

THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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Sabah Room, Basement II, Shangri-La Hotel Kuala Lumpur
Kuala Lumpur, Malaysia

Meeting Paper 3-A

Report of the Forum on the Asia-Pacific Financial Markets Integration Project, 13 March 2012, Melbourne, Australia

Office of the Advisory Group Chair

- PURPOSE** For consideration.
- ISSUE** This is the report of the Forum on the Asia-Pacific Financial Markets Integration Project that was convened on 13 March 2012 in Melbourne, Australia.
- BACKGROUND** The Forum was co-organized by the Advisory Group on APEC Financial System Capacity-Building, the APEC Business Advisory Council (ABAC) and the Australian APEC Study Centre at RMIT University. It brought together experts and thought leaders from around the region representing regulatory and government agencies, international institutions, the financial industry and academe. The Forum was convened with three major objectives in mind: (a) to review current developments in financial and regulatory reforms in the region; (b) to identify opportunities, challenges and bottlenecks, including policy and regulatory impediments that are relevant to improving financial market efficiencies, competitiveness and innovation in the region's economies and to regional financial integration; and (c) to identify measures that could enhance regional financial integration.
- PROPOSAL** Establish an Asia-Pacific Financial Forum (APFF), to be coordinated by the Advisory Group on APEC Financial System Capacity Building
- DECISION POINT** Endorse the proposal.
Endorse the Forum Report.



THE ASIA-PACIFIC FINANCIAL MARKETS INTEGRATION PROJECT

**A Forum Organized by
The APEC Business Advisory Council
The Advisory Group on APEC Financial System Capacity Building
The Australian APEC Study Centre at RMIT University**

*Tuesday, 13th March 2012
Council Chamber, Francis Ormond Building, RMIT University
Melbourne, Australia*

CONFERENCE REPORT

THE FORUM ON THE ASIA-PACIFIC FINANCIAL MARKETS INTEGRATION PROJECT

13th March 2012

*Council Chamber, Francis Ormond Building, RMIT University
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CONFERENCE REPORT

The Forum was co-organized by the Advisory Group on APEC Financial System Capacity-Building, the APEC Business Advisory Council (ABAC) and the Australian APEC Study Centre at RMIT University. It brought together experts and thought leaders from around the region representing regulatory and government agencies, international institutions, the financial industry and academe. The Forum was convened with three major objectives in mind:

- to review current developments in financial and regulatory reforms in the region;
- to identify opportunities, challenges and bottlenecks, including policy and regulatory impediments that are relevant to improving financial market efficiencies, competitiveness and innovation in the region's economies and to regional financial integration; and
- to identify measures that could enhance regional financial integration.

Over the past several years, the region's financial systems underwent a major transformation. The Asian Financial Crisis ushered in various initiatives to strengthen banking systems, develop capital markets and enhance authorities' capacity to maintain financial stability. Regional cooperation gave rise to the Asian Bond Markets Initiative (ABMI), the Asian Bond Fund (ABF), the ASEAN+3 Bond Market Forum (ABMF), the Chiang Mai Initiative (CMI) and the ASEAN+3 Macroeconomic Research Office (AMRO). Another wave of financial regulatory reforms swept the region in the wake of the Global Financial Crisis.

Significant advances in Asia's economic integration driven by domestic reforms, regional cooperation and the expansion of supply chains have amplified the calls for further development and closer integration of the region's financial markets, particularly from within APEC and East Asia. These reflect concerns about the region's capacity to address imbalances that have spawned economic tensions across the Pacific and contributed to the recent crisis. They also reflect concerns about the future impact of current demographic trends on the sustainability of financial systems in the region. Related to this is the low level of financial integration among Asian economies, which sharply contrasts with the very high level of trade integration that they have achieved.

Given that Asian capital markets still remain mostly underdeveloped despite the significant progress achieved since the Asian Financial Crisis, there is a growing sense within the region's business community that bodies such as APEC need to pay more sufficient attention to financial markets. While the focus on reducing barriers to trade and investment in goods and services has contributed to the region's prosperity, today's emerging issues have substantial financial and economic content, such as financial system stability and credit availability, among others, that increasingly need to be addressed.

Underlying these developments is the fact that the region is moving through huge structural changes that have economic, political and social dimensions. The central question is whether

we are able to build structures that will enable the region to adequately respond to these issues. The development of such structures can neither be achieved through quick fixes nor through continued duplication of efforts and initiatives. It will require a multi-year undertaking that will have to begin with a clear idea of what are the things we want to do and how we can do them, and an assessment of whether existing structures are sufficient and what needs to be done to enhance their relevance.

These issues were the focus of discussions in the Forum, which was organized around three major themes:

- the implementation of financial system reforms and initiatives in the region;
- the regulatory and policy constraints on efficiencies and innovation in financial systems and regional structures; and
- policy and supervisory perspectives on promoting regional financial system integration.

IMPLEMENTATION OF FINANCIAL SYSTEM REFORMS AND INITIATIVES IN THE ASIA-PACIFIC REGION

Strengthening banking systems. The Global Financial Crisis spurred new changes in the capital adequacy framework now known as Basel III. The main elements of the new framework consist of higher capital standards and more explicit liquidity standards. Measures to raise capital standards include raising quality, consistency and transparency of bank capital; enhancing risk coverage; and the introduction of a backstop with a simple leverage ratio, a counter-cyclical buffer and a surcharge for systemically important banks. Liquidity standards, which were previously dealt with under Pillar II, have been made explicit through the introduction of a liquidity coverage ratio and a net stable funding ratio.

A survey undertaken by the Asian Bankers' Association in October 2011¹ indicates that there is wide acceptance of the Basel framework in the region. Most of the 43 banks from 14 Asian economies responding to the survey adhere to Basel II using the standardized approach for credit risk. Capital ratios are high, being in excess of 12 percent in the case of most banks. Most of them already meet the liquidity coverage ratio and net stable funding ratio. They are mostly concerned about the prospects of a one-size-fits-all approach to buffers, and the possibility that efforts to meet return on equity targets in the face of higher capital costs may lead banks to take greater risks.

Various challenges remain. First, the weak global economy provides a difficult backdrop to the transition to Basel III. Second, a number of key issues remain unresolved, including over-the-counter derivatives and central counterparties, resolution regimes and how to deal with the shadow banking system. Third, institutionalizing a systemic perspective among supervisors, such as through the setting up of highly specialized macro-prudential authorities remains untested. There are also special challenges in Asia, including the withdrawal of European banks from trade finance, where they account for much expertise, and underdeveloped corporate bond markets.

Promoting competition is an important aspect of efforts to strengthen banking systems. Over

¹ Asian Bankers' Association. *Assessing Asian Banks' Adherence to Basel II and Their Readiness to the New Proposals Under Basel III* (http://www.aba.org.tw/p2_detail2.php?archivesID=30&&journalID=1).

the past few decades and particularly after the Asian Financial Crisis, various reforms have introduced greater competition in the region's banking systems. Some of these efforts involved liberalization of laws and regulations governing entry and operations of foreign banks in domestic markets, while others involved deregulation. Promoting transparency is another means through which regulators have improved competition in banking markets.

An example of the latter is Bank Indonesia's recent move to introduce new regulations that promoted transparency of banks' prime lending rates (PLR), which has a significant impact given the predominance of the banking sector in the economy's financial system. As of end-2011, banks accounted for 82 percent of assets in financial institutions. In undertaking these efforts, Bank Indonesia aimed to address the high borrowing costs and related factors that have limited access to finance. It was expected that this measure would improve the transparency of banking products and services. It would enhance good corporate governance and improve competition through better market discipline. It would boost consumer protection through the reduction of asymmetric information between banks and their customers. It would ensure more accurate and efficient loan pricing.

Bank Indonesia introduced the new regulation in February 2011, imposing several requirements on all commercial banks conducting conventional banking activities and covering corporate, retail, mortgage, and consumer (non-mortgage) loans. One was the requirement that banks report monthly to Bank Indonesia a detailed calculation of their PLR. Another required all banks with total minimum assets of Rupiah 10 trillion to publish their PLR in their offices, websites and newspapers. This measure has led to the reduction of the PLR, by 33 bps for corporate loans, 19 bps for retail loans, 45 bps for mortgage loans and 5 bps for consumer (non-mortgage) loans between March and December 2011.

An important lesson from this experience is that public-private collaboration is important for such initiatives to succeed. In this case, cooperation of the industry, an effective communications strategy that generated wide public support, and the support of business groups, the mass media and academic experts that encouraged commercial banks to collaborate with the regulator, all contributed to the success of this effort.

Similarly, public-private collaboration is important in providing an environment to foster financial innovation that will generate dynamic growth while maintaining stability. Innovation comes in the form of new market participants, some of whom may be highly specialized and offer depth to markets and opportunities to savers and investors. Ideally, policy and regulatory approaches should be supportive and collaboration between regulators and markets – the fundamental aim of this project – is particularly important.

