



THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

The Advisory Group on APEC Financial System Capacity-Building

2012 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS

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Summary of Recommendations

This year, the Advisory Group further build on its previous work focused on fostering sound and integrated financial markets in the Asia-Pacific region, expanding private financing of infrastructure, promoting greater access to finance for households and small businesses, and financing innovation. As a platform for collaboration among key international institutions, public agencies, and the private sector led by the APEC Business Advisory Council (ABAC), the Advisory Group convened and promoted discussions among key institutions and organizations this year. The results of these discussions are reflected in the following conclusions and recommendations.

Fostering Sound and Integrated Financial Markets in the Asia-Pacific Region

In the wake of the Global Financial Crisis, many economies in the region have proven vulnerable to liquidity and credit constraints due to their overreliance on a few traditional financial markets in advanced economies. The lack of robust and liquid domestic financial markets in these economies is also bound to pose a serious constraint to continued rapid growth in the future.

At a conference convened by ABAC in March 2012, senior representatives from financial authorities, the region's financial industry and key international bodies concluded that the region would greatly benefit from an overarching framework for enhanced regional public-private collaboration that can complement various ongoing initiatives to help the region develop sound, efficient and integrated financial markets.

This collaborative framework, provisionally named the Asia-Pacific Financial Forum (APFF), is envisioned to be a platform for public-private sector collaboration in: (a) the development of robust financial markets across the region; the convergence of financial standards, regulations and practices; and connectivity for facilitating cross-border financial flows; and (b) shaping global financial regulatory reforms in support of the region's financial development goals.

- *Considering that further discussions are needed on the concrete way forward, especially on how the APFF can add value, complement and not unnecessarily duplicate other ongoing regional initiatives, the Advisory Group recommends that discussions be held at a symposium with active participation by finance ministries and other relevant agencies from APEC economies in early 2013. This symposium will seek to develop a roadmap for enhanced public-private sector collaboration to promote the development, convergence and connectivity of markets in the region and to promote the development of global financial regulatory standards that are compatible with the region's needs. We propose that the outcomes of this symposium be reported to and considered by the Finance Ministers at their meeting next year in Indonesia.*

- *The Advisory Group also welcomes ongoing efforts made by finance officials and regulators to develop the Asia Region Funds Passport (ARFP), as previously recommended in our 2010 and 2011 Reports. We welcome closer collaboration with finance officials in further developing this work, particularly in the identification of a possible time frame for implementing a pilot ARFP.*

Expanding Private Financing of Infrastructure

In 2010, ABAC proposed an Asia-Pacific Infrastructure Partnership (APIP) to bring together high-level officials, experts and private sector advisory panelists from a wide range of relevant fields to help overcome constraints impeding private sector investment in the region's infrastructure. In 2011, a number of activities have been undertaken, including dialogues with the governments of three APEC economies and the preparation of studies responding to needs identified in the dialogues. Preparations are currently underway for further dialogues with several interested governments.

- *The Advisory Group requests APEC Finance Ministers to continue supporting the APIP Dialogues, to collaborate in further expanding these dialogues in 2012 and 2013, and to include in their 2012 joint statement a call for intensified public-private sector collaboration in infrastructure finance, in particular through the Asia-Pacific Infrastructure Partnership. The Advisory Group encourages interested member economies to collaborate with APIP in undertaking Dialogues and in taking steps to address challenges identified in these Dialogues.*

Promoting Greater Access to Finance for Households and Small Businesses

Since 2008, the Advisory Group has consistently advocated the importance of financial inclusion for the region and encouraged APEC to play a more active role as a platform for policy dialogue, sharing of experiences and capacity-building in promoting greater financial access. To this end, the Advisory Group regularly brings together relevant officials, regulators, and representatives from the private sector, key international institutions and academe to discuss key issues in providing enabling environments for successful financial inclusion.

The 2012 Asia-Pacific Financial Inclusion Forum identified common basic elements of an enabling environment to promote financial inclusion - financial literacy, financial identity, proportionality of regulations and consumer protection, as well as linking microfinance to remittances. In addition, further extensive discussions were conducted on three issues that are of great importance to MSMEs: financial regulation, secured lending and credit information.

- *The Advisory Group urges APEC Finance Ministers to develop a multi-year agenda for financial inclusion linked with ongoing efforts by the G20 and international financial institutions, focused on assisting member economies build their capabilities in providing a favorable environment for expanding access to finance for households and small businesses. We recommend that this multi-year agenda include public-private collaboration in developing robust and sustainable frameworks for financial literacy, financial identity, consumer protection and cross-border microfinance, as well as intensive capacity building for policy makers and financial regulators and supervisors to help them develop and implement effective and proportionate regulatory frameworks for financial inclusion.*
- *The Advisory Group recommends the development of model elements for an APEC code of security interest creation, perfection and enforcement. This includes creating clear perfection rules covering a broad array of collateral types, an exclusive and efficient registry system and broad licensing authority for commercial finance. We also recommend the continuation of public and private dialogue in order to validate*

improvements, as well as capacity-building focused on encouraging collaboration among justice and law ministries where further Civil Code reforms are needed, information ministries where central e-databases are needed, and SME ministries where it is possible to educate and build support for reforms.

- *The Advisory Group recommends that policy makers and financial regulators, in partnership with the private sector, promote the development of commercial credit information in the region as a way to improve access to finance by MSMEs. Efforts should focus on key issues, including (a) availability, quality, access and reuse of public sector data; (b) disclosure and compliance; (c) regulatory framework for data sharing; (d) access to bank information (loan performance data); and (e) financial literacy of MSMEs.*

Financing Innovation

Overcoming existing challenges to the financing of innovation is important for maintaining the region's continued rapid economic growth. There is much that can be learned from experiences, and the ongoing efforts in many economies from which to draw valuable lessons on what measures can lead to success. The Advisory Group identified several crucial roles that governments need to play in promoting a dynamic ecosystem for financing innovation. The first is catalyzing angel and venture capital through support programs. The second, which is indispensable for success, is providing an enabling legal and regulatory environment that will encourage the flow of more private sector resources into venture capital. The third is creating, maintaining and enhancing the fundamental conditions that encourage entrepreneurship and innovation.

- *The Advisory Group recommends that APEC collaborate with ABAC and the Advisory Group on APEC Financial System Capacity Building under the APEC Open Innovation Initiative to develop public-private partnership mechanisms that can help governments catalyze angel and venture capital through effective support programs, provide the indispensable enabling environments for financing business activities across various stages of innovation, and ensure the fundamental conditions for entrepreneurship and innovation, particularly at the incubation stage.*

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In the 2010 Report of the Advisory Group, it was predicted that, with persistently high unemployment, unresolved problems in banking systems, rising sovereign risks and the absence of clear signs of sustained recovery in private demand in advanced markets, the global economy will enter another difficult period after the effects of stimulus packages run their course. Last year's report noted the unfolding developments in the economies of Europe and the US, and subsequent events after its publication in November 2011 – including the Eurozone crisis and the weakening US economy – as this year's report is being written, further reinforce the correctness of this analysis.

As in its previous reports, the Advisory Group continues to emphasize the importance of addressing the fundamental causes of internal and external imbalances in advanced and developing economies. These imbalances that had produced a remarkably long episode of world economic growth have also paved the way for the most painful and protracted period of global economic adjustment since the 1930s. Huge investments in productive capacities built on unrealistic expectations of consumption growth in advanced economies present the region today with the challenge of how to create new and more sustainable sources of demand with which to prevent more significant economic and financial dislocations.

