



*Hernán Somerville*  
*ABAC Chair 2004*

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The Honorable  
Nicolas Eyzaguirre  
Minister of Finance of Chile and  
Chair, APEC Finance Ministers' Meeting  
Santiago, Chile

Dear Minister:

It is with great pleasure that I submit the attached report to you on behalf of ABAC, and in particular the Finance and Service Working Group (FSWG) of ABAC. The report incorporates our recommendations to you and to APEC Economic Leaders on important financial issues bearing on APEC's agenda. I would ask that you arrange to circulate the report to your APEC colleagues in preparation for your dialogue with ABAC in Santiago on 2<sup>nd</sup> September.

I will accompany Mr. Mark Johnson of ABAC Australia, Chair of the FSWG and Co-chair Mr. Kanzaki of ABAC Japan to the meeting. In his presentation Mr. Johnson will draw out some major points from the report and which should contribute to a fruitful dialogue with Ministers.

The economic climate has improved significantly over the last year. There are of course risks but business confidence is much improved and growth prospects are good. The climate is right to continue with and indeed to accelerate reforms to strengthen financial systems. We regard this as an imperative in building for a sustainable and prosperous future.


It is increasingly obvious to us that much will be gained by deepening the involvement of the private sector in partnership with the public sector in building the institutional and human capacities that underpin many of our recommendations – as they concern strengthening financial systems, improving security in systems, enhancing financial services liberalisation and in improving corporate governance.

We have given priority to the request of Ministers at last year's dialogue to provide private sector inputs to the issue of developing the region's bond markets. While the concept of a regional bond market is some way off, much valuable work is proceeding which should ultimately help create the environment for the concept to come to fruition. Deeper private sector involvement in this work is warranted. Building solid domestic market structures is of course highly important to deepening the region's financial systems.

The role of financial services is crucial to growth and development. We believe it is particularly opportune, given the breakthrough in the WTO Doha Round, to take actions to promote financial services liberalisation.

In closing, I would like to register our appreciation of the role played by Mr. Raul Saez as chair of the Officials Technical Working Group in deepening the contacts and the dialogue between TWG and ABAC FSWG. This has been particularly helpful in helping ABAC focus its work and in preparing for our meeting with Ministers in September. We would request that the relationship that has been established with TWG be continued as a permanent feature of ABAC's relations with the APEC Ministerial processes.

Yours most sincerely,



Hernan Somerville  
Chair, ABAC

## ABAC Report to APEC Finance Ministers

At the outset, ABAC expresses appreciation for the cooperation extended to it through the chair of the Officials Technical Working Group. The Finance and Services Working Group of ABAC and the TWG agreed measures to deepen and promote coordination on our respective agendas and this has proven to be most helpful in preparing this report.

Before turning to the report on ABAC's work this year, we take the opportunity to comment briefly on the two ABAC considered the *two major issues under enquiry in the APEC finance processes*. ABAC wholly endorses the benefits of sound fiscal management and budget discipline since they contribute to a sound business environment by:

- promoting economic stability and growth over the business cycle
- helping maintain price stability and thereby contributing to a more certain climate for investment decision-making
- containing taxes to reasonable levels, maintaining discipline on public expenditures and offering the prospect of lower taxes and incentives to promote productivity and employment growth

As regards the work commissioned on capital flows and macroeconomic stability, ABAC notes:

- significant increases in capital flows are occurring as a consequence of the low interest rate environment and declining spreads but that rising interest rates may well be troublesome for equity and debt markets, particularly in some emerging economies
- the benefits of open capital markets permitting inflows and outflows of capital as contributing to economic growth but these can and are offset by disruptive volatility in short-term flows
- measures to minimise disruptions, including the development of bond markets and deepening domestic markets are important (Ministers are referred to our recommendations later in this report on Policies to deal with the adverse consequence of volatile short-term capital flows and highly leveraged institutions)

Turning to ABAC's work this year, this report covers four broad themes: strengthening financial systems; improving financial system security; enhancing financial services liberalisation and measures to enhance institutional and human capacities.

Although risks to the improving global economic outlook temper the outlook, the APEC region is in significantly better shape than it was this time last year. Physical and financial markets are strengthening, trade is growing and while oil prices are high and volatile, price levels generally remain non-threatening - but with clear prospects of moving to higher levels of inflation targets in a number of countries. Interest rates are also rising but business confidence is robust and likely to sustain relatively high rates of global and regional growth over the period ahead.

