monopolistic practices&lt;br&gt;- threat of market failures</td>
<td>- corruption&lt;br&gt;- lack of accountability&lt;br&gt;- unpredictable market situation&lt;br&gt;- lack of competition&lt;br&gt;- strong corporate and public sector governance ethic&lt;br&gt;- capacity building measures to promote understanding and awareness of good governance&lt;br&gt;- competition policy and laws</td>
</tr>
<tr>
<td><strong>Poor property rights protection</strong></td>
<td>- inhibits ability of investor to offer innovative product lines&lt;br&gt;- inhibits willingness to fully participate in the markets</td>
<td>- asset seizure, including nationalization&lt;br&gt;- patent, copy right and trademark protection&lt;br&gt;- delays in processing temporary visa applications&lt;br&gt;- limited adjudication ability&lt;br&gt;- lack of clear criteria and procedures&lt;br&gt;- adequate laws and rights of redress&lt;br&gt;- eliminate ability to nationalize assets&lt;br&gt;- enforcement of property laws</td>
</tr>
<tr>
<td><strong>Restrictions on the Movement of Natural Persons</strong></td>
<td>- reduced ability to share expertise, technology and skills&lt;br&gt;- increases operational inefficiencies&lt;br&gt;- inhibits ability to offer and service innovative product lines on time</td>
<td>- delays in processing temporary visa applications&lt;br&gt;- limited adjudication ability&lt;br&gt;- lack of clear criteria and procedures&lt;br&gt;- facilitate business travel and intra-company transfers&lt;br&gt;- expedite visa processing for professionals</td>
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PAPER ON AGEING ECONOMIES AND ASSET MANAGEMENT / ASSET ALLOCATION STRATEGIES

Issue

The ageing of societies among APEC economies poses key challenges. The phenomenon means greater future economic risks for the APEC region, but also highlights the role of the financial services sector in helping to mitigate and manage such risks for societies at large. One of the choices available to governments, firms and/or individuals is using asset management and asset allocation strategies (whether by public pension funds or private investments) to achieve higher rates of return and diversify risk. Higher rates of return on monies invested, together with lower risk, will assist in meeting economies’ asset accumulation needs, which will become more acute as societies age.

Societies experience the greatest wealth accumulation when each succeeding generation outnumbers its predecessor generation. But as the working population begins to shrink, slowdowns in economic growth and productivity result. As older workers in a society retire and begin to draw down savings and receive retirement benefits, the population faces the challenge of accumulating sufficient savings to provide for the health and economic needs of the older generation, while generating enough growth to meet the current (and future) needs of the younger generation.

The demographic changes facing APEC economies are prompting an examination of available funding strategies to support the eventual needs of retirees. The rising health care and pension costs societies are facing can be financed through a combination of public financing and mandatory private contributions (described in the World Bank’s work on pension reform, “first” and “second” pillars) and supplemented by voluntary tax-advantaged private savings (“third” pillar), and in the case of the poorest countries, through resource transfers.

This paper considers the opportunities and challenges presented to APEC economies in light of ageing societies and the role of the financial services sector (primarily, but not exclusively, the insurance sector) in helping to mitigate the demands on public treasuries posed by ageing societies. The paper also examines the additional reforms and sector liberalization that would be necessary in order for asset management strategies to be most effective. Finally, three brief case studies are presented, illustrating the specific steps undertaken by Chile with respect to pension reform, the steps being contemplated by Japan with respect to long term care insurance needs, and an approach being adopted by Australia to increase public savings in order to meet the unfunded liabilities of several public pension plans. In each case asset management strategies could prove to be pivotal in ensuring the success of the reforms taken.

The Ageing Crisis Is Expected to Hit Different APEC Economies at Different Times

APEC economies are ageing at different rates. Those reaching the peak of their working-age populations the fastest face the steepest adjustment path and have the shortest timeframes within which to make the necessary economic adjustments. How the demographic changes will affect world economic growth generally is also a factor – economies may be faced with making internal policy changes just as the global economy is slowing down. The year shown marks the point after which the “dependency ratio” (e.g., the ratio of workers to non-workers) will rise for developed economies and decrease for developing ones. In developed economies, the increase in elderly will outpace the decrease in the number of child dependents. In developing economies, birthrates will shrink the number of child dependents by more than elderly populations increase.
The Beginning of the Turning Point:
Year When Working Age Population-Share Peaks, by Region

<table>
<thead>
<tr>
<th>Region</th>
<th>Year</th>
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<tbody>
<tr>
<td><strong>East Asia</strong></td>
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<td>China</td>
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<td>Japan</td>
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<td>Hong Kong</td>
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<td>Taiwan</td>
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<tr>
<td>South Korea</td>
<td>2010</td>
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<td><strong>North America</strong></td>
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<td>Canada</td>
<td>2010</td>
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<td>United States</td>
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<td>Mexico</td>
<td>2025</td>
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<td><strong>South America</strong></td>
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<tr>
<td>Chile</td>
<td>2025</td>
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<td>Peru</td>
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<td><strong>Eastern South Asia</strong></td>
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<td>Brunei</td>
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<td>Myanmar</td>
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<td>Thailand</td>
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<td>Vietnam</td>
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<td><strong>European CIS</strong></td>
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<td>Russia</td>
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<td><strong>Pacific</strong></td>
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<td>Australia</td>
<td>2010</td>
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<td>New Zealand</td>
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<tr>
<td>Papua New Guinea</td>
<td>2050</td>
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Implications of the Changing Age Structure in APEC Economies

Once the peak working-age population is reached, the pace at which the birthrate declines and the rate at which working age immigrants are permitted to enter, will determine how an economy is affected. With a traditional pyramid structure undergoing conversion to a hexagonal structure as the birthrate falls, the economy can maintain a healthy growth rate in the near term. (For example, the U.S. is expected to remain healthy economically, despite demographic changes, until at least 2050.) Young workers predominate at the middle of the hexagon, with more mature workers in their peak wealth accumulation years just ahead of them. Younger workers have fewer child dependents to support. But in the longer term, the shrinking pool of new workers leads to slower growth. The worst case scenario would be an inverted pyramid structure – one in which many elderly must be supported by smaller and smaller cohorts of younger workers.

(1) The developed economies, with large numbers of mature workers in their peak earning and asset accumulation years, offer the major source of capital and investment on which the developing economies can draw in the years immediately ahead. In 10 to 20 years’
time, however, the mature workers in the developed economies will begin to draw down
these assets, no longer offering as ready a capital resource as before.

(2) The available capital assets will flow, however, to the economies offering the best returns
and the best investment conditions. The developed economies also offer promising
markets for the goods and services produced by developing economies.

(3) Developing economies, meanwhile, will continue to have far larger numbers of young
adults relative to the developed economies. These economies will continue to offer
labor at competitive rates to the rest of the world.

(4) Consequently, increasing shares of the world’s assets will shift to the developing
economies that have been most successful in marketing their advantages. This wealth
will be controlled by them and will need to be put to productive uses, to prepare for
their own challenges of ageing societies by mid-century. The development of deeper
capital markets and competitive financial services sectors will become more urgent for
these economies as a result.