The Advisory Group had concluded from previous years' discussions that ensuring continued robust global economic growth in the future would require expanding the world economy's growth potential, particularly through increased consumption and business activity in emerging markets. There is considerable growth potential in developing APEC member economies, where accelerated movement of labor to sectors with higher productivity and more rapid growth of domestic private demand could pave the way for the emergence of a new engine of global economic growth.

Harnessing this potential, however, would require actions to address constraints to the growth of domestic consumption and investment. These include the lack of access to finance of small enterprises and the large low-income segment of the population, policy environments that hinder expanded private investment in infrastructure and innovative enterprises, and underdeveloped financial markets, especially those for long-term local currency financing. Addressing these constraints would need to include efforts to improve and update financial regulatory systems and policies through capacity-building.

This year, the Advisory Group builds on the work of previous years that has focused on financial sector solutions to these issues. Being a platform for regional public-private sector collaboration led by the APEC Business Advisory Council (ABAC), the

Advisory Group outlines its proposals in this report, which is divided into four sections: (a) accelerating the development of sound and integrated financial markets in the Asia-Pacific region; (b) expanding private financing of infrastructure; (c) promoting greater access to finance for households and small businesses; and (d) financing innovative enterprises.

I. FOSTERING SOUND AND INTEGRATED FINANCIAL MARKETS IN THE ASIA-PACIFIC REGION

The current global economic situation underscores the compelling rationale for the development of sound and integrated financial markets in the region. 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 emerging markets in coming years, particularly in Asia, where savings are abundant. However, the underdevelopment of the region's financial markets, unless addressed very soon, is bound to pose a very serious constraint to growth.

In the case of Asia, there is yet no adequate financial market infrastructure that can effectively support its next stage of growth. For example, classic term repo markets are not yet so common. 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 predominantly integrated with the advanced financial markets of North America and Western Europe, as evidenced by the fact that industrialized markets account for roughly three quarters of Asia's total holdings of equity securities and over 90 percent of debt securities.

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.

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.

Regional financial integration is important for the development of the region's emerging 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.

- ♦ First, markets need to be built up where they remain underdeveloped, which is still the case in most of the region's economies.
- ♦ Second, 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.

- ♦ Third, regulations and market infrastructure need to be developed to facilitate cross-border transactions.

Key to the development of the region's 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 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 has significant implications for the region's participation in global financial regulatory reform and standard-setting processes. Recent global efforts at financial regulatory reforms have focused overwhelmingly on the priorities of Western Europe and US financial systems, which are dictated by the imperatives of responding to recent crises, while the priorities of Asia and the region's emerging markets, which are focused on growth, have not been adequately considered. As the region's financial systems and markets evolve to meet its economies' and peoples' rapidly changing needs, it is important to ensure that regulatory frameworks and market infrastructure are not constructed from templates that fulfill North Atlantic requirements alone, but are and will be supportive of dynamically evolving structures and needs in the Asia-Pacific region as well.

These require closer regional collaboration among public and private sectors to develop a deeper understanding of the region's evolving financial systems and the standards, regulations and practices needed to support sound and efficient markets that can facilitate the continued growth of the region's economies. To be effective, such collaboration must involve key players including finance ministries, central banks, financial regulatory agencies, other relevant public agencies and the region's financial industry. It 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.

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.

In November 2011, APEC Finance Ministers in Honolulu pledged to take coordinated action to strengthen global recovery, reinforce financial stability, maintain open markets and build a foundation for strong, sustainable and balanced growth. Ministers welcomed the Advisory Group's recommendation, adopted and conveyed by ABAC, on improving collaboration among financial regulators to reflect and promote increasing regional financial market integration and for enhancing efficiency in capital markets.

Taking up that challenge, the Advisory Group convened with ABAC and partner institutions a forum in March 2012 in Melbourne, Australia, attended by senior representatives from financial authorities, the region's financial industry and key international bodies. The full report of this Forum is presented in Appendix A. The issues identified in the Forum suggested that the region would greatly benefit from an overarching framework for enhanced regional public-private collaboration that can effectively complement various ongoing regional initiatives to help the region develop sound, efficient and integrated financial markets.

This collaborative framework, provisionally named the Asia-Pacific Financial Forum (APFF) is envisioned to be a platform for public-private sector collaboration in:

- the development of robust financial markets across the region; the convergence of financial standards, regulations and practices; and connectivity for facilitating cross-border financial flows, with the objective of creating dynamic and integrated financial markets that will support the region's sustained rapid growth; and
- shaping global financial regulatory reforms in support of the region's financial development goals, through coordination of views on agreed areas of common regional concern and ensuring that these concerns are adequately reflected in global financial standards and regulations.

It is proposed that the APFF be open to participation from finance ministries, central banks and financial regulators, multilateral and international institutions and standard setters, regional and international financial industry groups and major financial institutions. It would utilize the strengths of APEC, particularly the strong engagement of the private sector, to identify measures that support and complement ongoing efforts, fill in gaps and help overcome the fragmentation of the region's markets. It would be a multi-year informal pathfinder initiative to be coordinated in partnership among ABAC and interested relevant multilateral organizations and private and public sector bodies, including APEC FMP or individual finance ministries.

Considering that further discussions are needed on the concrete way forward, especially on how the APFF can add value, complement and not unnecessarily duplicate other ongoing regional initiatives, the Advisory Group recommends that discussions be held at a symposium with active participation by finance ministries and other relevant agencies from APEC economies in early 2013. This symposium will seek to develop a roadmap for enhanced public-private sector collaboration to promote the development, convergence and connectivity of markets in the region and to promote the development of global financial regulatory standards that are compatible with the region's needs. We propose that the outcomes of this symposium be reported to and considered by the Finance Ministers at their meeting next year in Indonesia.

The Advisory Group also welcomes ongoing efforts made by finance officials and regulators to develop the Asia Region Funds Passport (ARFP), as previously recommended in our 2010 and 2011 Reports. We welcome closer collaboration with finance officials in further developing this work, particularly in the identification of a possible time frame for implementing a pilot ARFP.

II. EXPANDING PRIVATE FINANCING OF INFRASTRUCTURE

A forum convened in 2010 under the auspices of the Advisory Group by ABAC, ADB and Japan Bank for International Cooperation (JBIC), confirmed that infrastructure finance is a central issue for the region. There is huge demand for infrastructure investment necessary for continued economic growth, which public sector investment alone cannot meet. The forum yielded the following key messages:

- Despite recent improvements in infrastructure-related policies, key constraints impeding private investment remain – lack of capital market depth, dearth of good quality projects, inadequate regulatory frameworks and concerns about transparency and political, country, exchange and interest rate risk.
- Given the complexity of infrastructure PPPs, overcoming these constraints requires improved understanding and greater trust among relevant parties involved. Structures enabling parties to frankly and objectively discuss and consider complex matters facing each economy can contribute to better understanding of the issues and risks they face and conducive environments for private financing of infrastructure.

In 2010, ABAC proposed a model for such a regional structure – an Asia-Pacific Infrastructure Partnership (APIP) – bringing together high-level officials, experts and private sector advisory panelists from a wide range of relevant fields. ABAC proposed to undertake activities to demonstrate the effectiveness of this model. In 2011, a number of activities have been undertaken, among which were the following:

- *Formation of the APIP Private Sector Panel.* ABAC invited senior private sector experts selected for their knowledge of and experience and active engagement in infrastructure projects from a wide range of relevant fields, including the asset management, commercial banking, investment banking, engineering, property development, information technology, legal and consulting sectors. To date, the panel has 39 members, including current and former ABAC members, chief executives and chairmen of major companies, and other senior executives, legal practitioners and consultants with extensive experience in infrastructure.
- *2011 Dialogues with individual governments.* Candid and open dialogues among relevant high-level officials from three APEC economies, the APIP advisory panel and experts from multilateral development banks were held in 2011. The agenda were tailored to meet specific needs of individual governments and determined after consultations with concerned ministries and agencies. Dialogues were held with Mexico and Peru in August 2011 in Lima, followed by a dialogue with the Philippines, held in October 2011 in Manila.
- *Forum on Promoting Private Financing for Infrastructure in APEC.* A forum was organized in November in Honolulu under the auspices of the Advisory Group, with ABAC and the World Bank as lead co-organizers in collaboration with the APEC Deputy Finance Ministers. It discussed the outcomes of the Dialogues and

the way forward for public-private collaboration to promote infrastructure finance in 2012 and beyond.