Innovations that improve credit enhancement in infrastructure financing by providing guarantees to investors and thereby mitigate risks may increase confidence in both public and private sectors in long-term investment in infrastructure projects. The extension of microfinance services by financial institutions significantly contributes to financial inclusion, but requires proper alignment of risk and capital charges, involving concepts of proportionate regulation. Adoption of new technology that needs to be encouraged by regulators to promote financial inclusion will also require public-private collaboration.

Bond market development. Bond market development became a priority for many Asian economies after the Asian Financial Crisis, which was brought about by a double mismatch in banks' balance sheets, over-reliance of firms on bank borrowing, and macroeconomic weaknesses. Bond markets were seen as important for Asian economies to better utilize the

THIRD DRAFT AS OF 7 MAY 2012

region's large pool of savings and thus alleviate double mismatch problems and diversify funding sources.² To this end, Asian economies established the ABMI under the auspices of the ASEAN+3 and the ABF under the auspices of the Executives' Meeting of East Asia Pacific Central Banks³ (EMEAP) in 2003.

These efforts have achieved significant success, though much remains to be done. The double mismatch problem has been significantly reduced, but not totally eliminated. There has been tremendous growth of government bond markets, but local corporate bond markets remain underdeveloped. Markets for asset-backed securities and derivatives also remain very small. In the meantime, Asian economies have achieved impressive gains in improving current account and fiscal balances, in contrast to the current situation in many advanced economies.

The ABMI, which was established to develop efficient and liquid bond markets in Asia, has advanced steadily over the years. Among major achievements during its first five years (2003-2008) were the establishment of the Asian Bonds Online website, which was developed by the Asian Development Bank (ADB) with funding from the Japanese government to disseminate information on regional bond markets and attract institutional investors. Various local currency bonds have been issued by the ADB, the World Bank, the Japan Bank for International Cooperation (JBIC) and the International Finance Corporation (IFC). A cross-border collateralized bond obligation was issued to support SMEs.⁴ Asian bond markets grew in size from US\$1.4 trillion in 2002 to US\$3.2 trillion by 2008.⁵

Now on its second five-year period since 2008, the ABMI continues to make significant contributions to the development of bond markets. The current five-year roadmap focuses on four areas: promoting issuance, facilitating demand, improving regulatory frameworks and developing market infrastructure. (*See Table 1.*) One important achievement was the establishment in 2010 of the Credit Guarantee and Investment Facility (CGIF), an ADB trust fund with an initial capital of US\$700 million from ASEAN+3 and ADB (including US\$200 million contributed by the Japanese government through JBIC) to support the issuance of local currency corporate bonds in the region.⁶

² There were two other important lessons drawn by Asian economies from the crisis. One was the need for cooperative arrangements to address short-term liquidity difficulties and supplement existing international facilities such as those provided by the IMF. The second was the need to accumulate foreign exchange reserves, improve external balances and enhance fiscal soundness. Learning from these lessons, Asian economies established the Chiang Mai Initiative as a regional arrangement to provide liquidity in times of crisis and undertook serious efforts to strengthen current account and fiscal balances.

³ The EMEAP was established in 1991 as a cooperative organization among central banks and monetary authorities in the region. It currently lists 11 members: the Reserve Bank of Australia, the People's Bank of China, the Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, the Bank of Korea, Bank Negara Malaysia, the Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, the Monetary Authority of Singapore and the Bank of Thailand.

⁴ In 2004, Korea and Japan collaborated in issuing cross-border yen-denominated CBO that supported financing of 46 Korean SMEs.

⁵ These efforts were pursued under four working groups established in 2003, which focused on the following four issues: (a) creation of new securitized debt instruments; (b) credit guarantee and investment mechanisms; (c) foreign exchange transactions and settlement issues; and (d) rating systems and information dissemination. Source: ADB.

⁶ The CGIF was designed to address difficulties arising from conservative investment policies of institutional investors in the region, which affect even issuers rated investment-grade by local credit rating agencies. It aims to support issuance of corporate bonds in ASEAN+3 markets by providing credit enhancements. The CGIF provides guarantees to local currency denominated bonds issued by companies in these markets that are rated BBB or above by local credit rating agencies for the purpose of financing projects that contribute to economic development in the region, such as infrastructure projects that

THIRD DRAFT AS OF 7 MAY 2012

Another accomplishment of ABMI was the establishment of the ABMF in 2010 as a common platform to foster the standardization of market practices and harmonization of regulations related to cross-border bond transactions in the region. Its members include officials from ASEAN+3 finance ministries, central banks and relevant institutions and financial experts from the private sector in these economies. Its work is organized between two sub-fora – one focusing on collecting information on regulations and market practices and the other on enhancing regional straight-through processing (STP) through harmonization of transaction procedures and standardization of messaging formats.

Through regular meetings, the ABMF has absorbed some of the previous work done under the ABMI, notably the work on improving the regulatory framework and that of the Group of Experts on Cross-Border Bond Transactions and Settlement Issues. The latter involves identifying the main barriers to cross-border investment and settlement in ASEAN+3 bond markets, including regulatory and policy barriers (such as cash and foreign exchange controls and taxes) and settlement barriers (such as messaging formats, securities numbering and settlement cycles among others).

TABLE 1: ISSUES FOR ABMI TASK FORCES UNDER THE NEW ROADMAP (2008-2013)

<p>TASK FORCE 1: Promoting Issuance of Local Currency-Denominated Bonds</p> <ul style="list-style-type: none"> • Credit guarantee and investment mechanism • Promotion of medium-term note program • Debt instruments for infrastructure financing • Development of derivatives and swap markets 	<p>TASK FORCE 2: Facilitating the Demand for Local Currency Denominated Bonds</p> <ul style="list-style-type: none"> • Development of investment environment for institutional investors • Development of repo markets • Enhancing cross-border transactions (regulations on capital movements, taxation of non-residents) • Disseminating efforts under ABMI to institutional investors in ASEAN+3 economies
<p>TASK FORCE 3: Improving the Regulatory Framework</p> <ul style="list-style-type: none"> • Strengthening the regulatory and supervisory framework • Facilitating collaboration among securities dealers associations • Promoting application of accounting and auditing standards broadly consistent with international standards 	<p>TASK FORCE 4: Improving Related Infrastructure for Bond Markets</p> <ul style="list-style-type: none"> • Facilitating discussion by private sector participants on desirable regional settlement systems • Increasing liquidity of bond markets (developing and maintaining a benchmark yield curve) • Fostering a credit culture (development of a credit risk database)

Source: ADB

The new ABMI roadmap is now under discussion. Issues being considered include promoting infrastructure finance, developing an investment-friendly environment, establishment of a regional settlement intermediary, consumer and SME finance, credit ratings and raising financial awareness.

In parallel to the work of ASEAN+3, the EMEAP member central banks and monetary authorities launched the ABF, making use of their foreign exchange reserves. The ABF, which focuses on the demand side, complements the ABMI, which focuses largely on the supply

require considerable long-term funding. The recipient of the guarantee pays a guarantee fee on a commercial basis to CGIF.
Source: ADB.

side. ABF projects focused on sovereign and quasi-sovereign bond markets in 8 economies – China, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand. In these projects, the funds are passively managed against designated benchmark indices.

ABF1 was established in June 2003, with EMEAP central banks investing around US\$1 billion, the Bank for International Settlements as fund manager and assets denominated in US dollars. ABF2, which was launched in March 2005, consisted of 8 funds (one for each of the 8 emerging economies) and a bond exchange-traded fund, the Pan-Asian Bond Index Fund (PAIF), which was listed in the Hong Kong and Tokyo stock exchanges. EMEAP member central banks first invested around US\$1 billion in a fund of funds (parent fund) that invested in the 8 individual funds, and another US\$1 billion in PAIF. Other public and private investors were then invited during the second phase.⁷

The ABF projects contributed significantly to the development of the region's bond markets, by raising investor awareness and interest in these markets. They also served a catalytic role in identifying areas for regulatory and policy reforms and improvements in market infrastructure. Among the improvements undertaken in the wake of ABF were tax changes (e.g., withholding taxes), deregulation of investment rules that made these markets more attractive to foreign investors, and measures to develop legal systems and information technology infrastructure. The ABF proved to be a case of successful public-private collaboration, as reflected in the increasing share of private sector investors in PAIF, which has grown to about 45 percent of total investments as of March 2011.

Moving forward, a number of issues are currently being discussed. One of these is how to further promote ABF2, such as through marketing efforts by fund managers or another cross-listing in the region. A second issue is how to attract more investors in Asian bond products, such as through expansion of eligible collateral, possible launch of another project focusing on corporate bonds, increasing availability of credit risk transfer and hedging instruments, and possible establishment of a regional credit rating system. A third issue is how to increase secondary market transactions, such as through promotion of repo agreements and cross-border collateral arrangements. Finally, discussions continue on further regulatory enhancements, deregulation, harmonization and improvements in financial market infrastructure through greater coordination among authorities and relevant institutions.