(5) The creation of globalized capital markets will be driven by these trends and facilitated
by regulatory harmonization, the more active role of multilateral financial institutions
and the spread of technology.

Role of the Insurance Industry in Capital Formation

For demographically older societies, the insurance industry offers much needed individual and
group products such as traditional life insurance, annuities and long-term care insurance to help
older workers and retirees meet their financial needs. The insurance sector can also play a key
role in managing pension assets (including public pensions, where these are opened up to private
management).

In developing economies, especially those that succeed in attracting sizeable amounts of foreign
direct investment and capital through export-led strategies, the insurance sector helps to pool
stable, long-term sources of capital which can be used to support needed investments in
infrastructure, including construction, transportation, and increasingly, telecommunications. Life
insurers must match their long-term liabilities with assets, and so they look for long-term
investment prospects. The ability for these companies to invest cross-border is also essential so
that assets can be properly managed and diversified, and the best returns on investment realized.
To place overly restrictive limitations on the types of investments these companies can make, or
to restrict them to investing only in domestic markets, makes it difficult for companies to
manage liabilities properly and results in suboptimal returns. Such investment restrictions are
often justified as prudential measures. However, studies have shown that their actual effect is
often to lower investment returns and reduce solvency rather than enhance it (Davis, OECD,
2001). Ideally, within well-supervised limits, insurers should be able to invest their portfolios in a
mix of quality domestic and non-domestic assets, taking proper account of both risk and return
factors. For example, excessive restrictions requiring the majority of assets to be held in
sovereign bonds can hamper the development of capital markets and suppress investment
returns.

Privatizing Pension Systems

The need for retirement income is a pressing issue facing societies as populations age and the
ratio of workers to non-workers diminishes. Governments must choose how to provide
retirement income pensions to their elderly. Current systems include: no pensions; “pay-as-you-
government-paid pensions funded from current taxation; mixed pay-as-you go/pre-funded
government pensions; mandatory employer/employee advance-funded pensions; and voluntary
employer-sponsored pensions (funded or unfunded). The pension reform debate recognizes
that no single solution exists. Governments may need to strengthen the traditional “first pillar”
(pay-as-you-go) approaches at the same time they consider supplementing these with second
and/or third pillar options.

However, it is becoming clear that having to sustain a pay-as-you-go government pension system
(even as a partial solution) will severely constrain economic growth as the burden to pay for
pensions is shifted to a shrinking percentage of workers in an ageing population. The quicker
governments move to include a pre-funded pension option as part of their retirement schemes,
the less strain they will feel as populations age. The pre-funded, privatized pension system can
reduce the burden so that government’s responsibility is limited to providing income support to
those who were unable to accumulate sufficient assets during their working lives to fund
subsistence-level pensions.

Since pre-funded private accounts are the “saving banks” on which millions of retirees will
depend to provide for their needs during their retirement years, they must be safeguarded and
controlled from excessive risk-taking, from unscrupulous or foolish investment managers and
from use as short-term savings vehicles. Therefore, a successful privatized pension system must
rely upon transparent and reliable regulation during both (i) the pay-in phase (as an
“Accumulation Fund” is being built for each depositor), and (ii) the payout phase (when a life-
time pension is being provided to the client, based on the value of his/her Accumulation Fund at
retirement).

Recommended characteristics of a private pension system (“third pillar”):

Contributions and Tax Status:
- A minimum mandatory contribution (as a percent of salary and bonus) should be
  imposed, plus permission for additional voluntary contributions (up to a stated annual
  maximum);
- Voluntary contributions by non-working adults (e.g., stay at home parents) should be
  permitted;
- Contributions should be tax-free and given tax advantages during the accumulation
  phase.

Asset management:
- Accumulation Funds should be managed only by asset management institutions licensed to
  conduct the business and subject to regulatory oversight for expertise, solvency and conduct
  (including sales and investment practices);
- Asset management activities should be governed by the following principles:
  o Non-discrimination based on nationality of asset management institution;
  o Transparent periodic reporting to clients and regulators;
  o Transparent investment trading rules to ensure efficient and fair market conduct.

Restrictions on Investment Options:
- Appropriate restrictions should be established on investment options available to clients in
  order to avoid excessive reliance on high-risk assets or concentration of risk:
  o A broad range of investment assets should be permitted (equities, bonds, real
    estate, etc.), including a limited percentage in below investment grade assets and
    in non-domestic assets;
- Mandatory diversification should be required by asset classes and individual assets within each class;
- Aggressiveness of permitted asset classes for each client should be related to age of the client, with those closer to retirement required to invest in lower risk portfolios;
- Severe restrictions should be imposed on withdrawals of Accumulation Fund by client (e.g., only for medical emergencies) to avoid depletion of assets available at retirement.

Administration of private pensions:
- Clients should have freedom to change their Fund Manager, but subject to minimum time commitments and reasonable advance notice periods in order to avoid excessive costs to employers and customers, and to minimize market volatility;
- Withdrawals of Accumulation Funds at retirement should be restricted to avoid speculation or excessive spending by the retiree, thereby eliminating the risk of fall-backs of retirees on the public welfare system:
  - At retirement, accumulated funds should be transferred to a mandated annuity or to some other form of value at the choice of the retiree, under prudential supervision and designed to providing income over the time of retirement and to avoid the need to access public pensions
  - If the policy is to annuitise the accumulation fund, this could be done to provide a lifetime annual income equal to a targeted percentage (e.g. 65%) of annual income, plus an adjustment for inflation
  - Only the excess amount in the Accumulation Fund, beyond the amount necessary to create a mandatory lifetime annuity, should be available for client withdrawal.
- Selection of annuity company at retirement should be according to the customer’s choice
  - Annuity companies must be licensed and regulated;
  - Annuity companies’ investments must also be regulated.
- To avoid risk of a fall-back on the public welfare system for support in the event of the insolvency of an annuity company, consideration should be given to creating an industry-sponsored or government-sponsored guarantee fund:
  - This guarantee fund could be pre-funded by collecting a small percentage of Accumulation Funds as they are being converted to annuities (e.g., 1%)

Guidelines on Prudential Supervision of Pensions

Extensive work has been undertaken on developing guidelines for designing and implementing effective private pension systems. While there are many variations of asset accumulation models that can be sued to prepare for ageing populations – evident in the variation of experiences observed in international system comparison – there are a number of principles that are fundamental. A brief overview of principles outlined by the OECD, UNCITRAL, the World Bank and other, is shown in the Appendix. These cover the design of pension systems, supervision and more broadly the regulation of finance and capital markets.
Case Studies: Chile, Japan and Australia

Ageing societies present APEC economies with both opportunities and challenges. Among the challenges are the often daunting tasks of meeting the unfunded liabilities of “pay-as-you-go” pension systems and long-term health care needs as societies age. The following case studies focus on Chile’s efforts to build a successful privately-funded pension system, Japan’s ongoing effort to change the funding structure for long-term health insurance, and measures being taken in Australia to deal with unfunded liabilities that have accrued under certain defined benefit schemes in the public sector. The report points to the lessons to be drawn from these experiences.