The 2011 Lima and Manila Dialogues identified a number of areas where governments needed more specific advice. These include:

- contractual arrangement options and requirements for success
- best practices on legal frameworks to protect interests of and attract long-term investors, including how to deal with necessary adjustments while avoiding modification creep;
- best practice taxation measures to support PPPs;
- best practices in the design of infrastructure funds providing equity, debt and/or guarantees to catalyze private investment;
- best practices in design/implementation of bidding process to achieve value for money;
- best practices in outsourcing of PPP processes, especially to circumvent civil service requirements that make it difficult for governments to directly hire experts; and
- best practices in design of PPPs for social infrastructure, particularly health care and education.

As a follow-on measure to respond to these needs expressed by economies during the Dialogues, the Advisory Group initiated research projects conceptualized and managed by the Australian APEC Study Centre at RMIT University with support from the ABAC Research Fund. The projects focused on five of the previously mentioned topics: (a) comparative study of legal frameworks to protect the long-term interests of pension funds investing in PPPs; (b) comparative study of contractual clauses to provide for the smooth adjustment of physical infrastructure and services through the lifecycle of a PPP project; (c) best practice in design of PPPs for social infrastructure, particularly in health care and education. (d) comparative study of best practice taxation measures to support PPPs and (e) ways to evaluate externalities of PPPs.

At the time of drafting of this Report, three of these research projects have already been completed. The studies will be shared not just with the governments that have expressed their need for advice on these issues in the course of the previous Dialogues, but also more widely across and beyond APEC. Following are the recommendations provided by these studies:¹

Contractual Clauses for the Smooth Adjustment of Physical Infrastructure and Services through the Lifecycle of a PPP Project. Economies with well-developed PPP frameworks have, through experience, developed contractual mechanisms that introduce sufficient flexibility through the life of PPP contracts and allow for variations in the physical infrastructure or the services. The need for flexibility to implement variations in a PPP typically arises either as government wishes to implement a new policy initiative, or as government's project-specific needs change.

The types of variations required by government depend upon the nature of the infrastructure. Network issues are a common driver for variations in economic infrastructure PPPs, whereas interface issues are a common driver for variations in social infrastructure PPPs operated by government. Based on the analysis of PPP

¹ These three studies were undertaken for the Advisory Group and ABAC by Foster Infrastructure (www.fosterinfrastructure.com).

frameworks in this report, the study identified the following recommendations for the inclusion of flexibility in PPP contracts:

- PPP contracts should include a right for government to request changes to both the physical infrastructure delivered by the private party and the services provided by the private party. Some variations affect only the physical infrastructure (for example, installation a new electrical socket in a classroom); some variations affect only the services provided by the private party (for example, a change in the acceptable range of temperature that the private party must maintain in a classroom); some variations affect both the physical infrastructure and the services.
- The contractual variation process should allow the private party sufficient time to consult with its subcontractors and financiers before responding to a variation request from government. The assessment of variation requests can be a complex process. If the private party is not given sufficient time to consult with its subcontractors and financiers, its response to the variation request is unlikely to be acceptable to government.
- Government should consider including in PPP contracts an obligation to compensate the private party for a percentage of its verifiable third party costs if government requests a variation but later decides not to proceed with it. Sharing costs in this way rather than full compensating the private party provides an incentive for government to refrain from requesting variations if it is not committed to proceeding, and an incentive for the private party to contain the costs of assessing the variation.
- PPP contracts should either directly prescribe the limits on the size or nature of the variations that government can require, or preserve the private party's risk/reward outcome if the contract does not prescribe direct limits on the size or nature of the variations that government can require. Government should consider the likelihood and nature of variations that may be required, and assess whether prescribed limits on the size or nature of the variations are acceptable, or whether it requires greater flexibility but is willing to preserve the private party's risk/reward outcome when it requires variations.
- The variation process under a PPP contract should include a mechanism to enable government to satisfy itself that the variation costs represent value for money. It is good practice for government to require that any procurement be undertaken through processes to ensure that value for money is received and the outcome is transparent. Where procurement takes the form of a variation under a PPP contract, the variation process should enable government to satisfy itself that the variation costs represent value for money.
- If small and common variations can be foreseen, the parties to a PPP contract should agree a schedule of rates for those variations and include a streamlined "minor works" variation process in the contract. A schedule of rates is an efficient way of ensuring costs are reasonable for small and common variations, but can only anticipate the most common variations,
- For small and medium sized variations, the PPP contract should fix the margin that the private party can charge on top of its costs. Fixing the private party's margin mitigates the risk that the private party will add an excessive margin to the sub-contractor costs in order to derive additional revenue.

- For larger variations, PPP contracts should include a mechanism for establishing that the variation costs reflect market prices. Benchmarking is a mechanism that is particularly appropriate during the construction phase of the project, while requiring the private party to put the variation works out to competitive tender can be appropriate during the operating phase.
- PPP contracts should provide for independent expert resolution of disputes in relation to variation costs. Use of an independent expert can efficiently avoid or resolve disputes in relation to costs.
- In PPP contracts under which government makes unitary payments, it should consider including an option for government to pay for variations by increasing the amount of the unitary payments, provided the private party can finance the capital costs of the variation. Paying for variations through the unitary payments provides a similar level of risk transfer to the variation as that applicable to the original construction of the infrastructure.
- If a significant future variation can be foreseen at the time a PPP project is initially tendered, government should consider asking bidders to price it as a pre-agreed variation during the tender process. By asking bidders to offer a fixed price for the variation at the time they lodge their tenders for the project, government can benefit from pricing the variation in a very competitive environment and then request the private party to proceed with the variation at a later date.
- Where government proposes a significant policy change that can be implemented through both the variation process and the change in law process in a PPP contract, government should consider the relative merits of using each process, including the impact upon value for money and the long term PPP relationship.
- Voluntary termination rights can provide some additional flexibility in PPP contracts, but are significantly constrained by compensation obligations and political risk considerations, and should only be used where other mechanisms cannot provide a satisfactory outcome for government.
- In addition to including appropriate clauses in its PPP contracts to provide flexibility, government should establish appropriate contract management arrangements to effectively manage the variation process.

Best Practice in Design of PPPs for Social Infrastructure. Economies with well-developed PPP Frameworks have, through experience, developed a range of mechanisms to promote good design in social infrastructure PPPs. These mechanisms have been influenced by broader procurement regulations and policy considerations, such as the need for fairness and transparency in government procurement. The benefits and risks of the various mechanisms identified will vary in their significance depending upon a range of factors including the particular PPP model being used, the applicable legal system, and relative importance of design in comparison to the other outcomes that will be driven through delivery of the project as a PPP.

Some of these mechanisms are substitutes for one another – for example, Australia’s form of interactive tender process and competitive dialogue serve similar purposes, and it would usually be unnecessary to use both of these mechanisms. Other mechanisms identified in this report are complementary and can be used together – for example, user groups complement functional brief development.