APEC also undertook discussions on the development of bond markets. In 2002, it launched a Securitization and Credit Guarantee Market Initiative to assist interested members in developing their asset-backed securities markets. This involved high-level policy dialogues in Seoul and Hong Kong and expert panel group visits to China, Thailand and Mexico, where policy recommendations were discussed.

An important initiative under APEC auspices was the work of ABAC and the Advisory Group in promoting dialogues among the public and private sectors and international institutions on bond market development. Three dialogues (2004 in Taipei, 2005 in Tokyo and 2006 in Washington, DC) were held to develop a catalogue of recommendations that the Advisory Group and ABAC compiled and submitted to APEC Finance Ministers.

In 2006, the APEC Finance Ministers meeting in Hanoi accepted ABAC's recommendation to hold a series of dialogues focusing on regional cooperation to support efforts by member

⁷ PAIF uses the iBoxx ABF Pan-Asia Index composed by International Index Company Limited as its benchmark. State Street Global Advisors acts as fund manager and HSBC Institutional Trust Services serves as trustee and custodian.

economies to develop their local currency bond markets. From 2007 to 2010, an annual APEC Public-Private Sector Forum on Bond Market Development was held in conjunction with meetings of APEC senior finance officials. These were held in Melbourne (2007), Cusco (2008), Singapore (2009) and Sapporo (2010).

It is difficult to measure to what extent these initiatives have contributed to the development of local currency bond markets in Asia. What is clear, however, is that these markets have experienced tremendous growth in certain aspects since the Asian Financial Crisis. Local currency bonds outstanding in major emerging East Asian economies⁸ grew more than 15-fold from US\$356 billion in 1997 to US\$5.5 trillion at the end of September 2011. Major improvements in market infrastructure⁹ and legal and regulatory frameworks¹⁰ have been achieved, and the role of contractual savings institutions as investors in these markets has grown.

The development of government bond markets is an important factor for the next stage, which is the development of corporate bond markets, where the sovereign yield curve plays an important role as a benchmark. Although the swap curve can perform such a function as well in more advanced markets, in practical terms the progress achieved by Asian economies in promoting the growth of government bonds will significantly facilitate the future growth of corporate bond markets.

Nevertheless, much remains to be done. Despite the growth of these markets, they remain relatively small, in terms of volume (8 percent of total local currency bonds worldwide) and ratio to GDP (52.6 percent as of March 2011). While market liquidity has significantly grown, it remains low compared to developed markets. There is limited diversity in the issuer base (dominated by governments in most markets) and investor base (still more than half held by commercial banks). Market infrastructure, legal and regulatory frameworks and availability of information on issuers need much further improvement. Finally, these markets continue to play a very limited role in recycling savings within the region, with Asian debt securities accounting for less than a quarter of Asia's total debt security holdings.

Integration of financial markets. Broadly defined as the efficient, low-cost and unimpaired movement of capital between savers and capital markets across borders, financial markets integration has made some progress in the Asia-Pacific region, but many challenges remain. In particular, institutional owners of capital have been benefiting from government actions and market developments that have brought about closer financial integration.

However, individual owners of capital continue to face challenges. Over the next several years, retail markets, particularly through collective investments, are likely to become an important component of market activity. This process will be driven by a number of factors, including the continued economic growth of the region's emerging markets, high savings rates, demographic factors and development of the pensions industry and households' growing affluence and investment knowledge.

⁸ These include China, Hong Kong, Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam.

⁹ These include the establishment of real-time gross settlement systems with delivery-versus-payments facilities, organized exchanges for trading fixed-income securities and local credit rating agencies.

¹⁰ Among these are the strengthening of institutional and organizational frameworks for capital market regulation and supervision, improvement of laws and regulations governing securities markets, reform of withholding taxes on coupon and interest and improvement of information dissemination.

Even as retail market financial intermediation has grown more complex, recent initiatives have facilitated regional financial markets integration over various pathways. Retail investors' direct access to the region's financial markets is improving through such developments as the growing linkages among exchanges (including the new ASEAN trading link), creation of ETF platforms and the launch of ABF2. Investments coursed through banks and wealth management firms are also being facilitated by common issuances and the development of professional markets.

However, intermediation through collective investment products remains a weak link. Facilitating the flow of collective investments across the region can bring significant benefits to consumers and economies, in terms of a broader range and wider variety of products and services at lower costs, a more developed financial services industry, improved recycling of savings within the region and more developed domestic financial markets.

Various initiatives are currently under way to address these issues. One of these is the concept of a regional funds passport, which is being discussed within the region. Presently, there are no cross-border fund vehicles in the region and cross-border recognition of products is very limited. UCITS products, which are intermediated by institutions regulated in European jurisdictions, have been more successfully offered within the region and dominate Asia's cross-border funds market.¹¹ While UCITS products' success in some Asian markets indicates that a funds passport scheme can work, their failure to penetrate other markets suggests that an alternative scheme is needed to unlock regional funds, by giving regulators the comfort they need to increase cross-border recognition of regional products.

The region's collective funds market, with estimated total assets of US\$3.9 trillion as of end-2009,¹² has very significant growth potential. For a selected group of Asian emerging markets (China, India, South Korea, Chinese Taipei, Hong Kong and Singapore), for example, collective fund assets under management are expected to grow by 86 percent over a five-year period from roughly US\$1 trillion in 2009 to US\$1.87 trillion by 2014. Possible initiatives now being discussed include an Asia Region Funds Management Passport (ARFMP) scheme under APEC,¹³ an ASEAN Collective Investment Scheme Initiative,¹⁴ wider acceptance of

¹¹ First proposed in 1976, the Undertakings for Collective Investment in Transferable Securities (UCITS) became a reality through a directive of the European Commission in 1985, aimed at enabling the sale of fund management products among member economies ("passporting") and establishing a set of principles by which UCITS funds must manage their assets. Since 1985, the European Commission has amended the scheme. With these improvements, UCITS funds achieved tremendous growth and expanded their geographical coverage. They continued to grow in popularity relative to non-UCITS funds, and by the end of 2009 already accounted for 75% of the total European fund market. While UCITS was originally intended to facilitate intra-European distribution of funds, it has become a popular product in other parts of the world, including the Middle East and several Asian economies.

¹² In terms of individual economies' market shares, this is broken down as follows: Australia 38%; Japan 28%; China 11%; South Korea 8%; India 4%; Chinese Taipei 4%; and others (Malaysia, Hong Kong, Thailand, Singapore, New Zealand, Indonesia and the Philippines) 7%. Source: State Street Global Advisors, Cerulli Associates, Investment Company Institute and various industry associations.

¹³ Following the publication of the *Australia as a Financial Centre Report*, the Australian Treasury proposed the initiative, which was endorsed by the Advisory Group on APEC Financial System Capacity Building and ABAC. It was discussed by APEC finance ministries and supported in their November 2010 ministerial statement. Various discussions have been held, including dialogues hosted by the Advisory Group in Tokyo and Seoul and meetings of regulators in Hong Kong, Singapore and Malaysia under APEC. The APEC Finance Ministers expressed support for continued work on this concept during their meeting in Honolulu in November 2011.

¹⁴ This initiative is being pursued as part of the ASEAN Economic Community (AEC) Plan of 2015 under the Capital Markets Implementation Plan. Discussions are currently under way among member economies' regulatory authorities and an early agreement among an initial set of interested members has been proposed for 2012.

THIRD DRAFT AS OF 7 MAY 2012

UCITS and traditional cross-border products, and expansion of the domestic funds sector in the region.

In essence, a regional funds passport scheme would facilitate the entire process of manufacture, domicile and custody, management and sale of collective funds products within the region. This would help develop financial centers within the region and provide greater opportunities for the region's human resources, but also involve the emergence of a value chain, where economies at different levels of development could participate in its different aspects.

Another set of initiatives is in the area of listed products. Closer integration of the region's stock exchanges would expand investor choice through regional exchange products and access through an established trading infrastructure, and increase local trading volumes through greater local demand and cross-border arbitrage. Given these considerations that balance out concerns over potentially losing market share to others, exchanges in the region have become more open to integration initiatives including bilateral and regional cross-trading arrangements.

Although existing regulatory frameworks already permit cross-border activity, further work is needed to overcome challenges. Some of these challenges are illustrated by the experience of PAIF, the only regionally domiciled large fund offering that is available across a wide range of Asian jurisdictions. PAIF is domiciled in Singapore, but in order to be listed in Hong Kong it needed to create a local branch of the Singapore investment management company that then had to deal with different regulations and disclosure requirements in these two jurisdictions. An important lesson from this experience is that for cooperation to succeed, governments must be motivated to act together, in particular, to overcome regulatory and administrative barriers. It has also proven to be practical to limit the number of jurisdictions involved at the beginning of the project.