ABAC's focus this year, continues to develop from the platform established over recent years to strengthen financial systems and to deepen capital markets – and in particular measures to promote domestic and regional bond markets. The improving global outlook presents an excellent opportunity to press on with and indeed to accelerate reforms to financial systems. Regional economies should continue work to improve prudential and supervisory standards in financial sectors, in particular in banking. We have also considered the challenge arising from the promotion of new financial reporting standards. We believe that more attention should be given to reduce the vulnerability of some economies to the adverse impact of volatile short-term capital movements and to the activities of highly leveraged institutions and hedge funds. We note that Ministers are seeking advice from the IMF on volatile capital flows.

We believe that deeper public/private sector coordination is necessary to combat money laundering and to prevent terrorists using financial systems in financing their activities. Similarly, more intensive public/private sector cooperation is required to improve corporate governance in the region.

Against the background of the recent breakthrough in the WTO Doha Development Round, we believe it timely to take major initiatives to promote financial services liberalisation in the Round.

The Advisory Group on APEC financial system capacity building (jointly developed by ABAC and PECC) has developed a number of recommendations to enhance the skills and the institutional frameworks in both the public and private sectors. We propose to continue to focus efforts to build capacities in the clear knowledge that even if best policies and practices are adopted across the region and across all major sectors, there is little hope for their successful implementation unless human skills and sound policy frameworks are in place.

Our detailed recommendations are outlined below.

## **1. Strengthening financial systems**

### **A. Measures to support the implementation of Basel 2**

There is wide support, including from the Asian Bankers' Association, for the new Basel 2 capital accord to strengthen banking systems through the promotion of sound risk management practices. While some economies will not be in a position to implement Basel 2 till some years after its implementation (late 2006), many banks are intending to adopt and develop risk management systems to eventually qualify for the advanced risk management approaches under Basel 2. There is a welcome trend by regulators to move toward risk-based management supervision. Against the failure of some supervisory regimes evident in the Asian financial crisis, ABAC strongly endorses and supports these supervisory developments. There is increasing emphasis in risk management supervision in the insurance sectors and in other financial sectors and indeed in the corporate world. Increased cooperation between regional regulators and with relevant international agencies, in particular the Bank for International Settlements, should be pursued and support given to capacity building initiatives to support the implementation of Basel 2 in banking and improved regulatory arrangements in other financial sectors.

### **Recommendations**

- endorse the implementation of Basel 2 in the region's banking systems and increase the capacities and resources of regulatory agencies to support the implementation of Basel 2 standards, and to improve regulatory**

## **standards in other financial sectors**

- endorse measures to increase cooperation between regional regulators, relevant multilateral and regional agencies and private financial groups to implement Basel 2**

## **B. Promote domestic and regional bond markets**

In response to your request to ABAC during discussions in Phuket last September, for a business input into your deliberations on the development of bond markets in the region, ABAC and PECC jointly convened a major conference on the subject in Taipei in May. Participation included experienced bond market specialists, accountants, lawyers, financial academics and regulators. Our report of that meeting is attached to this report. The conference represented a major extension of the work we in ABAC have undertaken in the past on this important matter.

Our report notes that economies stand to greatly benefit from having deep, liquid and robust capital markets with bond markets as the integral component, facilitating long-term financing and yield structures, vital for a diversified financial system by widening investor and borrower opportunities. Bond markets lessen the vulnerability to crises by diversifying financial sources and by reducing currency and maturity mismatches.

The report highlights the characteristics of the environment which is conducive to efficiently functioning domestic markets and outlines the history of market developments in some Asia and Pacific economies. It notes the high relevance of capital market liberalisation and exchange rate flexibility as two of a number of important factors that would be a prerequisite to facilitate the growth of a truly regional bond market in Asia.

It comments favourably on a number of important initiatives that are being pursued in the region, which if successful would contribute in a significant way to the evolution of a regional market. Of overwhelming importance is the concept of an entirely commercial environment within a sound legal and competitive framework open to market makers in which pricing and yields would reflect wholly commercial judgment of credit risk and the cost of capital. While the report recognises that that concept of a regional bond market is a long way off, many constructive measures are being pursued under APEC and in other forums. They include improving the regional credit rating industry, the promotion of domestic and region-wide insolvency creditor rights systems and convergence to international accounting standards. Significant capacity building initiatives would help accelerate progress on these matters.