Based on the analysis of mechanisms used in PPP Frameworks to promote good design outcomes, the study identified the following recommendations for governments wishing to adopt best practice in design for social infrastructure PPPs:

- Governments should identify an appropriate combination of mechanisms to promote design outcomes through the stages of the PPP lifecycle, taking into account relevant factors such as the particular PPP model being used, the applicable legal system, and relative importance of design in comparison to the other outcomes that will be driven through delivery of the project as a PPP.
- Action taken in the earlier stages of the PPP process will have the greatest impact upon design outcomes. Governments should therefore devote sufficient time and allow sufficient resources for proper consideration of design issues during the project development phase of PPPs.
- Governments should develop functional briefs to provide a robust foundation for the broad range of other activities that drive good design outcomes in social infrastructure PPPs.
- Governments should involve user groups in PPP project development due to their understanding of how design influences service delivery, but should also ensure that project teams carefully manage these groups.
- For projects that involve complex design issues, government should consider conducting market sounding in relation to these issues prior to commencement of the formal tender process. However the market sounding process should be carefully managed.
- Government architects can provide expertise that enhances the effectiveness of other design related activities throughout the PPP lifecycle.
- Governments should consider establishing community advisory groups as a means of two-way communication between the project team and the community, particularly in relation to urban design and master planning issues. However community expectations must be appropriately and efficiently managed.
- Governments should establish mechanisms for interaction between government and bidders during the tender process to ensure that the design solutions developed by bidders meet government's needs. This process should not be structured as a negotiation of government's design requirements, as these requirements should have been fully developed prior to the tender process. The focus of the interaction should be on ensuring the bidders understand these requirements.
- Governments should only require bidders to follow design templates and standards if there is only one feasible or acceptable solution to the relevant aspect of design. To the extent possible, such templates and standards should be expressed in output terms.
- Governments should only mandate the overall design where there is compelling reason to give design considerations priority over other aspects of the project. In circumstances where this is the case, government should reconsider whether PPP delivery is the best delivery model for the project, as the scope for innovation and value for money may be compromised by the mandated design.

- Providing the risks can be managed by the project team and it is permissible under the relevant procurement rules, governments should use qualitative evaluation of bidders' designs in order to drive good design outcomes.
- Governments should ensure that designs are sufficiently developed by bidders during the competitive tender process so that any subsequent design review need only focus on compliance of the detailed design documentation with the PPP contract. The design review process must be carefully managed to prevent government taking back risk.

Frameworks to protect the Long Term Interests of Pension Funds Investing in PPPs.

Pension fund investment in PPP projects is influenced by three regulatory and policy frameworks: the PPP framework, the investment and financial market framework, and the pension fund framework. The different pension fund systems in Australia and Canada result in pension funds in those economies taking different views as to the merits of infrastructure investment and the issues and risks they face in investing in PPPs. This illustrates that the attractiveness of PPP investment opportunities to pension funds is influenced as much by the pension fund framework as by the PPP Framework.

Any government wishing to facilitate pension fund investment in infrastructure must understand how each of the three frameworks affects the ability of pension funds to invest, and must consider what policy, regulatory and transparency initiatives are required to remove barriers within each framework. Governments in Latin America have taken this approach. Based on the analysis of PPP frameworks, the study identified the following recommendations for governments wishing to promote pension fund investment in PPP projects:

- Governments wishing to promote pension fund investment in PPPs should consider the impact of each of the following policy and regulatory frameworks: the PPP framework, the investment and financial market framework, and the pension fund framework.
- Policy changes to PPP frameworks should support long-term investment and provide transparency for all potential PPP investors, rather than focusing specifically on the needs of pension funds.
- PPP frameworks should offer attractive risk/reward propositions to investors, while retaining the underlying benefits of the PPP model, including the allocation of risk, where appropriate, to the private sector.
- Policy changes to investment and financial markets frameworks should facilitate the repackaging of the risk/reward investment opportunities offered by PPPs into products that are attractive and available to investors, including pension funds.
- If PPPs offer attractive investment opportunities, and the pension fund framework allows investment, there will be a strong incentive for the pension fund sector itself to establish new financial instruments and infrastructure investment funds to facilitate investment in PPPs. However, if there are regulatory barriers within the investment and financial market framework that prevent the pension fund sector acting in this way, there is a case for government to remove those regulatory impediments.

- Policy changes to pension fund frameworks should balance the benefits of removing barriers to investment (including investment in PPPs) against the fiduciary and prudential protections required in a pension fund system.
- In reforming policy and regulatory frameworks to promote pension fund investment in PPPs, governments should consider how the unique features of their pension fund systems and PPP markets affect the appetite of pension funds for PPP investments.

The remaining two studies are expected to be completed on or before the fourth quarter of this year. In addition, the Advisory Group will hold discussions among participating institutions involved in infrastructure finance issues on how capacity building activities can be developed to address the needs of developing economies. The Advisory Group is also discussing the possibility of holding a forum on specific aspects of infrastructure finance where economies might benefit from an exchange of views with the private sector and multilateral institutions. Finally, as this report is being drafted, preparations are underway for a Dialogue with the government of Vietnam in July 2012 in Hanoi, while discussions are currently ongoing with the governments of Indonesia, Russia and Thailand.

The Advisory Group requests APEC Finance Ministers to continue supporting the APiP Dialogues, to collaborate in further expanding these dialogues in 2012 and 2013, and to include in their 2012 joint statement a call for intensified public-private sector collaboration in infrastructure finance, in particular through the Asia-Pacific Infrastructure Partnership. The Advisory Group encourages interested member economies to collaborate with APiP in undertaking Dialogues and in taking steps to address challenges identified in these Dialogues.

III. PROMOTING GREATER ACCESS TO FINANCE FOR HOUSEHOLDS AND SMALL BUSINESSES

Addressing the needs of many people living in poverty in the Asia-Pacific region through improved access to finance remains a major challenge. With growing constraints on public resources in the wake of the Global Financial Crisis, mobilizing private resources to serve financial needs of low-income households and small enterprises has become ever more important. Stronger, more balanced and more inclusive growth also requires efforts to further expand financial access through new channels, while addressing the key obstacles small enterprises face in accessing traditional sources of finance.

Since 2008, the Advisory Group has consistently advocated the importance of financial inclusion for the region and encouraged APEC to play a more active role as a platform for policy dialogue, sharing of experiences and capacity-building in promoting greater financial access. To this end, the Advisory Group regularly brings together relevant officials, regulators, and representatives from the private sector, key international institutions and academe to discuss key issues in providing enabling environments for successful financial inclusion.

The first APEC Financial Inclusion Forum held in 2010 focused on how to provide enabling environments to extend the reach of microfinance, improve its commercial viability, and increase private investment in microfinance institutions (MFIs). In their Kyoto Report on Growth Strategy and Finance, APEC Finance Ministers welcomed

the outcomes of this Forum and the holding of subsequent discussions under the leadership of ABAC.

In 2011, the Advisory Group convened with ADB Institute (ADBI) the second Forum, where measures to provide an enabling environment in three areas - consumer and micro/small enterprise lending, grassroots savings mobilization, and remittances, were discussed. The 2011 Forum also discussed two key issues for expanding credit to micro-, small and medium enterprises (MSMEs): credit information and legal frameworks for secured lending.