ASEAN is currently undertaking an initiative to develop capital market infrastructure and regionally focused products and intermediaries and promote capital market integration through the creation of a network of mutual recognition agreements and harmonized regulations. Among specific initiatives under way are the following:

- Equity exchanges: Several stock exchanges (Indonesia, Malaysia, Philippines, Singapore Thailand and Vietnam) are collaborating to create an integrated regional market for investors to freely trade ASEAN products on any of the exchanges. As a first step, the ASEAN Stars Initiative lists 30 stocks from each exchange.
- ABMI: In addition to the specific projects already described above, efforts are being undertaken with the support of ADB to catalogue and improve post-trade and settlement practices.
- ASEAN and Plus Standards Scheme: This aims to facilitate cross-border offerings of plain equity and debt securities among member economies that will be available to issuers from within and outside the region. Standards are based on international securities, accounting and auditing standards, plus additional ones required by some ASEAN jurisdictions to conform to local market practices, laws and regulations.
- Collective Investment Schemes (CIS): ASEAN is discussing allowing the cross-border

sale of CIS within the grouping by 2015.¹⁵ These discussions are currently overlapping with similar discussions on a regional passport scheme under APEC.

- **Market Professionals:** Discussions focus on harmonizing accounting and auditing standards and mutual recognition of certification and qualification of market professionals.

The road ahead for regional financial integration faces a number of challenges. First, while finance ministries have taken the lead in several of these initiatives, there are various key issues that at times are beyond or not fully under their control, including legal reforms, currency controls, tax and customs issues. Second, more coordination is needed among initiatives being undertaken in ASEAN, APEC and other fora involving economies in the region, in order to avoid increasing the complexity and fragmentation of markets. Third, while the pathfinder approach offers a flexible way to move forward, a way to ensure the eventual participation of all economies in the region, in a manner consistent with their respective levels of development, needs to be found.

Going forward, the role of the Asia-Pacific Financial Markets Integration Project needs to be clarified, in particular, how it fits in with efforts already being undertaken in the region and how it can complement these initiatives. It could play a role in cataloguing and updating ongoing efforts by relevant organizations within the region; promoting collaboration between regulators and the business community in identifying and addressing common priorities; and supporting greater coordination between regional initiatives to develop individual markets and cross-border trade with efforts being undertaken by the G20 and international standard setting bodies and institutions.

Promoting the development of sound and efficient markets. The Global Financial Crisis, which arose in advanced economies with well-developed capital markets, underscored the importance of balancing the development of efficient and competitive markets with sound regulatory and supervisory frameworks. It also underscored the importance of a diversified financial system, where pension and insurance firms play significant roles beside banking institutions.

In designing regulatory and supervisory frameworks to be implemented in the region, however, it is important to ensure that these do not merely copy the frameworks adopted to address problems elsewhere, but fit the needs and priorities of the region's economies. In particular, these should support the sustainable growth of underdeveloped capital markets, the continued strengthening of banking systems, the further diversification of the investor and issuer base, and the healthy expansion of cross-border financial flows throughout the region. Marrying the opportunities arising in the Asian Century with regulatory regimes that effectively protect investors and consumers is a challenge that will need to be met.

REGULATORY AND POLICY CONSTRAINTS ON EFFICIENCIES AND INNOVATIONS IN FINANCIAL SYSTEMS AND REGIONAL STRUCTURES

There is broad agreement that market mechanisms are generally more effective and efficient

¹⁵ Some issues remain to be clarified, in particular, whether the initiative will apply only to products that are created, domiciled and managed within the region or also to those outside the region, such as UCITS.

than single individuals or governments in allocating resources and inducing responsible economic behavior. This applies as well to the channeling of financial resources from savers through financial intermediaries and markets to those who can put these savings to work in the most efficient and profitable manner. In the real world, however, the workings of market mechanisms are constrained for various reasons, which will be explained below.

In spite of the not insignificant costs and frictions that have arisen from efforts to liberalize and deregulate economies and industries over the past several decades, the consensus within the region that the benefits of giving the market a larger role far outweigh these costs has gained rather than diminished in strength. This is particularly the case in APEC. In 2010, the APEC Economic Leaders gave this view an official expression when they defined the vision of a Free Trade Area of the Asia-Pacific (FTAAP) as “a community that is more economically integrated, in which goods, services, and business people *move seamlessly across and within borders*, and a dynamic business environment is further enabled.”¹⁶

Financial systems play an important role in the economy, much like the role of the heart that pumps blood into the system. When financial systems come under stress and collapse, enterprises across industries are starved of finance and the whole economy begins to break down. Well-developed financial systems perform central functions in the economic system. They provide the payment services that facilitate the exchange of goods and services. They enable the pooling and mobilization of savings from large numbers of investors. They collect and process the information about enterprises and projects that allow the savings of society to be used most productively. They exert a monitoring function over investments and corporate governance. They enable the diversification and reduction of liquidity and inter-temporal risk.¹⁷

For this reason, if financial systems are to effectively support the regional economic community that the Economic Leaders have envisioned, these functions must also be undertaken on a cross-border basis. APEC needs to work toward enabling seamless and efficient financial transactions within and across borders. While this goal is unlikely to be fully realized in the near-term future, the region, as previously discussed, has already made significant progress in moving toward that goal, with the help of globalization, technology, enhanced regulatory standards, liberalization in certain markets and international cooperation. How to continue moving forward, particularly by grappling with the more difficult and complex issues, is the central question.

An example that illustrates the challenges involved in dealing with regulatory and policy constraints in the region relates to the many, interrelated and complex requirements for promoting secondary market liquidity in government bond markets. A liquid secondary market for government bonds is very important not just for funding of government expenditures but for the development and stability of the whole financial system, including the development of corporate bond markets, money markets and the institutional investor base.¹⁸ For such secondary markets to develop, a number of basic requirements need to be

¹⁶ APEC Economic Leaders, Pathways to a Free Trade Area of the Asia-Pacific (Yokohama, Japan, 13 November 2010).

¹⁷ R. Levine, 1997. “Financial Development and Economic Growth: Views and Agenda,” *Journal of Economic Literature* 35, pp. 688-726.

¹⁸ Liquid domestic government bond secondary markets are important because they (a) establish risk-free reference yield curves; (b) allow accurate derivatives pricing; (c) facilitate cost-effective risk management; (d) support the development of sound corporate debt capital markets; (e) support the development of sound money markets; (f) create risk-free assets to meet regulatory liquidity requirements; (g) allow optimal bank liquidity management; (h) enable governments to borrow

satisfied:¹⁹

- *Bond issuance programs.* Supporting large benchmark issues involves disciplined and transparent bond issuance and re-issuance programs that allow market participants to anticipate and plan. Active retiring and re-issuance encourage the development of benchmark issues. Good programs are those that make a broad product range available in the market, including long-dated, inflation-indexed and zero-coupon bonds and strips.
- *Liquid classic term repo markets.* Such markets that allow easy short-selling of government bonds are important because they support primary markets and allow primary dealers to hedge. They support secondary market liquidity by fostering price discovery through two-way pricing, market making and counterparty participation for shorting, which provides multiple trading strategies and hedging tools. In addition, they are necessary for the emergence of bond futures markets and the development of OTC derivatives markets. They help broaden funding markets and link together the money, bond, futures and OTC derivatives markets.
- *Active government bond futures markets.* These are critical for the rapid hedging of large value transactions that typically involve underwriters and primary dealers. They facilitate the development of OTC derivatives, enhance bond (cash) and OTC market liquidity, and reduce systemic and credit risk.
- *Active OTC derivatives markets.* A broad range of liquid OTC and exchange-traded derivatives contracts helps develop primary markets and allows hedging by primary dealers and corporate bond underwriters, as well as by banks and corporate issuers. It enhances the liquidity of bond (cash) and futures markets, and sustains project finance and other long-term ventures. It is important for the functioning of interest rate OTC markets that are in turn key to that of foreign exchange, commodities, equities and other OTC derivatives markets.
- *High quality, efficient and cost-effective electronic price discovery, trading, clearing and settlement platforms.* Such platforms help reduce inefficiencies and costs that tend to reduce trading volumes and enhance competition that stimulates the development of new products.
- *Broad and active investor base.* This would include domestic institutional investors such as pension and mutual funds and insurance companies, retail investors and foreign direct investors in domestic inter-bank government bond markets, repos and derivatives.
- *Market-friendly regulatory, accounting and tax regimes.* Various taxes have an impact on market activity. These include withholding (domestic and foreign), transaction, business, value-added and capital gains taxes, taxes on total assets or total liabilities and other factors that have a similar impact, such as high cost of services provided by state-owned monopolies. Laws and regulations that affect market development may include capital and foreign exchange controls, excessive liquidity requirements, those that favor hold-to-maturity behavior, lack of protection or clarity of creditor rights, restrictions on

long-term; (i) promote the development of pension funds, insurance companies, mutual funds and the entire institutional savings sector; (j) reduce government funding costs; (k) promote overall financial stability; (l) act as shock absorbers during crises; (m) reduce systemic risk; and (n) facilitate full capital account convertibility. Source: Asia Securities Industry & Financial Markets Association (ASIFMA).