Chile: Privatizing the Pension System

Chile moved in May 1981 to convert its unsustainable “pay-as-you-go” publicly-funded pension system to one utilizing individual accounts funded through payroll deductions. Today, the system has contributed in important ways to Chile’s economic growth. While generally regarded as successful, the system has been criticized for its high (although declining) administrative costs, and the regulatory limitations on pension funds being able to invest assets on a cross-border basis. Despite these deficiencies, Chile’s system remains the world’s best known example of a largely privately-funded pension system and is therefore deserving of careful examination.

The working assumption in setting up Chile’s system was that workers would pay in 10% of their salary over 30 years. Assuming a 4% real rate of return, it was projected that the system should be able to fund a pension equal to 70% of a worker’s average salary over the last 10 years of his or her working life. The government does guarantee a minimum pension as a safety net measure, provided that a worker has contributed to his or her individual account for at least 20 years. Chile has paid this minimum in over 33,000 cases (compared with some 400,000 private accounts).

Workers contribute 10% of their salary plus a commission fee of 2.3% of taxable wages (this fee includes a premium of 0.7% which pays for life and disability insurance coverage for the worker). The cost of the privately-funded pension system is about 40% lower than for the old government-run system and has ranged between 1.4% and 4.4% of annual GDP. Returns (net of administrative costs) between 1981-2001 ranged between 7.18% and 7.5%. Because Chile had to build its capital markets essentially from scratch, costs of setting up the system were initially high – about 18% of contributions. These costs have since moderated, to about 10% of contributions. The new system’s replacement rate for men ranges between 81-86%; and for women, 52-57%. Although the replacement rate under the old system was officially 70%, during periods of high inflation it was actually far less in real terms. The Chilean Government acknowledges that the old system was not viable and could not have been sustained.

Chile confronted the following transition costs in moving to its privately funded pension system:

1. The cost of providing for existing retirees and those who had opt not to convert to the new system
2. The cost of “recognition bonds” that were issued to those transferring from the old system to the new system. These bonds would become due when the holder retires.
3. The cost of providing the minimum government safety net payment for those who paid into the system for 20 years but did not accumulate enough to collect more than the minimum.
Chile used five methods to pay for these transition costs:

(1) Issued new government bonds acknowledging the unfunded liabilities under the old pension system.
(2) Privatized state-owned enterprises.
(3) For a period of time, retained a portion of the payroll tax deducted from workers as a “transition tax.” This provision sunsets, and is now zero.
(4) Reduced government expenditures (some of which would have been for the old pension system had it been retained.
(5) Pension privatization and other economic reforms have helped Chile’s economy grow more quickly. This increment of growth also helped to defray the cost of the system. The private pension system accounted for nearly 56% of GDP in 2002, several times the amount in any other Latin American country that has instituted similar reforms.

Lessons Learned

Over-regulation in some areas has discouraged investment diversification under Chile’s system.

Pension management firms are penalized under the system’s regulations if their returns fall below the standard deviation for returns from all such firms, which the government tracks closely. This regulation was intended to discourage speculation and protect the interests of workers, but in practice it has forced the pension management companies to invest in very similar portfolios. This effectively reduces investor choice and could affect investment returns.

Chile’s regulations also restrict the amount of foreign securities the pension fund administrators may hold, although this limitation has gradually been allowed to increase and now stands at 20%. Such restrictions reduce investor choice, affect investment returns and make investment portfolios more vulnerable to local economic conditions, however. At the same time, the pension funds have become important investors in housing in Chile (Peru is the only other example of this), and represent the largest holder of government, mortgage and corporate bonds in the economy.

As long as returns on pension investments have been healthy – 11.3% annually – the adverse effects of these restrictions have not yet been felt. More diversification of investment portfolios may well strengthen the system as a whole over time and would help to broaden and deepen the capital markets that Chile has worked so hard to develop.

Japan: Revamping the Long-term Care Insurance System

Japan is currently evaluating options for revamping funding for the economy’s long-term care insurance program and expects to introduce a new system by April 2006. Under the ordinary health care system, patients bear 30% of the costs and the remainder is borne by insurance or through the tax system, except for children under three years of age. Long-term insurance care is different to the ordinary health care insurance program.

Under the current long-term care insurance system, citizens pay about 10% out-of-pocket to cover the cost of most long-term healthcare services. Taxes and insurance pay for about half of the remainder. Those aged 65 and over pay average costs of about $30.00 per month, according to where they fall on a five-tiered personal income scale. Fees charged vary by local area and type of service received. For the 40-64 age group, the average premium for health care services is $31.00 per month, paid through one’s employer. The employer currently pays half of this fee.
For Japan’s 2001 fiscal year, the Ministry of Health, Labor and Welfare estimated that expenditures for pensions, health insurance and long-term care insurance surpassed $800 billion, a record figure that represented 22% of household income. With 3.74 million people enrolled in long-term care insurance as of November 2003, Japan estimated that expenditures for long-term health insurance would reach $50 billion in fiscal year 2004, and by 2025, are projected to be greater than $200 billion per year.

Changes to the program are controversial. Japan judges that its options are to:

1. Reduce or revamp available benefits.
2. Raise premiums for the long-term care insurance coverage offered.
3. Increase the number of persons paying into the system, through a combination of insurance and taxes. For instance, Japan could charge premiums to the 20-39 age group to help defray the cost of the program, while also adding new disability insurance coverage for these younger workers. However, business objects to this approach.

Japan is currently evaluating comprehensive approaches to its social welfare programs. The review will consider dealing with pensions, health insurance and long-term care insurance coverage as a package.

Lessons Learned

Japan has estimated that future health care costs will rise rapidly and will become unsustainable. The costs of adjusting the current plan are considerable, but so is the cost of doing nothing. By projecting the known costs of the present system into the future, Japan can quantify for its citizens the size of the problem and show them clearly the costs of doing nothing, as well as the costs of the various options under consideration. Making the hard choices now will be controversial and difficult, but waiting will surely be more expensive still.

Australia: Addressing Unfunded Liabilities in Public Pension Plans

Australia introduced a mandated superannuation guarantee scheme in the 1980s for all workers, whereby over a period of time the equivalent of 9% of wages would be paid into individual superannuation accounts, managed by private sector financial institutions. The scheme is an integral component of the retirement income system, consisting of a universal aged pension (the safety net), the mandated superannuation scheme and voluntary superannuation.

The total value of superannuation assets at the end of September 2004 was $A648.0 bn, and these are growing at a rapid rate. Many retirees will invest their assets upon retirement, to provide income streams through their retirement years.