This year's Forum was jointly organized by the Advisory Group and ABAC with ADBI and the Asia-Pacific Finance and Development Center (AFDC) in Shanghai, China in June 2012, with the collaboration of a number of Advisory Group partner institutions.² It built on the conclusions of the 2011 Forum, which identified common basic elements of an enabling environment to promote financial inclusion - financial literacy, financial identity, proportionality of regulations and consumer protection. In addition, it also took further initial discussions on linking microfinance to remittances, which has great growth potential in the context of ongoing regional economic integration. The following are the key messages from these discussions.

Approaches to promoting financial literacy. The utilization of new technologies such as mobile banking is often regarded as crucial to the scaling of microfinance services to reach the unbanked. However, financial education and increasing financial capability are rapidly becoming priority issues as the industry comes to learn that access is not enough for the poor, and that understanding the services available to them is equally important. The success of effective financial capability building requires the attention of multiple stakeholders including policy makers and regulators, the traditional banking sector, microfinance institutions (MFIs) and educational institutions. By making financial education a priority, regulators have an opportunity to provide important support to the industry's health and growth.

Promoting and facilitating financial capabilities for children and youth is important to create financially responsible citizens for the future. Child-friendly regulation and certification for child-friendly banking are examples of ways to realize this. Financial education should be included in the curriculum of educational institutions and teachers unions should also be engaged to secure their support. A standardized financial education curriculum could be developed in line with the interests and needs of children, teenagers and young adults.

Traditional financial education programs are expensive, and new economically viable and efficient methods of delivery are important. The use of public-private partnerships is particularly important as a way of sharing costs and increasing outreach. Governments could also play an important role by defraying the costs to deliver financial education training and simultaneously developing a better understanding of consumers and their levels of financial capability.

Effective promotion of financial literacy and education requires a multi-stakeholder approach with governments playing an active role leading and coordinating activities such as policy orientation, raising awareness and providing data. Greater coordination and alignment of stakeholders are also necessary to ensure efficient delivery and impact. Further guidelines are needed to better facilitate this as they will help the

² Among these were the Banking With The Poor Network, the China Association of Microfinance, Citi Foundation, and The Foundation for Development Cooperation.

industry define and understand the concepts of financial education and product marketing.

Greater involvement of financial institutions in financial education programs is needed. Financial education programs should be combined with access to adequate banking services to build financial capability; thus making financial institutions an important partner in promoting financial literacy. Financial institutions should also pay special attention to the development of products which meet the needs of their clients, noting the need to be cognizant of the distinction between financial education and product marketing.

Financial identity. There exist significant challenges for lower income segments to build the reputational collateral necessary to access formal lines of credit. The main challenges associated with this include establishing a financial identity and building financial histories. Information sharing can contribute to financial inclusion and help to bring people into the mainstream financial system by using alternative data such as utility payments, cell phone bills and rental and remittances payments.

Many economies manage financial identity through national identification data (ID) numbers. However, there are other unique non-financial ID sources which can also provide useful data on individuals for the purpose of establishing financial identity. Using multiple data sources to determine financial identity helps to overcome the difficulty of identifying individuals over the course of many life phases (e.g., name changes after marriage and divorce). Further collaboration with third-party sources (i.e. utilities, telecommunications companies) is needed to explore this potential to deliver positive identity proofing.

Access to a diverse set of microfinance services is important for poor people and household level business. For small and medium enterprises (SMEs) access to credit is particularly important. However, the majority of SME entrepreneurs do not have access to the formal financial sector. This is partly due to their lack of credit information or financial identity which is necessary to access credit. Another issue is the fact that movable assets are often not taken as collateral. Taking movable assets as collateral for SME lending has the potential to make a great impact on financial inclusion. The challenge remains, however, on how to best capture this data.

Regions that have greater access to financial services tend to have greater private sector involvement in credit reporting. So it is very much a matter of public and private sector involvement (credit bureaus). Credit information systems which involve private sector players tend to have a wider outreach. However, consumer protection (i.e. the confidentiality of personal data) also needs to be assured, making the involvement of governments equally important for the development of standards and supervision.

Throughout the region the majority of loans provided are by informal lenders. These informal lenders are also far more capable of reaching the poor, which make up the overwhelming majority of the region's financially excluded population. A key issue for policy makers is to determine how to incorporate these important players in data made available to credit bureaus. This is a critical challenge for regulators, and one which is necessary to overcome in order to achieve true financial inclusion and protect against, for example, over-indebtedness. The development of relevant incentive structures is likely a key element to the solution to this challenge.

While some companies (e.g., telephone companies) or utilities (e.g., water or electricity companies) may not see value in sharing their customer data, there is growing evidence of the business case for them to be more open to this. Some case studies have suggested that rental payment rates improved when clients were informed that it was included in their credit history. Rent and cell phone payments are considered to be the top two of non-financial data streams to have a huge potential for increasing financial inclusion. As such, regulators should seek to include important partners such as companies and utilities in order to achieve greater financial inclusion.

Microfinance regulation. An increasing number of actors are now entering the financial inclusion space. This creates many opportunities as well as challenges. More specifically, there is a need to further assess the informal economy to determine the potential to “work with it” rather than attempt to “fix it” for the benefit of greater financial inclusion. Further exploration of this approach, as well as other new models, are important steps to reach the financially excluded rather than a continued focus on trying to modify current models which are proving inadequate to the needs of the financially excluded.

Within financial regulation and among industry players more broadly, a renewed focus on the client is needed; particularly on those who are currently excluded or unbanked. Policies that are created for service providers need to enable them to deliver products that are geared to the actual needs of those clients. All consumers need the same level of protection regardless of who their provider is. Not all microfinance providers fall under the same regulatory authority, resulting in the greater importance of self-regulation.

However, finding the right balance between self-regulation and formal regulation is difficult. Key challenges are the development of policies on disclosure, fair treatment and effective recourse mechanisms and grievance channels which are also applicable for those not banked by the formal banking sector such as non-government organizations (NGOs), MFIs, cooperatives and non-bank financial institutions (NBFIs). Adequate supervisory capacity to enforce regulation is of equal importance as to the focus on the needs of the financially excluded.

With regard to supervisory capacity, it is suggested that financial sector stability oversight bodies should have the goal of promoting financial inclusion and specific consideration should be given to the development of government councils for financial inclusion.

Effective prudential regulation is necessary to protect regulated financial institutions as well as their clients. Non-prudential regulation, such as regulation for consumer protection, is also very important. However, non-prudential regulation, such as anti-money laundering (AML) and combating financing of terrorism (CFT), can potentially slow the progress of financial inclusion by, for example, stipulating Know Your Client (KYC) requirements which can exclude the poor.

The growth and development of the financial industry tend to move faster than regulation. This is particularly the case with technological innovations, such as mobile banking. The current state of the industry in this regard highlights five key areas where further regulation is required: (a) The industry needs more specific regulation on agent banking (regulation determines which agents are allowed, specifies the role of non-bank agents and non-bank issuers of e-money providers need to be held liable for actions of their agents). (b) Specific requirements are needed for AML and CFT.

(c) Protection of e-money is needed. (d) Consumer protection (specifically consumer understanding, data privacy and security) must be upheld. (e) There should be a legal authority to regulate and supervise providers of mobile banking services.

Regulatory approaches to financial inclusion should embrace the concept of proportionate regulation. The main principles behind proportionate regulation for financial inclusion are: (a) regulation should encourage market development; (b) regulatory initiatives should be subject to cost/benefit analysis; and (c) the regulatory environment should create incentives for market players to more actively engage in financial inclusion.