¹⁹ This listing is based on ideas presented by ASIFMA.

market participation, and regulations or accounting rules that lack clarity. Market development can also be impeded if authorities are not quick to respond to requests for rulings on regulations, taxes or accounting treatment, or introduce regulatory changes without an appropriate phase-in process.

There is still much that needs to be done in the region to fulfill these requirements. For example, classic term repo markets are not yet so common in Asia. There is also a disparity in levels of development of various markets across the region. Active and liquid government bond futures markets exist only in a few economies.

Asian financial systems are for the most part fairly well-integrated internationally. However, they are predominantly integrated with the advanced financial markets of North America and Western Europe. Roughly three quarters of Asia's total holdings of equity securities and over 90 percent of debt securities have been accounted for by industrialized markets.²⁰ These figures are comparable to the situation in the world's other developing regions. However, they pale in contrast to advanced North American and Western European economies, where domestically issued equity and debt account for over three quarters and more than 90 percent, respectively, of domestic securities holdings.

In the context of the large portion of the world's savings and a rapidly growing share of global economic activity accounted for by Asia, this continued overwhelming preference for Western assets reflects the underdevelopment of the region's financial markets. It also reflects the opportunities that the region's economies are missing in not developing these markets more effectively.

Regional integration is important for the development of emerging Asia's financial markets. As long as these markets, being much smaller compared to the leading markets in Europe and America, are fragmented, it will remain difficult to attract market players to participate in a more meaningful way. Building regionally integrated financial markets will need to involve three important undertakings:

- *Construction*: Markets need to be constructed where they remain underdeveloped, which is still the case in most of the region's economies.
- *Convergence*: The development of financial markets need to be undertaken in a way that makes it easier and less costly for market players to operate simultaneously in multiple markets, through convergence and/or greater mutual recognition of standards, regulations and practices.
- *Connectivity*: Regulations and market infrastructure need to be developed to facilitate cross-border transactions.

The work done by the Advisory Group and ABAC on policies and regulations to promote bond market development illustrates the complexity of such an undertaking and the multiplicity of authorities and issues involved. Various conferences and dialogues convened by the Advisory Group and ABAC during the period 2004-2010 helped identify a number of key overlapping areas that are relevant in this regard.

²⁰ These figures are based on the weighted average for a set of Asian economies (Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Pakistan, Philippines, Singapore and Thailand) as of end-2007 Source: Eduardo Borensztein and Prakash Loungani, *Asian Financial Integration: Trends and Interruptions* (IMF Working Paper), January 2011.

THIRD DRAFT AS OF 7 MAY 2012

- The first is promoting depth and liquidity of markets, which would require diversification of financial instruments and maturities and the development of secondary markets. This would also require greater diversity of the issuer and investor base, which in turn is influenced by the quality of corporate governance, disclosure and financial information, taxation and regulatory frameworks, among other things.
- The second is market infrastructure and architecture, which are subject to constraints on market making and price discovery. Key issues that need to be addressed to remove these constraints include benchmark yield curves, transparency, disclosure and accounting standards, post-trading information structures, clearing and settlement, credit ratings and derivatives and futures markets.
- The third is the legal, policy, regulatory and taxation environment. Challenges include creating level playing fields, improving legal protection for investors and lenders and legal infrastructure, addressing tax issues that have an impact on markets and cross-border investment and issuance, coordination among regulators, liberalization of capital markets, exchange rate policy and development of derivatives and repo markets.

In 2010, the Advisory Group and ABAC submitted to the APEC Finance Ministers a number of proposals on how regional financial integration can be accelerated.

- Establishment of a pathfinder initiative to introduce a funds passport scheme. Such a scheme is intended to facilitate the distribution of collective investment funds complying with a widely agreed common set of fund investment guidelines across participating jurisdictions. It should be designed to provide superior standards of retail investor protection and regulation compared to non-qualifying funds. Development of the common set of guidelines under which funds can apply for distribution across participating economies will need to be accompanied by efforts to address related regulatory and tax barriers as well as currency issues.
- Development of wholesale securities markets open only to professional investors (exempt from strict disclosure rules designed to protect retail investors), to encourage the expansion of the issuer base, including foreign issuers, and to promote more issuance by current issuers. Individual economies could establish such arrangements and eventually collaborate to develop regional arrangements for securities settlement, removing barriers to entry and undertaking further steps to create an integrated regional professional securities market.
- Collaboration between government and regulatory officials and market players to reduce barriers to cross-border settlement. The public sector should take the lead in addressing barriers related to tax, foreign exchange controls, cash controls, investor registration, omnibus accounts and quotas. The private sector should lead efforts to address barriers related to messaging formats and pre-matching. Both public and private sectors should collaborate in addressing barriers related to physical certificates, securities numbering and settlement cycle.
- Promoting the use of foreign securities as eligible collateral throughout the region to enable major domestic and foreign financial institutions and investors to participate in cross-border collateral markets. In these markets, bonds can be actively used as collateral in money market transactions or traded in repurchase agreements, contributing toward more liquid bond markets. Existing arrangements can be considered as starting points in developing new bilateral arrangements, with a view toward a region-wide system.

- Continued collaborative efforts among governments, regulatory agencies, credit rating agencies and market players to promote region-wide convergence of accounting standards, disclosure regimes and corporate governance practices toward robust global standards.

The process of re-designing financial regulations and market infrastructure to better serve the needs and aspirations of the region would involve confronting a number of issues. The first – referred to earlier in this section – is finding the right balance between achieving market efficiency and wider objectives of policy makers and the public. Some of these objectives are policy-related, e.g., curtailing money laundering and financing of terrorist organizations. Some have to do with social concerns, e.g., protecting consumers and promoting greater financial inclusion. Others are more political in nature, such as satisfying specific demands from constituents or the electorate at large. The most relevant to financial regulators are those related to ensuring financial stability and the soundness of financial institutions.

This is an area where very careful consideration is needed, because market efficiency – which is often sacrificed – in itself also contributes to wider objectives, such as ensuring the sustainability of economic growth through the reduction of costs, the fostering of competitive enterprises and the promotion of market discipline. Another example of clashing policy objectives is the conflict between the objectives of anti-money laundering measures and know-your-customer rules on one hand, and greater financial inclusion on the other, when such regulations produce disincentives for providing financial services to small depositors and borrowers. In finding the right balance, there is much that dialogue between regulators and policy makers and the private sector can accomplish, particularly in identifying unintended consequences of regulatory measures.

A second issue is how to satisfy the different needs and priorities of developed, developing and the least developed economies in the region. This would mean, for example, that parallel programs may be needed to target different needs of particular groups of economies. A good example is what APEC Finance Ministers are doing in the area of funds passport. Under this initiative, two parallel efforts are being undertaken. One is focused on policy dialogues on designing and developing an Asia Region Funds Management Passport (ARFMP) as a pathfinder initiative to be led by more advanced economies. The other focuses on providing technical support to a number of developing economies that are interested in strengthening their potential to participate in financial sector cross-border trading activities in the future.

Pathfinder initiatives have been very useful in such situations. They allow those who are ready to move ahead, while others remain free to join later. Given that many issues need to be addressed by regional initiatives involving overlapping participation from ministries, central banks and regulatory agencies, greater regional coordination can help ensure that these initiatives do not unnecessarily duplicate each other, but complement and build on each one's achievements.

A third issue relates to the multiplicity of regional organizations with overlapping memberships.²¹ The question of which organizations should play active roles is related to the question of how the Asia-Pacific should be defined, in terms of membership. This is an area where pragmatic solutions need to be found.

A fourth issue relates to global consistency, which is an important consideration in the design of the region's financial regulatory frameworks and market infrastructure. This would have to

²¹ To name a few, these include APEC, ASEAN, ASEAN+3, ASEAN+6, EMEAP and SEACEN.

be pursued hand in hand with the needs of the region. There is currently an underlying sentiment in Asia that recent global efforts at financial regulatory reforms have focused overwhelmingly on the priorities of Western Europe and the US, which are dictated by the imperatives of responding to recent crises, while the priorities of Asia as a region, which is focused on growth, have not been adequately addressed, and in some cases negatively affected by these efforts. These differences in priorities seem to be reflected in discussions about measures that affect market liquidity, which needs to be promoted rather than curtailed for the development of Asia's capital markets, and eventually for the successful rebalancing of the global economy.