In 2004, the Government established a Future Fund as a means of addressing (and hopefully fully funding) the unfunded superannuation liabilities that have accumulated under public service and defense personnel superannuation schemes, and to fund some ongoing liabilities. Those schemes are either totally unfunded or only partly funded, and funding and payment of benefits is on a pay-as-you-go basis, i.e., direct from the budget. It is intended that future budget surpluses will be used to build a balance in the Future Fund. Injecting capital to meet unfunded liabilities and closing defined benefit schemes to new entrants are central aspects of the policy. An essential purpose of the Future Fund is to reduce the call on the budget in coming years and to make room for the allocation of future revenues to other priority areas of government, such as health. The Fund will be invested in diversified assets, overseen by a Statutory Authority and investments managed by external managers.
Lessons Learned

The mandated guaranteed superannuation scheme has been successful in building individual wealth to support living standards in retirement. The scheme successfully involves the management of super funds by supervised private financial sector financial institutions. Funds invest in diversified assets, including overseas assets, under broad investment guidelines aimed essentially at ensuring an appropriate investment strategy and risk tolerance and prudential diversification.

The Future Fund will impact to some degree on future budget decision making; if the budget is not in surplus in a particular year, contributions to the Fund could be in doubt, and payments would be dependent on higher levels of surplus being achieved in subsequent years. The returns on investments will vary from year to year, and in some years of low returns could presumably require higher levels of funding from budgets.

Conclusions

The acute wealth accumulation challenge facing the developed economies over the next 20 years means that investment capital from these markets will seek higher returns, along with quality. Developing economies with strong investment prospects and liberalized financial services markets will be the most natural outlets for this capital. These economies stand to gain handily from the external investment flows.

Ageing populations in Europe, Japan and North America will eventually slow the growth of the developed economies, however. As retirees in these regions begin to draw down savings, investment flows from developed to developing economies will also slow. By this time, however, many of the APEC developing economies should have succeeded in accumulating substantial savings of their own. They will be investing and managing this capital in anticipation of meeting the pension and health needs of their own ageing societies as their working age populations begin to shrink by 2025.

Recommendations

Asset management and asset allocation strategies are key to maximizing investment returns and accumulating the savings needed to prepare societies for dealing effectively with the challenges posed by ageing. There is no single model for achieving the asset accumulation which will be required to meet the needs of ageing societies, but there are examples that could serve as useful models in certain APEC economies.

ABAC’s recommendations to ministers on regulating the financial services and pension sectors are as follows:

(1) Regulations should be flexible enough to permit the full range of investment options – in long-term domestic infrastructure as well as cross-border activities. Economies that attempt to place overly restrictive limitations on cross-border investments by pension funds and insurance providers risk shortchanging themselves (by foregoing higher returns) and increasing risk profiles. (Depending on the amounts held, overseas investment may need to hedge against losses arising from currency risk, as experienced by Japanese pension assets).

(2) Developing economies that are well-positioned early to attract and utilize increased investment flows by providing higher returns and sound investment options will benefit
The dynamics of ageing societies are such that the world’s developed economies are faced most quickly (some as soon as the next ten years) with the greatest and most pressing challenges. These economies will be looking to maximize returns on investments as quickly as possible as a means to assist in asset accumulation strategies.

(3) Economies ought to take actions to meet the needs of their ageing populations. Actions by APEC economies to put into place policy changes that will facilitate more rapid accumulation of capital in sound assets (including improved investment climates, financial services liberalization and increased domestic transparency of regulation), all worthwhile for their own sake, are also strategies that will help to address the coming ageing challenge. Demographic trends show that changes in dependency ratios in nearly all APEC economies are at most only a generation away, and for the developed economies, usually much nearer and more urgent. There is a pressing need for asset accumulation throughout the region to meet the ageing challenge, to which the development of efficient capital markets and stronger financial services sectors will clearly contribute.

(4) Key principles outlined in OECD guidelines on private pensions, covering the rights of members and beneficiaries, regulation and supervision and governance, should be considered as economies develop private pensions, as should measures to ensure equitable generational burden sharing of current and accruing public sector pension obligations.
APPENDIX

Summary of private pension and superannuation principles
(Drawn on OECD Principles and from other institutions)

Asset management and investment policies
Legal provisions should be established:
- To guide the establishment of plans and funds and the development of effective governance systems.
- To ensure the separation of plan assets and the plan sponsor
- To require portfolio management and investment policies to reflect principles relating to asset diversification, risk dispersion, and maturity and currency matching.
- To outline a prudent-person rule and some form of qualitative regulation to ensure that fund sponsors act in the best interest of the members and beneficiaries.

The rights of beneficiaries and members
Funds should have a written charter stating the objectives of the fund, the duties and responsibilities of the fund sponsor, and the rights of members and beneficiaries. The necessary legal provisions include ensuring:
- Non-discriminatory access
- Protection of vested rights and proper entitlement process in terms of contributions for both employees and the employer
- Regular assessment of the adequacy of private schemes
- Disclosure and education is promoted and is widely available, especially in terms of relative performance, fee structures and benefit modalities of different plans
- Portability of pension rights

Pension plan liabilities and winding up
Legal provisions are necessary to ensure that funds are able to meet their ongoing liabilities. Principles include:
- Mechanisms such as minimum funding rules to ensure adequate funding of liabilities.
- The development of calculation methods including actuarial techniques and amortization rules.
- The identification and maintenance of a level of assets sufficient to cover ongoing liabilities.
- The establishment of methods for dealing with situations of under-funding.
In the case of plan termination, legal provisions are required to allocate plan assets and the responsibility of under-funding. Further creditor rights of plan members and beneficiaries in the case of bankruptcy of the plan sponsor need to be outlined.

Regulatory framework of the industry
A broader regulatory framework for the industry as a whole is required to ensure protection of members and beneficiaries, the soundness of plans and funds, and broader economic stability. A regulatory system should not however place excessive burden on markets, institutions and the employer. The system needs to embody the flexibility to deal with advanced and complex system. Finally, the system should encourage a level playing field for all operators. The principles to guide the regulatory framework of the system include:
- Effective enforcement of financial contracts
- Legal separation between pension fund assets and the fund sponsor.
The development of accounting standards that embody the principles of transparency, consistency, and regular and reliable reporting.

Licensing process for specialized finance institutions provided by an independent, autonomous and authorized body.

**Supervision**

Supervision of pension funds and plans by an autonomous body is fundamental to an effective system. The supervisory institution needs to be endowed with appropriate regulatory and supervisory power over individual plans to be effective and must be endowed with the necessary resources to be effective. The supervisory body will observe over:

- Legal compliance
- Financial control
- Actuarial examination
- Supervision of managers.
INFRASTRUCTURE – FINANCING ARRANGEMENTS

Summary

Encouraging private sector involvement in infrastructure financing is one of the most pertinent challenges facing the region today. The public sector cannot meet the investment needs required. Since 1997, private sector involvement has been much lower than previously expected or needed. In the 1990s, the private sector finance accounted for 20 to 25% of infrastructure funding in developing economies. Between 1990-2002, private funding amounted to $805 billion; including in East Asia with funding of $190 billion. Financing peaked in 1997 but since the Asian financial crisis it has reduced dramatically and the recovery rate has been slow. Estimates point to the private sector now providing 5% of current needs in the Asian region. In 2002, finance from this source was $US 47 billion – the lowest since 1994 and concentrated in telecommunications and energy.