Consumer protection. Microfinance faces a number of contemporary issues which are often highlighted in the media, such as harsh collection practices, over-indebtedness, high fees and debate on its overall impact on alleviating poverty. To address these issues, collective action and the promotion of international standards is important. Some initiatives such as the Social Performance Task Force and Microfinance Transparency (SMART) Campaign, are global initiatives being undertaken to achieve greater responsible microfinance. These initiatives recognize the potential of microfinance to reach out to the financially excluded, and also function to indicate significant risks and ways to manage those risks. Regulators' input into such initiatives is necessary, not just to acknowledge their importance and promote inclusive finance practices, but also to create linkages with regulatory frameworks.

Noting the above mentioned industry-led initiatives, it is important to recognize that self-regulation and regulation go hand-in-hand. Regulation on consumer protection helps the fair player in the market from unfair competition. For example, price transparency is very hard for an MFI by itself alone to implement, and if others are not following these rules, that MFI will likely be uncompetitive. As such, external regulation is needed for this instead of self-regulation. This is also the same with over-indebtedness. The market cannot be protected by an individual MFI acting alone, or a couple of institutions. Regulation is needed to oversee these important aspects. A key point to acknowledge is that, if regulators pay attention and are seen to be actively engaging with clients in an effort to better understand what is going on, self-regulation will improve.

Established generic laws for consumer protection are useful, but these laws are not adequate on their own for large parts of the financially excluded population. One issue which limits their effectiveness is the fact that supervising bodies are often divided by provider type and do not contribute to the same client protection for everybody (banks, cooperatives, NBFIs, NGOs and MFIs). Regular client protection regulation for commercial banks typically does not apply to most MFIs, which often target a larger and more vulnerable part of the population.

The challenge is often lack of coordination between these multiple sector authorities and supervisors, lack of capacity and often lack of interest, since financial inclusion and client protection are not often regarded as a priority. Establishing a certification process would support the implementation of client protection for the poor. Another reason why general client protection laws often fail is that claims are often too small to justify the transaction costs of a legal process should a case be taken to court. As such, regulation on mandatory recourse procedures or grievance channel is important to addressing this.

In order to achieve a fully financially inclusive world, philanthropic funds will not be enough. Private sector involvement and contribution is essential to achieving this goal. Therefore, it is important that microfinance makes reasonable returns to attract private sector investment. A key challenge to overcome is the additional cost to MFIs of tracking their social performance and who pays for this. Also, a balance will need to be met to manage donor/philanthropic funds, which are typically tied to a social mission, with private sector funds, which have a commercial mission.

The private sector also needs to understand the long-term business case of ensuring consumer protection and social performance so that they too can weigh in their support for this cause when making investment decisions. Regulators can also support with standards for client protection such as: “Do no harm;” “Ethical business practice;” and “Do good.” While all industry standards typically observe points first and second, the third is less recognized. Regulators can play an important role in promoting this third standard by providing incentives.

Facilitating cross-border flows of microfinance. An estimated 220 million migrants worldwide are sending money back home. In 2012, global remittance flows totaled more than US\$395 billion, 40% of which was remitted to rural areas. Most of this money is remitted cash-to-cash with relatively limited use of formal channels. It is further estimated that migrant workers globally currently save almost US\$400 billion as well. Both the remittances and savings of migrant workers represent a huge untapped market.

Remittance flows across the Asia Pacific have greatly increased in recent years and are expected to continue increasing, particularly when taking into account the region’s demographic developments (i.e., East Asia’s ageing population, increased urbanization and greater dependence on foreign workers). As such, cross-border microfinance following the migration patterns represents a significant opportunity for financial inclusion by formalizing the informal remittance and savings channels and developing innovative product designs based upon the actual needs of the clients (i.e., migrants and their families), which will be important for domestic transfers as well, providing significant benefits to households and MSMEs.

Regulators should aim to move migrant workers from cash-to-cash transfer, to account-to-account transfers. Financial education, of both the migrant and his/her family, is crucial to accomplish this as a way to increase awareness of formal channels and strengthen financial literacy. Another important measure would be to allow recipients’ remittances to be considered as an income stream, to help establish credit and credit history.

Linking microfinance with remittances is particularly challenging. Effective partnerships are a key to addressing this challenge since remittance companies are unable to offer services to the migrant’s family and financial service providers (often MFIs and NBFIs) cannot make the transfer or remit the payment transaction for the migrant living abroad. Postal office networks are important partners to tap this market, as well as MFIs, especially for cost reduction and building sustainable business models. To reach the scale needed for the region, telecommunications and mobile money solutions are crucial as well.

To reach the necessary scale, mobile money solutions need to work through agent networks, particularly telecommunication networks. These network agents need to be recognized as banking agents and have clear regulation on KYC and AML

compliance requirements. With regard to the regulatory considerations for using mobile money to scale up to reach all pockets of society, key enablers from the private sector standpoint are: concrete regulations for telecommunication companies, clarity from financial regulators (i.e., license requirements to be allowed to work as an agent) and proportionate regulation regarding KYC and AML compliance requirements for agents..

Another issue regarding the facilitation of cross-border financial services is the need for cross-border data flow, following migration. Cross border migration of businesses and individuals do not accumulate any credit history in the host economy and remittances are not considered as income (in home economies). This makes assessing creditworthiness of migrant workers and their families difficult, if not impossible.

An efficient financial system infrastructure is very important to enable the necessary services for safe and affordable international payments. Remittance costs are still too high for many migrant workers. A World Bank estimate highlights that if the cost of remittance transfers is reduced by 5%, migrants and their dependants could save US\$15 million. To achieve greater financial inclusion, regulators could examine the following aspects of international remittances to determine ways by which costs might be reduced: market transparency (cost of remittance transfer); efficient infrastructure; assure remittance services are sound, predictable and non-discriminatory; create competitive market conditions; and appropriate governance.

The full report of the Forum will be published in the second semester of 2012 and will be widely disseminated.

In addition to the Forum, the Advisory Group held further extensive discussions on three issues that are of great importance to MSMEs: financial regulation, secured lending and credit information.

Financial regulation. Drawing on discussions in a recent capacity building activity it supported,³ the Advisory Group emphasizes the importance of broadening thinking on best regulatory practices and principles in providing a holistic approach to proportionate regulation to promote financial inclusion. To help economies deliver on the objectives of financial inclusion, further capacity building initiatives would be needed. Such initiatives may consist of any or several of the following components:

- sharing experiences between supervisors and regulators in the region on measures they are undertaking to promote financial inclusion;
- understanding the complex policy and administrative issues related to establishing credit reporting bureaus and collateral registries;
- the value of domestic councils of financial inclusion involving public/private stakeholders, their construction, legal base and the strategic directions they should promote;
- sharing of experiences among commercial entities, banks and securities groups, in particular, on viable business models and administrative approaches to

³ The capacity building training program “Implementing Best Regulatory Practices to Support MSME Access to Finance” was convened by the Australian APEC Study Centre at RMIT University on 5-9 March 2012 in Melbourne. For the complete report, please visit <http://www.apec.org.au/docs/12-tp-finincl/SMAFTP%20Report.pdf>.

commercialization, as distinct from seeing financial inclusion through the prism of corporate social responsibility;

- serious attention by regulators and policy makers to adjustments in regulatory approaches with the aim of encouraging the use of technology in the delivery of financial services to the underserved
- development of regulatory approaches which provide for the use of a widening range of authorized agents that can provide financial services to encourage financial inclusion

Secured lending. In its previous reports, the Advisory Group has called for improvements in the legal architecture for secured lending as a means to facilitate inclusive growth. Increasing the predictability and transparency of the legal structure will promote legal certainty, resulting in better risk decisions, improved credit access and increased lending to small businesses. Examples of gaps that need to be addressed are lack of an exclusive security interest registry, which may lead to “hidden lien” and similar issues; unclear perfection rules or lack of coverage of certain types of collateral (movables, receivables, intellectual property), the absence of blocked/pledged account security, untested or non-transparent legal systems, treatment of floating charges and lack of broad licensing authority for commercial lending.