Finally, there is the challenge of identifying an appropriate structure and mechanism to bring forward the regional financial markets integration project through concrete actions over the next several years. Ideally, such a structure should also involve – aside from the region's financial, monetary and regulatory authorities – regional institutions, multilateral bodies and key global institutions like the Basel Committee, the Bank for International Settlements (BIS), the Financial Stability Board and the International Organization of Securities Commissions (IOSCO).

POLICY AND SUPERVISORY PERSPECTIVES ON PROMOTING REGIONAL FINANCIAL MARKETS INTEGRATION

The current global economic situation underscores the compelling rationale for the development of Asia's capital markets. Given the present situation in the developed economies of North America and Europe, global economic recovery and the resumption of previous levels of growth will hinge on the continued rapid development of Asia's emerging markets in coming years. However, the underdevelopment of the region's financial markets, unless addressed very soon, is bound to pose a very serious constraint to growth. Asia does not yet have an adequate financial market infrastructure that can effectively support its next stage of growth.

This reality is most evident when emerging Asia (Asia ex-Japan) as a group is compared to the US and the EU. While accounting for roughly a quarter of the world's GDP (comparable to the US and the EU) and more than half of the world's total population, emerging Asia lags far behind the US and the EU in terms of their shares in global financial markets – only about 10 percent of funds under management and less than 10 percent of the markets for debt securities and interest rate derivatives.

Even the more developed financial centers of Hong Kong and Singapore are significantly far behind US and British financial markets, which together dominate the global hedge fund, private equity and fund management industries and the markets for interest rate OTC derivatives and foreign exchange, and together with France and Germany also the markets for cross-border bank lending and exchange-traded derivatives.²²

Key to the development of Asian financial markets is the emergence of integrated and diverse funding markets, particularly the debt securities and derivatives markets, which are needed to address the region's continuing over-reliance on bank funding. This will require the further

²² Information compiled by Goldman Sachs based on data from Asian Development Bank, the 2011 CIA World Factbook, PriceWaterhouse Coopers, IMF, TheCityUK and Capital Markets Monitor.

development of market infrastructure and regulatory frameworks, as well as the pension funds and insurance industries that are vital for the recycling of savings and the sustained growth of markets for long-term securities and infrastructure finance.

Care needs to be taken, however, that the development, evolution and integration of markets go hand-in-hand with efforts to ensure the continued soundness of financial systems. The recent crises in the US and Europe underscore the importance of regulation and supervision keeping pace with rapidly changing markets. This is expected to be a major challenge for the region's regulators, who must avoid the temptation to agree on the lowest common denominator for the sake of facilitating integration and ensure that regulatory convergence leads to stronger, not weaker, financial systems. This also imposes greater responsibilities on private financial institutions as they expand cross-border operations to align their strategies and conduct with the need to support stability of local markets, even as they contribute to the development of these markets through greater competition and diversity of market players.

Promoting regional financial integration requires a regional structure to develop sound and efficient markets that can facilitate the continued growth of Asian economies. To be effective, such a structure would need to provide a platform for key players including central banks, financial regulatory agencies, finance ministries, other relevant public agencies and the region's financial industry to collaborate in the development of regionally consistent regulatory frameworks and market infrastructure. Such collaboration should aim to facilitate integration among markets in the region, the convergence of standards and practices, and common approaches in shaping global financial regulatory reforms. The region should more actively promote standards and practices that contribute to and shape global standards in partnership with other members of the G20, and in collaboration with IFIs and key organizations such as the Financial Stability Board.

Closer cooperation among financial regulators is a necessary requirement for the success of regional financial integration. It is important to build confidence among them in each others' financial systems even as they undertake the necessary reforms toward market development and integration. For this to happen, efforts are needed to promote deeper understanding by regulators of other markets in the region, including through exposure to these markets. Regulators also need effective mechanisms for cooperation in dealing with cross-border operations of financial institutions. In this regard, supervisory colleges have worked well over the years, and have proven their effectiveness in helping financial regulators build sufficient knowledge about the operations and business of regionally active financial institutions.

Financial institutions operating across the region consider a number of key issues as important in facilitating the expansion of cross-border activities. These include, among others, more consistent implementation of capital adequacy rules (Basel III), improvements to insolvency laws, regulations that allow financial institutions to adopt efficient organizational structures (e.g., branch or subsidiary), development of payment and clearing systems, greater transparency and competitive neutrality of tax and accounting rules.²³

The road toward regional financial markets integration is complex and challenging. Two

²³ Competitive neutrality refers to the promotion of efficient competition between public and private businesses. Australia provides an example of such an approach, based on its June 1996 Competitive Neutrality Policy Statement and the Competitive Neutrality Guidelines for Managers. In this regard, the government requires public enterprises to (a) charge prices that fully reflect costs; (b) pay, or include an allowance for, government taxes and charges; (c) pay commercial rates of interest on borrowings; (d) generate commercially acceptable profits; and (e) comply with same regulations that apply to private businesses.

examples illustrate these challenges. The first example deals with the regulatory requirements that need to be addressed in order for economies to participate in a regional funds passport scheme, using Japan as a case in point. There are two main types of funds in Japan: the contractual (investment trust) and the corporate (investment company) type. The predominant contractual type of funds is the securities investment trust, which accounts for more than half of all investment in securities. In the case of the corporate type, real estate investment companies make up the dominant portion. As of March 2011, assets under management in the Japanese funds industry amounted to ¥150.2 trillion (US\$1.8 trillion), of which over 73 percent or ¥98.14 (US\$1.2 trillion) are in domestic investment trusts, over 13 percent in foreign investment trusts and companies and over 9 percent in collective investment schemes.

The regulatory framework for investment trusts revolves mostly around the interactions among three parties – the investment trust management company (trustor), the trust bank (trustee) and the investor (beneficiary). Distributing companies also play an intermediary role between trust banks and investors. Japan has a well-developed regulatory framework with very strong investor protection measures and rules to ensure the soundness of the industry. These requirements include registration of investment trust management companies with the Financial Services Agency, minimum capital, and ability to properly conduct business. Investor protection measures include duties related to exercise reasonable care in protecting the interest of investors, disclosure to investors and safekeeping of assets. Investments are allowed only in registered securities. Funds of funds must meet certain diversification requirements.

Comparisons of the Japanese regulatory framework with others in the region underscored the wide variety of industry structures and regulatory frameworks that need to be dealt with in the process of integrating the region's financial markets. It was pointed out, for example, that Japan and Australia have very different structures, such as with respect to the distinction made between trustee and fund manager. In the case of the proposed Asia Region Funds Management Passport, significant work will need to be undertaken in economies that wish to participate in this pathfinder initiative, in order to properly align regulatory frameworks and facilitate the successful passporting of fund management products.

The second example, provided by the Philippine case, illustrates the challenges faced by a developing economy. Over the past few years, the Philippines has initiated a number of significant reforms to develop its domestic bond market,²⁴ improve its financial regulatory framework²⁵ and strengthen banking supervision.²⁶ However, the government faces a number of challenges in preparing the economy for regional financial markets integration. One is the need to further strengthen the financial landscape, which is currently characterized by multiple regulators, small asset size of local market players, heavy reliance on the banking system and the dominance of few large financial conglomerates. A second relates to political challenges in reforming the legal architecture, which continues to pose restrictions on foreign

²⁴ These include establishing a fixed income exchange, launching the Philippine Payments and Settlement System (PhilPaSS) and the Philippine Dealing & Exchange systems, implementing the third-party custodianship system and developing domestic rating capacity. *Source: Bangko Sentral ng Pilipinas.*

²⁵ These are the passage of legislation for securities transaction enhancement, review of the regulatory framework for corporate rehabilitation, individual retirement funds and collective investment schemes, and reform of foreign exchange policies. *Source: Bangko Sentral ng Pilipinas.*

²⁶ These measures include the enhancement of corporate governance and transparency, adoption of international accounting standards and Basel II and III, formation of a Financial Stability Committee, formation of a Financial Sector Forum and adoption of risk-based consolidated supervision. *Source: Bangko Sentral ng Pilipinas.*

entrants and the establishment of foreign bank branches. The third is the need to further develop the capital market, in particular the corporate bond market, and to expand the investor base and develop institutional investors.

Policy makers and regulators acknowledge that regional financial integration can lead to cost and operational efficiencies that foster both economic growth and financial stability. There is support for financial integration that goes hand in hand with the development of globally competitive financial markets, the deepening (in terms of financial instruments) and diversification (in terms of products, services and region-wide risk-sharing activities) of these markets and an appropriate design of the regional financial integration framework.