The report emphasises the importance of engaging the private sector in developing these measures and in measures that would help expand the institutional investor base. There is strong support and deep interest by many market participants. Their experiences and expertise should be drawn on to accelerate the development of markets.

ABAC has produced a template for self-assessment by economies to assist in measuring progress toward the development of a bond market and to help identify capacity building needs.

## **Recommendations**

- endorse the implementation of the conclusions and recommendations arising from the ABAC/PECC Taipei bond market conference, as contained in the conference**

report, to accelerate work to develop regional bond markets, specifically

- deepen regional capacity building initiatives to develop bond market infrastructure, in particular the harmonisation of market standards and practices including solvency regimes, credit rating practices and accounting standards
  - involve private sector interests through public/private sector partnerships in regional capacity building
  - link regional initiatives to support the development of local markets with the establishment of effective policy coordination in local markets
- as an initial step toward the implementation of the recommendations, concerned APEC economies should adopt the template proposed by ABAC to undertake a self-assessment, in consultation with the private sector, on the institutional structures and other conditions for the development of bond markets. This is to help identify priority areas for regional capacity building efforts.

### **C. Measures relating to development of international accounting standards**

ABAC supports convergence to and early adoption of The International Financial Reporting Standards (IFRS) as proposed by the International Accounting Standards Board (IASB). However, complex issues remain for jurisdictions and firms in interpreting the concept of “fair value” and in comprehensive income reporting, and there is considerable potential liability of company directors and others who may unwittingly, incorrectly interpret financial reporting requirements. These risks are real, particularly in the light of more exacting legal requirements in some jurisdictions. A significant number of APEC emerging economies are not represented on IASB and they have had little or no input into the development of IFRS. Coordination within the region therefore would be helpful in promoting convergence.

#### **Recommendations**

- promote convergence to and early adoption of the IFRS as contributing to improved accounting measures and to supporting capital flows between economies.
- promote a regional forum of domestic accounting standard-setting bodies to help expand regional inputs into the development of global standards and to encourage the convergence to those standards, including through appropriate capacity building initiatives.

### **D. Policies to deal with the adverse consequences of volatile short-term capital flows and highly leveraged institutions**

Significant benefits arise from increases in capital flows to emerging markets. While there is a general risk to the level of flows because of rising interest rates, this should be accommodated through a relatively smooth market adjustment. Of continuing concern however are risks associated with short term capital flows and which may be susceptible to sharp reversals – as

occurred in some economies during the Asian financial crisis. There are also risks to financial system stability (in some economies, but potentially across economies) associated with the activities of hedge funds and highly leveraged institutions. Both the FSF and the BIS have recently issued commendable recommendations on measures to minimise the impact of adverse consequences of volatile flows and the activities of highly leveraged institutions. The Manila Framework is working to improve monitoring, reporting and disclosure standards on capital flows. However, because some emerging APEC economies which may be most vulnerable to risk are not well represented in the FSF and the BIS, ways are needed to ensure that their interests in these international forums are properly reflected.

### **Recommendations**

- **implement measures recommended by the FSF and the BIS aimed at stabilising capital flows and ameliorating the impact of highly leverage institutions and support regional forums such as the Manila framework in developing effective monitoring and reporting standards and disclosure on capital flows**
- **require central bank governors of the Asian Consultative Council to request the Council to inform the BIS, FSF and associated groups, of concerns arising from the operation of hedge funds and highly leveraged institutions**
- **request the IMF to ensure effective surveillance of payments developments of particular relevance to APEC's regional economies**

### **E. Strengthening corporate governance and transparency**

ABAC has previously recommended the adoption of the OECD Asian Roundtable White Paper priority recommendations to support the strengthening of corporate governance in the region. The International Institute of Finance (IIF) has proposed that the OECD move from a general set of principles to one that provides more direct guidance to stock exchanges, investors and corporations to emphasise shareholder rights. The APEC seminar in Kuala Lumpur in April noted that serious efforts must be taken to ensure that corporate governance practices meet the challenges brought on by the rapid integration of economies and the intensity of competition. ABAC believes that more major public/private sector coordination is necessary to promote improved governance in the region, involving international agencies, institutes of Directors, business and governments. ABAC proposes "An APEC Regional public/private sector Action Program for the Promotion of good corporate governance and Transparency" and intends to launch the program in a major conference to be organised in 2005.