A few APEC economies have some of the best practices on secured lending regimes and creditor protection in the region as well as predictable secured lending regimes that provide a clear and exclusive system for filing broad classes of collateral and perfecting security interests. Policy reforms that promote similar legal clarity will endorse lower risk premiums and encourage increased financing for SMEs. While a number of economies have introduced or modernized key aspects of property registration, collateral laws and bankruptcy codes in recent years, structural impediments remain to certain degrees. The secured transaction laws should aim for a more uniform, exclusive, and transparent system available so lenders can make more informed risk decisions, and eliminate the “hidden lien” problem.

Commercial credit information. For MSMEs, trade credit is the largest source of short term capital (potentially larger than unsecured loans from financial institutions). However, trade credit is dependent on accurate, reliable and timely credit information, which is not universally available. Market infrastructure constraints, lack of regulatory frameworks, and the absence of mandatory and voluntary disclosure retard the process of building effective commercial credit information services. The following key success factors in building effective commercial credit information services have been identified by the Advisory Group, based on a recent survey of credit information suppliers that the Business Information Industry Association undertook on behalf of the World Bank:

- Availability, Quality, Access and Reuse of Public Sector Data: The survey revealed that in many instances, public sector information providers were hostile towards information companies; accuracy, reliability and timeliness was questionable; there was a lack of efficient access, i.e. data transfer; and the high cost of data and the collection thereof was an inhibiting factor. With respect to the latter issue, it was noted that the European Union has taken a different route, by which public sector data is part of infrastructure and is to be provided free, except in cases where special services in data transfer were required. In this connection,

it was also noted that public sector data need to be provided to information companies for reuse of the data and to add value.

- **Disclosure and Compliance**: The survey concluded that if there is no mandatory disclosure one cannot expect voluntary disclosure. This is therefore one of the greatest inhibitors for eliminating asymmetries in information. It was suggested that the EU's fourth directive is a good role model in this regard, enabling the EU to take member economies to the European Court to enforce compliance.
- **Regulatory Framework for Data Sharing**: The survey noted that access to consumer credit information on proprietors and directors of companies are unnecessarily limited by privacy laws restricting the use of information on Proprietors, management and directors, and by privacy laws preventing access to credit bureaus for members of the credit grantors information companies which are outside the financial services sector. The survey concluded that a business owner, manager, partner, and a director of a company is part of the legal registration process and their names are thus in the public domain. Information in how they discharge their private financial obligations should be disclosed to credit grantors with a permissible purpose (granting of trade credit or trade finance for instance)
- **Access to bank information (loan performance data)**: The survey revealed that the absence of data on loan performances in commercial credit information is seen by the credit management profession as a particular impediment for granting trade credit. The lack of transparency regarding bank credit and lines of credit was also seen as a major source of losses and write-downs of accounts receivable during the financial crisis. Companies became insolvent, without warning, because of the sudden cancellation of existing lines of credit by their banks. The credit management community regards this as a major deficiency in transparency.
- **Financial Literacy**: Within the overall framework of transparency, two aspects need to be emphasized. The first is financial literacy. MSMEs need to be financially competent to manage their short- and long-term financial affairs. Providing credit alone is not the answer: MSMEs require assistance in balancing the extension of trade credit to clients as well as maintaining their credit standing with suppliers and financial institutions. MSMEs often find themselves in a cash squeeze: On one side they are confronted with sophisticated credit management systems of suppliers and financial institutions. On the other side MSMEs are confronted with their own shortcomings in credit and accounts receivables management and are therefore vulnerable to credit losses. The second is information literacy, which is an issue very much related to how MSMEs present themselves in their dealings with suppliers and financial institutions. In many of these enterprises, it not uncommon to find the attitude that financial disclosure and regular communication are requirements for large enterprises and that such practices do not apply to them. On the contrary, small and medium size enterprises should adopt disclosure and communications policies for their own good. MSMEs require the competence of managing information in their own business decision making processes, from marketing to the cash flow cycle.

The Advisory Group urges APEC Finance Ministers to develop a multi-year agenda for financial inclusion linked with ongoing efforts by the G20 and international financial institutions, focused on assisting member economies build their capabilities in providing a favorable environment for expanding access to finance

for households and small businesses. We recommend that this multi-year agenda include public-private collaboration in developing robust and sustainable frameworks for financial literacy, financial identity, consumer protection and cross-border microfinance, as well as intensive capacity building for policy makers and financial regulators and supervisors to help them develop and implement effective and proportionate regulatory frameworks for financial inclusion.

The Advisory Group recommends the development of model elements for an APEC code of security interest creation, perfection and enforcement. This includes creating clear perfection rules covering a broad array of collateral types, an exclusive and efficient registry system and broad licensing authority for commercial finance. We also recommend the continuation of public and private dialogue in order to validate improvements, as well as capacity-building focused on encouraging collaboration among justice and law ministries where further Civil Code reforms are needed, information ministries where central e-databases are needed, and SME ministries where it is possible to educate and build support for reforms.

The Advisory Group recommends that policy makers and financial regulators, in partnership with the private sector, promote the development of commercial credit information in the region as a way to improve access to finance by MSMEs. Efforts should focus on key issues, including (a) availability, quality, access and reuse of public sector data; (b) disclosure and compliance; (c) regulatory framework for data sharing; (d) access to bank information (loan performance data); and (e) financial literacy of MSMEs.

IV. FINANCING INNOVATION

Overcoming existing challenges to the financing of innovation is important for maintaining the region's continued rapid economic growth. In last year's report, the Advisory Group identified venture capital as a key element in a broader discussion on promoting innovation and small businesses with tremendous growth potential. Venture capital is an emerging area in the APEC region and some governments and institutions are pursuing activities in this area.

While it has not been possible to replicate in other places, including in the USA itself, the conditions that have made Silicon Valley the pre-eminent cradle of venture capital, the search for ways to develop venture capital across the region's economies continues. In this process, there is much that can be learned from experiences, and the ongoing efforts in many economies from which to draw valuable lessons on what measures can lead to success.

In a workshop convened by the Advisory Group and ABAC in May 2012 in Kuala Lumpur, participants identified several crucial roles that governments need to play in promoting a dynamic ecosystem for financing innovation:

The first is catalyzing angel and venture capital through support programs. Experiences of various economies, including China, Korea, Malaysia, New Zealand and Russia, as well as in economies outside the region such as Brazil, Israel, and the UK, illustrate various ways how such support could be structured. The experience of the Inter-American Development Bank's Multilateral Investment Fund also provides a good example of how lessons can be drawn from successes and failures of

investments in seed and venture capital funds over the years that can be applied to refine later investment strategies. It is important, however, for any government support to succeed, that such support is geared toward commercial success rather than political objectives.

The second, which is indispensable for success, is providing an enabling legal and regulatory environment that will encourage the flow of more private sector resources into venture capital. These include the legal environment (such as laws governing bankruptcy, technology transfer, foreign investment and company organization), tax policies and incentives and protection of minority investor rights, among others. Due to the higher risks involved in the financing of venture capital, governments and regulators need to provide an environment that does not discourage such risk-taking, while ensuring the soundness of the financial system.

Governments need to provide an enabling environment not just for venture capital, but for a whole chain of financial activities that support companies across various stages of innovation, of which venture capital forms part. These stages of innovation stretch from invention and R&D through business plan and market definition, pilot production, marketing/sales/distribution, full commercialization, market expansion/increased penetration and sale of the company or product. This whole process involves a varied set of players including angel investors in the early stages, venture capital in the middle, and private equity, commercial and investment banks and institutional investors such as pension funds in the latter stages.