Infrastructure needs in electricity, water, sanitation, telecommunications and transport over the next 5 years in new funding and in maintenance expenses are estimated to be in the order of $162 billion annually; with 80% from China. To put in context, the sum required is just over 6% annually of the region's GDP. **Estimates at the Indonesian infrastructure summit in January – after the tsunami – put that economy's needs for private sector finance for infrastructure over the next five years at $80 to $90 billion, with an expected one-third of the needs being met from the budget and $10 billion from multilateral lenders.**

Analysis shows that as income increases, different infrastructure needs emerge. Demand for sanitation and water is inversely related to income, whereas demand for telecommunications infrastructure increases as incomes rise. In low income economies, the power sector will account for 36% of all new investment; in middle income economies mobile phones will account for 36% of investment; in high income economies, roads will account for 60% of infrastructure financing.

Surveys of private sector participants in infrastructure projects in the Asian region point to policy uncertainty and high investor risks in the region as the key deterrents to private investment. Commitments by economies to reforms in legal and finance institutions, risk mitigation on pricing and the setting and adjustment of tariffs, improvements in auditing and accountability, and the removal of impediments to capital mobility are all seen as important reforms to encourage private participation.

Experience points to the importance of financing packages to suit individual projects. Flexible financing can accommodate specific risks, maturity requirements, the structuring of revenue streams and adjustment to financing requirements at different stages of a project. Depending on the characteristics of a particular project, financing can involve equity financing and equity funds, overseas and local bank financing, and financing through bond market issues. In the early 90's bond market financing was the fastest growing source of private finance with flows increasing from $2.3 billion in '93 to $45.8 billion in '96. The development of long-term contractual savings institutions (insurance companies, pension and superannuation funds) in the region would be highly important institutional changes linking long-term savings with infrastructure financing needs.
Introduction

This paper focuses on private sector involvement in infrastructure financing in the Asian region. The attachment notes some of the forms of arrangements for infrastructure financing. Section 1 provides a broad overview of developments relating to infrastructure in the region and major challenges; Section 2 provides some data on East Asia infrastructure requirements over the period to 2010, determinants and sources of financing, and Section 3 includes comment on some Asian economies. The Appendix outlines financing arrangements used in infrastructure financing.

Considerable work has been undertaken by the World Bank and the ADB and others on infrastructure financing; see "Connecting East Asia: A New Framework for Infrastructure", March 16, 2005, by the ADB, Japan Bank for International Cooperation and the World Bank. UNCITRAL has published important guidelines on private sector involvement in infrastructure and Model Legislative Provisions.

Section 1 - Broad overview of developments and challenges

➢ the central point arising from recent studies is that there is an overwhelming need for infrastructure across Asian economies; some economies have sustained high levels of investment, eg China and Vietnam; private sector involvement has fallen sharply and needs to be restored – but there are many significant challenges in doing this

➢ the World Bank notes that in China and Vietnam investment has been sustained over recent years, with gross fixed capital formation averaging around 40% of GDP and 30%, respectively

Table 1: Infrastructure investment as a Percent of GDP

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<th>0-4%</th>
<th>4-7%</th>
<th>Over 7%</th>
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<tr>
<td>Cambodia</td>
<td>Lao PDR</td>
<td>China</td>
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<td>Thailand</td>
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<td>Philippines</td>
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➢ Thailand and Malaysia have had sustained investment in infrastructure with particular emphasis on efficiency improvements, and have achieved a competitive advantage in infrastructure sectors. This is not so much the case in some other economies. As the World Bank states, ‘Often efficiency in the selection and management of investment in general, and infrastructure in particular, has been lacking.” More emphasis needs to be placed on efficient investment decisions to avoid “overheating” in infrastructure investment markets

➢ access to infrastructure services is high particularly in Malaysia and Thailand, but also in China and the Philippines; see following table:
there are many opportunities for private involvement, but there are significant challenges for most developing economies in getting the policy framework right to encourage private financing.

encouraging greater private sector involvement in infrastructure financing is one of the most important challenges facing the region to-day; the public sector cannot meet investment needs required

since 1997, private sector involvement has been much lower than previously expected or needed. In the 1990s, private sector finance accounted for 20 to 25% of infrastructure funding in all developing economies; for example, between 1990-2002, private funding amounted to $805 billion; including in East Asia with funding of $190 billion

private financing peaked in 1997 but since the Asian financial crisis it reduced dramatically and the recovery rate has been slow. Estimates point to the private sector now providing only 5% of current needs in the Asian region. In 2002, finance from this source was $US 47 billion – the lowest since 1994 and concentrated in telecommunications and energy

- reasons for private sector reluctance

surveys of private sector participants in infrastructure projects in the Asian region point to policy uncertainty and high investor risks in the region as the key deterrents to private investment. There is no question that concerns of regional financial stability arising from the Asian crisis has been a major contributor to falling private investment in infrastructure

commitments by economies to reforms in legal and finance institutions, risk mitigation on pricing and the setting and adjustment of tariffs, improvements in auditing and

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<th>Water Supply Access</th>
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<th>Electricity Access</th>
<th>Telephone Access</th>
<th>Internet Access</th>
<th>Road Network per 100km²</th>
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<td>22</td>
<td>4</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>58</td>
<td>30</td>
<td>41</td>
<td>3</td>
<td>0.3</td>
<td>14</td>
<td>15</td>
</tr>
<tr>
<td>Mongolia</td>
<td>60</td>
<td>30</td>
<td>90</td>
<td>19</td>
<td>5.8</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>Low &amp; Middle Income Countries</td>
<td>77</td>
<td>70</td>
<td>64</td>
<td>27</td>
<td>6.5</td>
<td>38</td>
<td>41</td>
</tr>
</tbody>
</table>
accountability, and the removal of impediments to capital mobility are all seen as important reforms to encourage private participation; these are essentially institutional issues and are they are not subject to quick or easy reform

- the challenges involve major and fundamental issues of governance

- some key issues raised in the World Bank/ADB Report referred to above, "Connecting East Asia", are instructive in pointing to the major policy challenges for Asian economies in coordinating across financial and planning institutions, coordination across infrastructure and fiscal institutions and coordination across decentralised government; they are:

1. the centre matters – infrastructure demands strong planning and coordination functions
2. decentralisation is important – but raises a host of coordination challenges
3. fiscal space for infrastructure is critical

- a number of key policy measures need to address issues relating to accountability in infrastructure and how accountability and risk management arrangements can play out when governments provide support to infrastructure providers; they are:

4. subsidies can be important, but are always risky and should be handled with care
5. regulatory independence matters more in the long-run than in the short-run
6. competition is hard to achieve in infrastructure – but it’s the best way to bring accountability
7. civil society has a key role to play in ensuring accountability in service provision
8. infrastructure has to clean up its act – addressing corruption is a priority
9. public sector reform matters – but be realistic (keep expectations modest – if the private sector can't be attracted because the state is unpredictable and lacks vision, or because tariffs plus subsidies are below costs, then public sector performance is likely to be disappointing also
10. the private sector will come back – if the right policies evolve
11. local capital markets matter – but are not a panacea
12. infrastructure needs reliable and responsible development partners