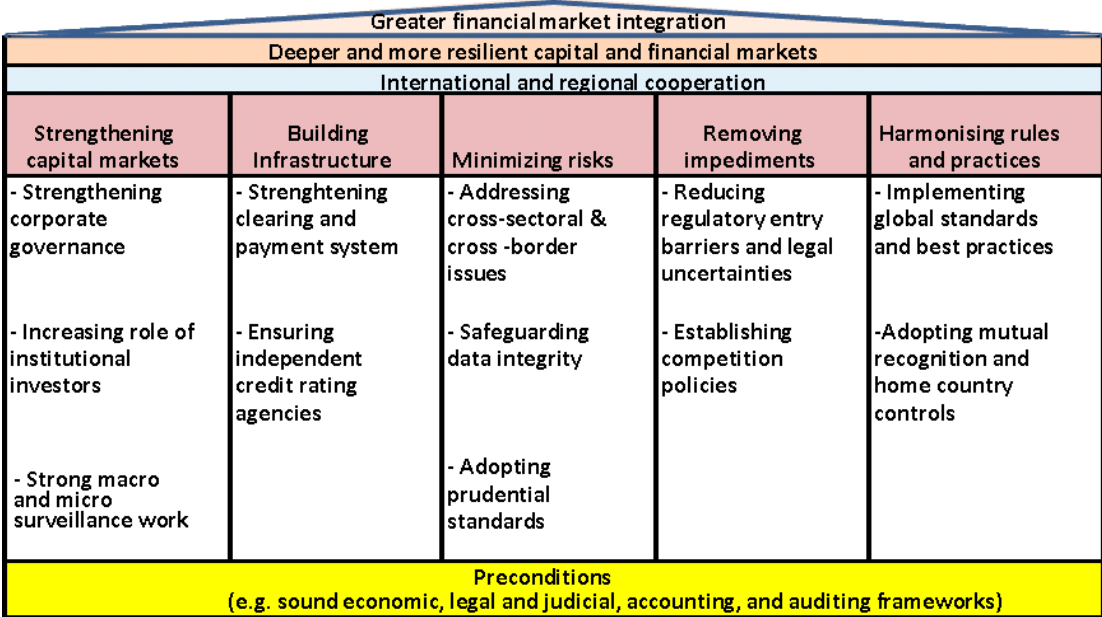
Given that more integrated markets in the region will remain vulnerable to systemic shocks, safety nets and controls to help prevent the build-up of future crises will also be needed. Measures to liberalize and deregulate markets will require complementary measures to engender mutual trust in each jurisdiction's supervisory capacity and prevent regulatory arbitrage or competitive regulatory laxity. Discussions need to be undertaken on exchange rates to be used for regional transactions and on financial and monetary cooperation to develop an exchange rate regime favorable to regional financial market integration.

From a regulatory perspective, a key challenge in designing the integration of financial markets is the great diversity and varying levels of maturity of markets across the region. In this context, a regional financial integration agenda will need to overcome three important roadblocks. First, the region needs a roadmap, which would ideally include the formulation of a long-term vision, and agreement on how synergy among initiatives can be achieved. Second, economies must address legal impediments to market integration, including barriers to entry and cross-border concerns. Third, they must work on market infrastructure, in particular to address the underdevelopment of capital markets and differences in market practices.

A good roadmap for regional financial markets integration identifies measures that need to be undertaken and how they relate to each other. Figure A is an example illustrating the kind of reform measures that the region could consider as a process similar to building a house from the ground up.²⁷ It lists the reforms that make up the foundations (preconditions), identifies the key areas and measures that comprise the walls, and proposes international and regional cooperation as the ceiling through which all these efforts will lead to deeper and more resilient capital and financial markets and greater financial markets integration. While these proposed measures will need to be reviewed in light of more recent developments, the region can benefit from using a similar framework in advancing financial integration and playing a more active role in shaping global standards and practices.

²⁷ Source: Cowen, David, Ranil Salgado, Hemant Shah, Leslie Teo and Alessandro Zanello (2006): Financial integration in Asia: recent developments and next steps", *IMF Working Papers*, 06/196. The illustration is taken from Jung Jee-young, "Regional financial cooperation in Asia: challenges and path to development," in *Regional financial integration in Asia: present and future. Proceedings of the first workshop of the Asian Research Network for Financial Markets and Institutions* organised by the BIS and the Hong Kong Institute for Monetary Research in Hong Kong SAR on 21 January 2008 (BIS Papers No, 42, October 2008) p. 134.

FIGURE A: KEY REFORMS TO FOSTER REGIONAL FINANCIAL INTEGRATION



Source: Cowen et al (2006)

On a practical level, priority areas need to be identified, where initial work undertaken over the next few years could have a significant impact on advancing the regional financial market development and integration agenda. Regulators and private sector participants proposed the following:

- Mapping financial regulatory systems in the region, including the identification of overlaps, commonalities and differences.
- Identifying a coherent set of measures based on clear long-term objectives to develop the full spectrum of financial markets in the region, ensure consistency of regulatory frameworks and market infrastructure, and facilitate the integration of these markets.
- Developing the region’s pension and insurance industries.
- Initiating capacity building programs to help emerging market regulators address preconditions and key measures to strengthen capital markets, build market infrastructure, minimize risks, remove impediments and develop common rules and practices, based on the diagram in Figure A.

THE WAY FORWARD FOR THE ASIA-PACIFIC FINANCIAL MARKETS INTEGRATION PROJECT

A critical first requirement is to provide key regional decision makers with a compelling case that demonstrates the value and the gains from an undertaking to develop and integrate the region’s financial markets. The discussions in the forum point to the progress made in regional market integration, but also quite clearly point to the need for sustained efforts to secure financial conditions that would support the pace of the region’s economic development, ensure robust, resilient and prudentially sound markets, and establish Asia as a strong engine of growth for the global economy with an enhanced capacity to eliminate poverty.

The case for such an undertaking is that despite massive economic and social gains in the region over the last three decades and significant financial reforms made since APEC was established, the region's financial systems continue to face serious challenges. Many of these systems remain inadequate to serve the needs of a rapidly changing real economy and a large part of the region's population that continue to live in poverty. Finance is not being allocated efficiently because of under-developed capital markets in a number of economies, while investors and savers are seriously constrained in the choices available to them.

The recent crisis has underscored Asia's vulnerability to liquidity and credit constraints given its underdeveloped financial markets and over-reliance on Western markets. Financial costs are higher than they need be and financial inclusion for the masses of underserved people in the region remains a distant prospect. More secure and integrated financial systems would increase systemic security, reduce exposure to external shocks, improve the region's ability to generate liquidity and to provide effective regulatory oversight of financial products and services offered within the region, broaden investor and consumer choice and security, raise living standards and increase social opportunities. These, in turn, will lead to more balanced, sustained and inclusive growth and a more stable global financial system that will benefit the entire international community.

This is a long-term undertaking that will require sustained effort and resources. It involves risks that will need to be addressed, and building strong and sound financial systems as markets evolve must form part of efforts to create regulatory frameworks and market infrastructure to support efficient and seamless financial transactions within and across borders in the region. It will also need to take into account the wide differences in development levels across the region, and different incentives and risk characteristics across the financial industry.

Such an undertaking will need to involve, in varying degrees, a diverse set of entities in order to meet with a good chance of success. This list would include governments in the region (particularly finance ministries and other agencies that have relevant involvement in financial markets). Among these, the governments of China and Japan (which are major sources of credit) will need to be involved. The USA (a major source of products, issues and structures), while currently preoccupied with issues closer to home, will be needed to support, if not actively collaborate with, such an undertaking. A number of other economies in the region have been at the forefront of efforts to promote the development of financial markets, and their active engagement will be crucial for advancing this project forward.

Regional organizations such as APEC, ASEAN and ASEAN+3 and broader organizations such as the G20 have provided platforms for the development and implementation of policy dialogues, capacity building and collaborative work on financial systems and markets. Together with other regional groupings such as the East Asia Summit and ASEAN+6, they all have the potential of helping to bring the regional financial markets integration project forward.

In addition to governments and their agencies, the involvement of central banks and financial regulatory authorities would be essential. The support and active involvement of regional organizations of central banks such as EMEAP and SEACEN, as well as the IOSCO Asia-Pacific Regional Committee, would be very helpful. A body that could play an important role is the FSB Regional Consultative Group for Asia, which brings together representatives from key institutions and agencies from the region.

THIRD DRAFT AS OF 7 MAY 2012

Multilateral and international organizations are active players in promoting financial market development in the region, particularly the ADB, the IMF, the IFC and the World Bank. Coordination with key bodies with global responsibilities, such as the FSB, the Basel Committee on Banking Supervision (BCBS) and the BIS is also essential. Finally, the involvement of academic institutions that are able to provide substantive support and business sector organizations such as ABAC, industry associations and major financial institutions would be necessary.