### **Recommendations**

- **endorse the IIF recommendations to the OECD to make more explicit its guidelines on corporate governance to strengthen shareholder rights**
- **endorse and promote the concept of "An APEC regional public/private sector Action Program for the promotion of good corporate governance" including the proposal to launch the program at a major conference in 2005.**

## **F. Support for the Unidroit Convention on International Interests in Mobile Equipment**

The Convention provides a framework for the creation and enforcement of security and leasing interests in high-value mobile equipment that move across borders in the ordinary course of business, for example, aircraft, ships, oil rigs, railway rolling stock and space equipment. It will be supplemented by protocols for different categories of Equipment. The Convention came into effect in April 2004, but the "*Protocol on matters specific to aircraft equipment*," has not yet received the necessary ratifications to give effect to the Convention. In 2002 ABAC recommended that APEC economies support for the Convention as an important instrument to reduce risks associated with cross-border financing in contributing to more secure financial systems. Those reasons for supporting the Convention and its associated protocols remain entirely valid.

### **Recommendations**

- **APEC economies give priority to ratifying the Unidroit Convention and the related Protocol on matters specific to aircraft equipment, and support the extension of protocols to other categories of mobile equipment**

### **2. Improving financial system security**

Previously, ABAC has made a series of recommendations concerning financial system security arrangements to combat money laundering and terrorist financing. ABAC seeks to ensure adequate protection of the bona fide interests of customers and financial institutions within an appropriate legal framework as security policies are implemented, and the maintenance of efficient payment systems. There is a need to deepen consultation between the public and private sectors and to raise broader understanding of financial system security issues, and the OECD/ADB Anti-Corruption initiative and action plan, at both the CEO level in financial institutions and non-financial institutions and at operational level with regulators and officials. ABAC is working with the Asia Pacific Group, based in Sydney, to explore areas of cooperation involving the private sector in these matters.

### **Recommendations**

- **deepen the consultative processes between public agencies and regional and international bodies with private sector groups to ensure the development of practical and market efficient anti terrorist funding, anti money laundering and anti corruption measures, backed by relevant legal safeguards to protect the bona fide interests of institutions and their customers and to ensure efficient payments systems**
- **endorse joint ABAC/APG initiatives to raise high level corporate awareness of these issues and to develop appropriate capacity building initiatives**

### **3. Promoting financial services liberalisation**

The gains from financial services liberalisation in terms of improved services, competition, investment and jobs growth are evident in many economies which are liberalising. A study



undertaken for ABAC reinforces these gains in the the four economies surveyed, Chile, Chinese Taipei, South Korea and Thailand. The survey is attached to this report. There are good reasons why liberalisation should be promoted on two tracks, namely by tabling offers at the Doha Development Round as soon as possible and by measures that would bring more consistency and uniformity among RTAs and FTAs.

An APEC public/private sector task force should be established to support this work.

### **Recommendations**

- **with the completion of the July 2004 Doha framework, give priority to financial services liberalisation in the Doha Development Agenda and require officials to table comprehensive services offers as soon as possible**
- **offers should contribute to broaden the scope of liberalization of financial services with emphasis on securities and insurance**
- **establish a public/private sector task force to identify best practices in financial services liberalisation and to identify economy-specific capacity building needs**

### **4. Enhancing regional capacity building**

ABAC and PECC have launched the Advisory Group on APEC Financial System Capacity Building to provide guidance and advice on the most effective ways of involving the private sector in support of identified capacity building needs. Relevant international financial institutions are invited to participate to ensure consistency in needs' identification and to avoid duplication in programs. The Advisory Group is focusing on initiatives which involve private sector institutions – some of which provide specialist training resources on a pro bono basis. Some initiatives are impeded by lack of funding – mainly in regulatory agencies – to cover the costs of accommodation and travel to allow their officials to participate in APEC sponsored programs. Some modest financial support by emerging APEC economies themselves to contribute to these costs should be encouraged.

ABAC in its mid-term Business Assessment of APEC proposed high level coordination to oversee the development and implementation of capacity building initiatives. Given the overwhelming importance of capacity building to realise the Bogor goals, this proposal should be implemented.

### **Recommendations**

- **establish a new APEC Ministerial Committee on Regional Technical cooperation, as recommended in ABAC's mid-term Assessment of APEC**
- **endorse the role of the Advisory Group on APEC financial system capacity building and economies be encouraged to allocate funding to regulatory and policy agencies to enable their officials to participate in APEC sponsored programs and which would augment contributions from international and regional agencies and from the private sector**