- reforms in the following areas are needed:
  - legal and financial institutional strengthening
  - reducing the costs of doing business
  - improving risk mitigation techniques and sharing arrangements
  - improving auditing procedures and financial accountability standards in the region
- reducing pricing risks: many infrastructure services exist in a tariff-regulated sectors; private investors require certainty about the processes of setting and adjusting tariffs, to ensure an adequate rate of return
- reducing regulatory barriers to capital mobility

Section 2 – Infrastructure – needs, determinants and sources of financing

➢ analysis shows that as income increases, different infrastructure needs emerge. Demand for sanitation and water is inversely related to income, whereas demand for telecommunications infrastructure increases as incomes rise. In low income economies, the power sector is likely to account for 36% of all new investment; in middle income economies mobile phones will account for 36% and in high income roads will account for 60%

➢ infrastructure needs in East Asia in electricity, water, sanitation, telecommunications and transport over the next 5 years will require new funding and maintenance expenses in the order of $165 billion annually, with 80% for China. To put in context, the sum required is just over 6% annually of the region’s GDP – 4% of GDP will be needed to meet new infrastructure requirements and over 2% on maintenance. (See tables below, drawn from World Bank sources)

➢ 44% of the total regional expenditure will be required for electricity in China.

| Investment and maintenance needs, East Asia (2006-2010), US$ and %GDP |
|---------------------------------------------------|-----------------|-----------|-----------|-----------------|-----------|
|                                                   | US$ million     | percentage GDP |          |          |          |          |
|                                                   | Investment      | Maintenance   | Total     | Investment | Maintenance | Total     |
| Electricity                                      | 63,466          | 25,744       | 89,190    | 2.4       | 1.0        | 3.4       |
| Telecom                                          | 13,800          | 10,371       | 24,171    | 0.5       | 0.4        | 0.9       |
| Roads                                            | 23,175          | 10,926       | 34,102    | 0.9       | 0.4        | 1.3       |
| Rails                                            | 1,170           | 1,598        | 2,768     | -         | 0.1        | 0.1       |
| Water                                            | 2,571           | 5,228        | 7,799     | 0.1       | 0.2        | 0.3       |
| Sanitation                                       | 2,887           | 4,131        | 7,017     | 0.1       | 0.2        | 0.3       |
| Total                                            | 107,049         | 57,998       | 165,047   | 4.0       | 2.3        | 6.3       |

| Investment and maintenance needs, China (2006-2010), US$ and %GDP |
|-------------------------------------------------------------|-----------------|-----------|-----------|-----------------|-----------|
|                                                               | US$ million     | percentage GDP |          |          |          |          |
|                                                               | Investment      | Maintenance  | Total     | Investment  | Maintenance | Total     |
| Electricity                                                   | 51,668          | 20,739      | 72,407    | 0.6       | 0.4        | 1.0       |
| Telecom                                                       | 11,735          | 8,232       | 19,967    | 1.0       | 0.4        | 1.4       |
| Roads                                                        | 19,345          | 7,424       | 26,769    | 0.1       | 0.1        | 0.1       |
| Rails                                                        | 963             | 1,258       | 2,221     | 0.1       | 0.2        | 0.3       |
| Water                                                        | 2,097           | 4,090       | 6,187     | 0.1       | 0.1        | 0.2       |
| Sanitation                                                    | 1,830           | 2,644       | 4,474     | 4.6       | 2.3        | 6.8       |
| Total                                                        | 87,638          | 44,387      | 132,025   |             |             |           |
### Investment and maintenance needs, East Asia excl China (2006-2010), US$ and %GDP

<table>
<thead>
<tr>
<th></th>
<th>US$ million</th>
<th>Maintenance</th>
<th>Total</th>
<th>US$ million</th>
<th>percentage GDP</th>
<th>Investment</th>
<th>Maintenance</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Electricity</strong></td>
<td>11,778</td>
<td>5,005</td>
<td>16,783</td>
<td>1.6</td>
<td>0.7</td>
<td>2.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Telecom</strong></td>
<td>2,065</td>
<td>2,139</td>
<td>4,204</td>
<td>0.3</td>
<td>0.3</td>
<td>0.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Roads</strong></td>
<td>3,830</td>
<td>3,503</td>
<td>7,333</td>
<td>0.5</td>
<td>0.5</td>
<td>1.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Rails</strong></td>
<td>207</td>
<td>341</td>
<td>547</td>
<td>-</td>
<td>-</td>
<td>0.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Water</strong></td>
<td>474</td>
<td>1,138</td>
<td>1,612</td>
<td>0.1</td>
<td>0.2</td>
<td>0.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Sanitation</strong></td>
<td>1,057</td>
<td>1,486</td>
<td>2,544</td>
<td>0.1</td>
<td>0.2</td>
<td>0.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>19,411</td>
<td>13,612</td>
<td>33,023</td>
<td>2.6</td>
<td>1.9</td>
<td>4.5</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


(NOTE: this table is unlikely to take into account most recent estimates of Indonesia's infrastructure needs; these are discussed separately below, in Part 3)

- private sector involvement in regional infrastructure

- **philosophies changed in the 1980s and 1990s** in favour of emphasising the role of the private sector in infrastructure sectors in Indonesia, the Philippines, Thailand and Malaysia (and to a lesser extent China and Vietnam)

- as noted earlier, private sector investment peaked at around 20 to 25% of total investment (in the mid-90's) and is now around 5%

### Private sector Investment in East Asia

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>NUMBER OF PROJECTS</th>
<th>Percentage of total East Asian investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>361</td>
<td>53%</td>
</tr>
<tr>
<td>Thailand</td>
<td>77</td>
<td>11%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>74</td>
<td>11%</td>
</tr>
<tr>
<td>Philippines</td>
<td>70</td>
<td>10%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>67</td>
<td>10%</td>
</tr>
<tr>
<td>Vietnam</td>
<td>15</td>
<td>2%</td>
</tr>
<tr>
<td>Other</td>
<td>22</td>
<td>3%</td>
</tr>
</tbody>
</table>


- a “Perception Survey of East Asia and the Pacific Private Investors in Infrastructure” noted that China, Thailand, Indonesia, Vietnam and Malaysia are regarded as the top five East Asian nations for future private infrastructure investment


<table>
<thead>
<tr>
<th>Country</th>
<th>Value US$ million</th>
<th>Approximate Percent of Total Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>$4736</td>
<td>15%</td>
</tr>
<tr>
<td>Vietnam</td>
<td>$154</td>
<td>7%</td>
</tr>
</tbody>
</table>
Philippines $935 6%
Malaysia $2358 6%
Thailand $632 3%
China $3532 6%
India $3222 9%


- in the early 90’s bond market financing was the fastest growing source of private finance with flows increasing from $2.3 billion in '93 to $45.8 billion in '96. The development of long-term contractual savings institutions (insurance companies, pension and superannuation funds) in the region would be highly important institutional changes linking long-term savings with infrastructure financing needs. Such links are of course already in play in some economies, eg Australia. (comments on financing arrangements are shown in attachment 2)

- experience points to the importance of financing packages to suit individual projects. Flexible financing can accommodate specific risks, maturity requirements, the structuring of revenue streams and adjustment to financing requirements at different stages of a project. Depending on the characteristics of a particular project, financing can involve equity financing and equity funds, overseas and local bank financing, and financing through bond market issues.