For the longer term components of this undertaking, it is worth considering the development of a regional financial architecture built around existing entities such as the APEC Finance Ministers Process, ASEAN+3 or +6, EMEAP and the FSB Regional Consultative Group for Asia, and – should it emerge – an Asian caucus within the G20. An Asia-Pacific Financial Forum responsible for coordinating the undertaking, involving the public and private sectors and key international institutions, has also been proposed. The undertaking may also address such issues as the expansion of the Chiang Mai Initiative and the development of a regional credit rating system, among others.

The undertaking could move forward based on a combination of (a) a pathfinder approach, (b) parallel programs for different sets of economies to address varying needs and priorities, and (c) regional coordination to synergize these initiatives. The focus of work would be priority areas that will have the most significant impact on the objectives of building strong and efficient markets across the region and promoting their convergence and connectivity. Setting priorities would require an analysis of the roadblocks and the development of a roadmap for building the region's legal and regulatory architecture and market infrastructure.

A number of elements have been proposed for inclusion in a possible short- and medium-term work program to advance the undertaking:

- Mapping financial regulatory systems in the region, including the identification of overlaps, commonalities and differences.
- Identifying a coherent set of measures based on clear long-term objectives to develop the full spectrum of financial markets in the region, ensure consistency of regulatory frameworks and market infrastructure, and facilitate the integration of these markets.
- Developing the region's pension and insurance industries.
- Promoting the liquidity of the region's bond markets, particularly through the development of repo, bond futures and derivatives markets.
- Starting pathfinder initiatives toward the following goals:
 - ❑ a regional funds passport scheme;
 - ❑ a regional professional securities market;
 - ❑ reducing barriers to cross-border settlement;
 - ❑ use of foreign securities as eligible collateral throughout the region; and
 - ❑ region-wide convergence of accounting standards, disclosure regimes and corporate governance practices toward robust global standards.
- Building mechanisms for coordinated policy dialogue, sharing of best practices and capacity-building in the following areas:
 - ❑ sound legal and judicial, accounting and auditing frameworks;
 - ❑ promoting greater financial inclusion;

THIRD DRAFT AS OF 7 MAY 2012

- ❑ strengthening corporate governance;
 - ❑ increasing the role of institutional investors;
 - ❑ promoting robust macro- and micro-surveillance;
 - ❑ strengthening clearing and payment systems;
 - ❑ promoting independent credit rating agencies;
 - ❑ addressing cross-sectoral and cross-border issues;
 - ❑ safeguarding data integrity;
 - ❑ adopting prudential standards;
 - ❑ reducing regulatory entry barriers and legal uncertainties;
 - ❑ establishing competition policies;
 - ❑ implementing global standards and practices; and
 - ❑ adopting mutual recognition and home-country controls.
- A program to build mutual confidence among regulators in each others' regulatory environments and financial systems.
 - Development of benchmarks and indices to promote peer group pressure, based on the experience of the World Bank's Ease of Doing Business index.

As an initial step, an informal Asia-Pacific Financial Forum (APFF) will be established, to be coordinated by the Advisory Group on APEC Financial System Capacity Building, whose mandate is consistent with this task.²⁸ Its initial core participants will be drawn from the institutions represented at the Melbourne Forum on the Asia-Pacific Financial Markets Integration Project. Other institutions that were unable to send representatives but which have expressed interest in the undertaking, will also be invited to collaborate.

The APFF will seek to position itself as an informal public-private sector grouping that can offer advice to or dialogue with such bodies as the IOSCO Asia-Pacific Regional Committee, the FSB Regional Consultative Group for Asia and EMEAP, among various others. The APFF will be initially tasked with disseminating this report, reaching out to and seeking further views from key institutions and organizations, and facilitating the next steps, including the next round of discussions on how the undertaking could move forward. It will seek ABAC's endorsement of this report and its call for the launch of a multi-year undertaking to the APEC Finance Ministers.

This report was prepared on behalf of the Advisory Group on APEC Financial System Capacity Building by the Advisory Group Coordinator. This conference report reflects the author's summary of presentations by and discussions among participants at the Forum, and not necessarily the views of the Advisory Group on APEC Financial System Capacity Building, the APEC Business Advisory Council and the Australian APEC Study Centre at RMIT University unless explicitly endorsed by them. For further information, please contact the Coordinator, Dr. Julius Caesar Parreñas (c/o The Bank of Tokyo-Mitsubishi UFJ, Ltd., 2-7-1, Marunouchi, Chiyoda-ku, Tokyo 100-8388, Japan - Tel 81-3-3240-5279; Fax 81-3-3240-3879; Email jc_parrenas@mufg.jp)

²⁸ The Advisory Group on APEC Financial System Capacity Building is an informal grouping that was launched by ABAC and the Pacific Economic Cooperation Council in 2003. Its aim is to support the work of APEC finance ministers by promoting synergy and collaboration among public and private sector institutions and organizations engaged in strengthening and developing the region's financial systems. In addition to ABAC and the Pacific Economic Cooperation Council, participants include international financial and multilateral development institutions and agencies, as well as private sector organizations representing the region's financial industry. For more details, visit <https://www.abaconline.org/v4/content.php?ContentID=1304>.

ANNEX
Forum Program

- 08.30 – 08.45 REGISTRATION/COFFEE
- 08.45 - 09.15** **SESSION 1: WELCOME AND INTRODUCTION TO PURPOSES AND OBJECTIVES OF THE PROJECT**
- Moderator: Mr Ken Waller, Director, Australian APEC Study Centre at RMIT University*
- Professor Ian Palmer, Pro Vice-Chancellor & Vice President, School of Business, RMIT University
- Mr Mark Johnson AO, Forum Chair (ABAC member) and Senior Advisor, Gresham Investment House
- 09.15- 10.30** **SESSION 2: OVERVIEW OF IMPLEMENTATION OF REFORMS AND INITIATIVES IN THE ASIA PACIFIC REGION, WITH A FOCUS ON OUTSTANDING CHALLENGES**
- Moderator: Mr Jim Murphy, Executive Director, Markets Group, The Australian Treasury*
- Dr Eli Remolona, Chief Representative, Bank for International Settlements, Representative Office for Asia & the Pacific, Hong Kong, China
- Dr Shinobu Nakagawa, Associate Director-General, Head of Center for Monetary Cooperation in Asia, International Department, Bank of Japan
- Mr Hon Cheung, Regional Director, Official Institutions Group, State Street Global Advisors Singapore
- Dr Jae-Ha Park, Deputy Dean for Special Activities, Asian Development Bank Institute, Tokyo
- 10.30 – 10.45 COFFEE BREAK
- 10.45 - 11.15 Open discussion
- 11.15 -12.45** **SESSION 3: REGULATORY AND POLICY CONSTRAINTS ON EFFICIENCIES AND INNOVATION IN ECONOMIES' FINANCIAL SYSTEMS AND REGIONAL STRUCTURES**
- Moderator: Mr Ken Waller, Australian APEC Study Centre at RMIT University*
- Mr Nicholas de Boursac, Chief Executive Officer, Asia Securities Industry & Financial Markets Association, Hong Kong, China
- Dr Agusman, Executive Researcher, Bank Indonesia

THIRD DRAFT AS OF 7 MAY 2012

Ms Akemi Kishimoto, Deputy Director, International Financial Markets Office of International Affairs, Financial Services Agency, Government of Japan

Dr Julius Caesar Parrenas, Advisor for International Affairs, The Bank of Tokyo-Mitsubishi UFJ, Tokyo, Japan

12.45 – 14.45

LUNCH

Corrs Chambers Westgarth
600 Bourke Street, Melbourne, Level 36

Host: Mr John W.H. Denton, (ABAC member Australia), Partner and Chief Executive Officer, Corrs Chambers Westgarth

14.45-15.45

SESSION 4: POLICY AND SUPERVISORY PERSPECTIVES ON PROMOTING REGIONAL FINANCIAL SYSTEM INTEGRATION

Moderator: Dr Julius Caesar Parrenas, Advisor for International Affairs, The Bank of Tokyo-Mitsubishi UFJ, Tokyo, Japan

Mr Charles Littrell, Executive General Manager, Policy Research and Statistics, The Australian Prudential Regulation Authority (APRA)

Mrs Judith E. Sungjai, Director, Bangko Sentral ng Pilipinas

Mr Graham Hodges, Deputy Chief Executive Officer, Australia and New Zealand Banking Group Limited

Mr James R.F Shipton, Managing Director & Head of Government Affairs, Asia Pacific, Goldman Sachs (Asia) LLC

15.45-16.00

COFFEE BREAK

16.00-17.00

SESSION 5: WAYS FORWARD TO DEVELOP OBJECTIVES OF THE PROJECT

Moderated Open Discussion: Mr Mark Johnson AO

17.00 – 17.15

SUMMARY AND CONCLUSIONS

Mr Mark Johnson AO

17.30 – 18.30

COCKTAILS

Siglo Bar at the European, 159 -161 Spring Street, Melbourne