Exit mechanisms are also important, for which strong local capital markets that allow exits through initial public offerings and local companies that are attractive to strategic buyers must exist.

The third area where governments need to play an important role is in creating, maintaining and enhancing the fundamental conditions that encourage entrepreneurship and innovation, particularly at the incubation stage. These conditions need to provide an environment that is conducive to the growth of micro-, small and medium enterprises, the development of a cadre of good fund managers and human capital, that sufficiently rewards risk-taking and innovation and promotes good corporate governance, transparency, sound risk management, research and development, tie-ups between university and industry, foreign investment and international trade, among others.

International institutions, particularly multilateral development banks, can play important roles not just in catalyzing private investment in venture capital, but also in the discovery of what works and what does not through the documentation of their experiences in multiple economies over many years and identifying factors that account for success and failure.

APEC can have a role to play in helping governments of emerging economies in the region to identify ways of expanding venture capital. It can, for example, provide a platform for public and private sectors and related international institutions such as multilateral agencies to share experiences within and outside the region, to learn from these experiences, to discuss new ideas for policy and to facilitate capacity building for officials and regulators in translating these ideas into action.

APEC senior officials and ministers could collaborate with the private sector within the framework of an APEC Open Innovation Initiative, as proposed by the recent APEC Conference on Innovation and Trade. Through such an initiative, policy

makers can work together with venture capitalists and financial institutions, research institutes, universities, businesses and non-government and other supporting organizations to promote an innovation-friendly business environment, human resources leading innovation and seamless interconnectedness in APEC, with the goal of expanding absorptive capacity for innovation, trade and investment.

The Advisory Group recommends that APEC collaborate with ABAC and the Advisory Group on APEC Financial System Capacity Building under the APEC Open Innovation Initiative to develop public-private partnership mechanisms that can help governments catalyze angel and venture capital through effective support programs, provide the indispensable enabling environments for financing business activities across various stages of innovation, and ensure the fundamental conditions for entrepreneurship and innovation, particularly at the incubation stage.

APPENDIX

THE FORUM ON THE ASIA-PACIFIC FINANCIAL MARKETS INTEGRATION PROJECT

13th March 2012

*Council Chamber, Francis Ormond Building, RMIT University
Melbourne, Australia*

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 2011⁴ 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

⁴ 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).

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 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 region's large pool of savings and thus alleviate double mismatch problems and diversify funding sources.⁵ 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 Banks⁶ (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.⁷ Asian bond markets grew in size from US\$1.4 trillion in 2002 to US\$3.2 trillion by 2008.⁸

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

⁵ 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.

⁶ 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.

⁷ In 2004, Korea and Japan collaborated in issuing cross-border yen-denominated CBO that supported financing of 46 Korean SMEs.

⁸ 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.

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.⁹

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).

⁹ 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 require considerable long-term funding. The recipient of the guarantee pays a guarantee fee on a commercial basis to CGIF. Source: ADB.

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 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.¹⁰

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 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).

¹⁰ 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.

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 economies¹¹ 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 infrastructure¹² and legal and regulatory frameworks¹³ 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.

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

¹¹ These include China, Hong Kong, Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam.

¹² 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.

¹³ 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.

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.¹⁴ 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-2009,¹⁵ 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,¹⁶ an ASEAN Collective Investment Scheme Initiative,¹⁷ wider acceptance of 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

¹⁴ 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.

¹⁵ 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.

¹⁶ 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.

¹⁷ 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.

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 2015.¹⁸ These discussions are currently overlapping with similar discussions on a regional passport scheme under APEC.
- **Market Professionals:** Discussions focus on harmonizing accounting and auditing

¹⁸ 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.

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 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.”¹⁹

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.²⁰

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.²¹ For such secondary markets to develop, a number of basic requirements need to be satisfied:²²

¹⁹ APEC Economic Leaders, Pathways to a Free Trade Area of the Asia-Pacific (Yokohama, Japan, 13 November 2010).

²⁰ R. Levine, 1997. “Financial Development and Economic Growth: Views and Agenda,” *Journal of Economic Literature* 35, pp. 688-726.

²¹ 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 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

- *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 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

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).

²² This listing is based on ideas presented by ASIFMA.

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.²³ 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.

- 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,

²³ 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.

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.²⁴ 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

²⁴ To name a few, these include APEC, ASEAN, ASEAN+3, ASEAN+6, EMEAP and SEACEN.

would have to 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.²⁵

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 development of market infrastructure and regulatory

²⁵ 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.

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.²⁶

²⁶ 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

The road toward regional financial markets integration is complex and challenging. Two 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,²⁷ improve its financial regulatory framework²⁸ and strengthen banking supervision.²⁹ However, the

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.

²⁷ 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.*

²⁸ 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.*

²⁹ 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.*

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 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.

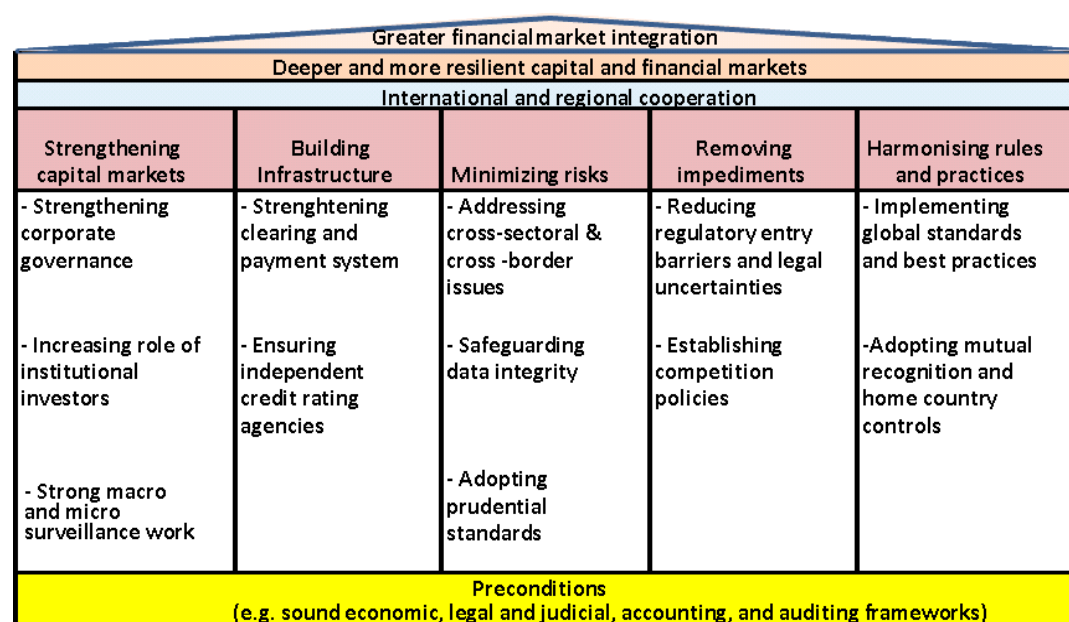
From a regulatory perspective, a key challenge in designing the integration of financial markets is the great diversity and varying levels of maturity of markets across the region. In this context, a regional financial integration agenda will need to overcome three important roadblocks. First, the region 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.³⁰ 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

³⁰ 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.

using a similar framework in advancing financial integration and playing a more active role in shaping global standards and practices.

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.

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;
 - 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.³¹ 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,

³¹ 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.abaonline.org/v4/content.php?ContentID=1304>.

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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

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. Sungsaï, 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