Section 3 – Selected country challenges

- Indonesia

- the Post-Suharto reformasi regime implemented significant decentralisation reforms that sought to reduce the role of the centralised policy planning and coordination institutions (BAPPENAS and the Coordinating Ministry for the Economy and Industry (EKUIN). Local governments have been assigned the task of planning and implementing infrastructure development programs to service localised needs.

- a significant finance gap has developed as a consequence of limitations placed on fiscal space for infrastructure spending in the last few years; while it is expected that the public sector will continue to play a dominant role, this will need to be accompanied by efficiency improvements in public expenditure and by greater private sector involvement.

- while nearly 10% of the total private sector investment in infrastructure in East Asia has occurred in Indonesia (over 50% of the total East Asian share going to China), the access to services in that economy is generally below average.

<table>
<thead>
<tr>
<th></th>
<th>Indonesia</th>
<th>Low and Middle Income Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Water Supply Access</td>
<td>78</td>
<td>77</td>
</tr>
<tr>
<td>Sanitation Access</td>
<td>55</td>
<td>70</td>
</tr>
<tr>
<td>Electricity Access</td>
<td>55</td>
<td>64</td>
</tr>
<tr>
<td>Telephone Access</td>
<td>13</td>
<td>27</td>
</tr>
</tbody>
</table>
uncertainty about the regulatory and legal environment over the lifetime of a project is one of the risks which is a cause of concern to potential private investors in the infrastructure sector.

- estimates made at the January Indonesia infrastructure summit – after the tsunami – put Indonesia’s needs for infrastructure financing over the next five years at around $US150 billion, with an expectation of private sector financing of $80 to $90 billion, one-third being met from the budget and $10 billion from multilateral lenders.

- at the January summit, the government identified 91 priority projects valued at $22.5 billion for tenders beginning in March; gas, electricity, telecom, transportation, toll roads and water; a second batch of projects is to be announced in November, valued at $57.5 billion.

- the government also announced a number of regulatory reforms including to investment and banking regulations wherein the Central Bank will issue a new set of bank rulings, including an easing of the legal lending limit and new credit limits will set the allowable lending for a one particular project at 30% of a bank’s capital, up from 20%; the new rules also envisage a more flexible credit assessment procedure.

- private sector involvement in Indonesian infrastructure financing over the last five years is shown below:

<table>
<thead>
<tr>
<th>Primary Sector</th>
<th>Segment</th>
<th>Total Investment in Government Assets (US$ millions)</th>
<th>Total Investment in Facilities (US$ millions)</th>
<th>No of Projects</th>
<th>Total Investment (US$ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy</td>
<td>Natural gas distribution and transmission</td>
<td>*187.6</td>
<td>0</td>
<td>1</td>
<td>187.6</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>187.6</td>
<td>0</td>
<td>1</td>
<td>187.6</td>
</tr>
<tr>
<td>Telecom</td>
<td>Mobile access</td>
<td>*0</td>
<td>510</td>
<td>2</td>
<td>510</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>0</td>
<td>510</td>
<td>2</td>
<td>510</td>
</tr>
<tr>
<td>Transport</td>
<td>Terminal</td>
<td>*388</td>
<td>1,226.6</td>
<td>4</td>
<td>1,614.6</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>388</td>
<td>1,226.6</td>
<td>4</td>
<td>1,614.6</td>
</tr>
</tbody>
</table>

Source: IEA (2003), WB World Development Indicators, country-specific sources (publications, interviews, etc), ITU Telecommunications Indicators Database.
Water and sewerage | Water treatment and distribution | * | 0 | 36.7 | 1 | 36.7
---|---|---|---|---|---|---
Total | 0 | 36.7 | 1 | 36.7 | 36.7
Total | 575.6 | 1,773.3 | 8 | 2,348.9 | 2,348.9


-Vietnam-

- currently Vietnam invests an average of 6.8% of GDP on infrastructure (relatively high compared to other East Asian nations); it is estimated that to meet infrastructure needs over the current 5-year period, this needs to be raised to around 15% per annum

- transport infrastructure require the greatest amount of financing, with the Ministry of Construction estimating that Ho Chi Minh City alone ‘will need $2.6 billion this year for roads, bridges, railways, an underground railway system and ports.

- only 10% of expected needs can be financed through the budget with the rest coming from other sources of finance. The government hopes to raise US$4 billion by 2010 for infrastructure and it is intended that bonds will be issued with 5-10 year maturities to finance off-the-budget infrastructure expenditure

- the table below shows private sector involvement in Vietnam infrastructure over the last five years:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary Sector</td>
<td>Sub-Sector</td>
<td>Total Investment in Government Assets (US$ millions)</td>
<td>Total Investment in Facilities (US$ millions)</td>
<td>No of projects</td>
</tr>
<tr>
<td>Energy</td>
<td>Electricity</td>
<td>*</td>
<td>0</td>
<td>1,012.50</td>
</tr>
<tr>
<td></td>
<td>Natural Gas</td>
<td>0</td>
<td>1,300.00</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>0</td>
<td>2,312.50</td>
<td>5</td>
</tr>
<tr>
<td>Telecom</td>
<td>Telecom</td>
<td>*</td>
<td>0</td>
<td>230</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>0</td>
<td>230</td>
<td>1</td>
</tr>
<tr>
<td>Transport</td>
<td>Toll Roads</td>
<td>*</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>0</td>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td>Water and sewerage</td>
<td>Potable Water</td>
<td>*</td>
<td>0</td>
<td>154</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>0</td>
<td>154</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>*</td>
<td>*</td>
<td>0</td>
<td>2,706.50</td>
</tr>
</tbody>
</table>

- China

- at a 2001 Conference on Private Participation in Infrastructure in China, the World Bank estimated the infrastructure needs to meet demand by 2010 to be $US75 billion a year. Recognising the limited budget capacity of government, and the limited role the private sector has played in infrastructure financing thus far, the WB argued that the development of “appropriate umbrella policies and regulations, which provide adequate comfort to investors and financiers while protecting the public interest” was the most fundamental step to ensuring adequate infrastructure financing in the next decade. Foreign direct investment makes up most of the private participation currently, and is less than 10% of total investment in infrastructure.

- there is a need for capacity building in the regulatory, judicial and legal institutions to ensure enforcement of contracts, and indeed the development of a legal framework specific to private participation in infrastructure.

- as well, the conference noted the importance of measures to develop a more attractive investor climate, to move away from equity-based financing to a “broader mix of financing which makes greater use of available debt instruments” and the high domestic savings rate, through the development of the bond market. The potential role of capital markets and the involvement of insurance companies and pension funds was also.

- from 1996-2003 total infrastructure investment involving private participation was largest in transport, energy and telecommunications, a trend likely to continue into the future. Energy/power and transport sectors have high priority in accelerating regional development especially in Western China.

- during the 2001-2003 program period, over half the ADB’s lending to China went into transport and energy sectors. Of total investments required in infrastructure 40% was for transport, 27% for power, just under 20% for telecommunications, and 13% for water.

<table>
<thead>
<tr>
<th>Investment in infrastructure projects with private participation ($ millions) 1996-2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transport</td>
</tr>
<tr>
<td>Energy</td>
</tr>
<tr>
<td>Telecommunications</td>
</tr>
<tr>
<td>Water</td>
</tr>
<tr>
<td>Primary Sector</td>
</tr>
<tr>
<td>---------------</td>
</tr>
<tr>
<td>Energy</td>
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<td></td>
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<tr>
<td>Telecom</td>
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<td>Water and sewerage</td>
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<td></td>
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<tr>
<td>Water treatment and distribution and sewerage collection and treatment</td>
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<td>---</td>
</tr>
<tr>
<td>Water treatment and sewerage collection and treatment</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

*Source: World Bank PPI database (2005)*

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**Some useful references:**


Thong, Ba (2005), “Time to get it right: The way the country builds and upgrades its infrastructure needs to be re-examined,” *Vietnam Economic Times*, No.132, 01/02/2005
WAYS OF INVOLVING PRIVATE SECTOR FINANCE IN INFRASTRUCTURE FINANCING

Many infrastructure projects are characterised by high start up costs and long-term revenue streams. Financiers play an essential role in facilitating the development of infrastructure by changing the ‘requisite time profile of taxes or user charges by providing financing in the forms of loans or equity,’ that eventually can be repaid or remunerated. A number of financing options that may be appropriate in this environment are discussed in this paper. Further, there are policy approaches that can assist developing economies in attracting private financiers or private sector involvement.

Given the peculiar nature of infrastructure projects it is important that financing packages be established that are suitable for individual projects. Flexible financing packages can accommodate for specific risks, maturity requirements, structures of revenue streams, and changing financing requirements at different stages of a particular project. Different financing mechanisms can accommodate different needs. For example, telecommunications generally requires shorter maturities, and the high market risks may require relatively low debt component with debt to equity ratios of 1:1. Power projects on the other hand have longer pay-off time frames and thus require longer debt maturities. Certainty about power purchase arrangements can allow for debt to equity ratios of 2.5:1 to 3:1.

EQUITY FINANCING AND THE ROLE OF EQUITY FUNDS

Private sector infrastructure projects often require heavy reliance on equity financing given the high levels of risk involved and high start-up costs. Project sponsors generally provide some of the equity, although there is often a need for external equity sources as well.

Equity funds provide a portfolio of projects to investors. As a result the source of repayment does not depend on the cash flow from one project but rather a number of projects. This allows for a pooling of project specific and country specific risks that are involved when investment in one project takes place. These have the potential of playing an important role in emerging market economies. The French water and sanitation company Lyonnaise des Eaux introduced an infrastructure equity fund in Asia in 1995, providing US$300 million for a water fund. Contributors to the fund include Allstate Insurance Company, the Employees Provident Fund Board of Malaysia, and the Lend Lease Corporation of Australia.

International infrastructure Funds such as the Asian Infrastructure Fund (AIG) or the Global Power Fund are a source of equity for well-structured projects with good credit ratings. These institutions provide the capacity for international investors to pool risks by providing a mix of projects to invest in. Given the different risk profiles at different stages in the life of an infrastructure project, institutional investors may become involved in restructuring finances once the initial high risk construction stage is complete.

Historically multilateral organisations such as the ADB or IFC can provide limited amounts of equity. More importantly, however, their involvement in a project is a signal for other private investors that the project may be a sustainable one.
INTERNATIONAL AND LOCAL COMMERCIAL BANKS

While commercial banks are a large source of private finance their involvement in developing country infrastructure projects has been limited given the risks involved. Often when they are involved they require government guarantees. Primarily, maturity miss-match is the most significant deterrent to commercial bank involvement. However there is potential for involving commercial banks on a more short-term basis as part of a financing package.

INTERNATIONAL BOND MARKETS

International bond markets are more suitable for infrastructure financing given their long maturities (often 10-30 years). In the 1990s (before the Asian crisis) this was the fastest growing source of private finance with total flows increasing to $2.3 billion in 93 to $45.8 billion in 96. However access to this market for infrastructure projects may be difficult and generally only available to companies with high credit ratings. The more successful projects are in developing economies, the more available this source of financing is likely to become. Given their longer maturities international bonds can be used to re-finance short-term loans that cover the costly and risky construction phase.

DEVELOPING DOMESTIC CAPITAL MARKETS AND DOMESTIC FINANCE CAPABILITIES

Historically, East Asian economies have exhibited high levels of domestic savings. Further, domestic investors can have lower risk perceptions of domestic investment than overseas lenders and, as a consequence, may require lower expected rates of return. As a consequence developing deep, liquid and well-functioning domestic debt and equity markets could in the long term be essential ways of meeting infrastructure-financing needs. High domestic saving levels, sound macroeconomic performance and the development of long-term contractual savings institutions (insurance companies, pension funds or superannuation) are necessary institutional changes for such markets to form.

AN EXAMPLE: THE POTENTIAL OF SUPERANNUATION IN AUSTRALIA

In 2004 over AUS$648 billion was invested in superannuation funds, with a net inflow of roughly AUS$5.8 billion a year. Infrastructure assets provide the potential for attractive rates of return in the long-term, and are attractive investment options for funds whose members are not retiring for a number of years. There are a number of reasons for this:

- Infrastructure projects, given their high replacement costs and natural monopoly characteristics have the potential of generating steady earnings over the long-term.
- Dividends can be tax effective given
- The performance of investments in infrastructure are less likely to be linked with the performance of other asset classes
- Long-term maturities.

There are a number of issues that need to be addressed such as liquidity constraints, pricing, determining value gains or losses for departing members, a limited market for selling the asset, the implications of regulated tariffs, and the large number of projects that have ownership reversions set at a particular date.
In the Australian experience there are a number of ways in which superannuation funds may be involved in infrastructure projects. These include:

- Debt financing – lending to the owners or operators of infrastructure
- Direct partnership with other entities to own and operate the asset
- Managed unlisted investment trusts
- Listed infrastructure investments.

**INNOVATING INSTRUMENTS USED IN INFRASTRUCTURE DEBT FINANCING**

- Mezzanine debt (hybrid instruments that are somewhere between debt and equity) such instruments include simple subordinated debt, convertible debt, debt with stock warrants and debt with an additional interest payment above the coupon rate, contingent upon financial performance
- Appealing to investors looking for higher returns than secured debt but provides for a share in the “up side” risk of the project