



# THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

## **2013 REPORT ON CAPACITY BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS**

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*Summary of Recommendations*

This year, the Advisory Group built upon the results of its past activities to significantly advance the agenda for developing sound and integrated financial markets, promoting private financing of infrastructure and accelerating the pace of financial inclusion. It also resumed its focus on the legal architecture governing financial transactions, the role of credit rating agencies in encouraging greater cross-border investment and the prospects for catalyzing more investment in innovative enterprises through angel and venture capital. The Advisory Group undertook a number of activities to discuss these issues. The results of these discussions are reflected in the following conclusions and recommendations.

**CREATING A PLATFORM FOR PUBLIC-PRIVATE COLLABORATION TO DEVELOP THE REGION'S FINANCIAL MARKETS**

In 2012, APEC Finance Ministers welcomed ABAC's proposal to explore the creation of the Asia-Pacific Financial Forum (APFF), a regional platform for public-private collaboration to help accelerate the development of integrated financial markets. A symposium hosted in Sydney by the Australian Government for this purpose underscored the importance of such collaboration in promoting financial market development that supports the needs of the real economy and regional aspirations for sustained, balanced, inclusive and innovative growth. APFF can add value to ongoing initiatives under various fora by bringing the private sector to work with public officials to identify crucial gaps not yet currently being addressed and unintended consequences of new regulations, as well as to help financial authorities take a more active role in shaping global financial regulatory standards. The Advisory Group also notes the progress of the Asia Region Funds Passport (ARFP) initiative, which it has recommended to APEC Finance Ministers in 2010.

- *The Advisory Group recommends that APEC Finance Ministers endorse the launch of the Asia-Pacific Financial Forum (APFF) based on the work program priorities proposed in the report of the Sydney Symposium.<sup>1</sup>*
- *The Advisory Group commends the development of the Asia Region Funds Passport (ARFP) and recommends that officials increase their engagement with market participants as the initiative is progressed.*

**ESTABLISHING A REGIONAL FRAMEWORK TO PROMOTE PRIVATE FINANCING OF INFRASTRUCTURE**

Significant amounts of savings and private sector know-how can be harnessed to help the region meet its needs for higher quality infrastructure at lower cost to taxpayers and users. However, governments need to work closely together with the private sector and multilateral

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<sup>1</sup> To view the full report, please refer to <https://www.abaconline.org/v4/download.php?ContentID=22611284>.

institutions to provide a conducive environment. Dialogues with several economies undertaken by the Asia-Pacific Infrastructure Partnership (APIP) have highlighted key elements: coordination and collaboration among agencies; deeper understanding of risks and which parties are best positioned to assume each of them; strong, credible and creditworthy public institutions; capacity for policy reforms, planning, transactions and viability gap finance; clearly communicating priority sectors and projects; and long-term local currency finance.

- ***The Advisory Group recommends that APEC Finance Ministers establish a regional framework under a multi-year initiative to coordinate capacity building and sharing of best practices in infrastructure finance, with the collaboration of the APIP.***

#### **HARNESSING INNOVATION TO EXPAND FINANCIAL ACCESS OF LOW-INCOME HOUSEHOLDS AND SMALL ENTERPRISES**

Innovation promotes financial inclusion by significantly reducing the costs and increasing the efficiency of financial services being offered to low-income households and small enterprises. The 2013 Asia-Pacific Financial Inclusion Forum hosted by the Indonesian Government and convened through the Advisory Group by ABAC and its partner institutions and a training program hosted by the Australian APEC Study Centre at RMIT University identified various measures that can help governments harness innovation to promote financial inclusion.

- ***The Advisory Group proposes that APEC economies commit to policy reforms to facilitate the delivery of mobile and branchless banking and remittances and to improve the market infrastructure, particularly payment and credit reporting systems and secured lending frameworks; and to undertake capacity building to promote innovative approaches and effective financial education and consumer protection regimes.***

#### **UNDERTAKING LEGAL ARCHITECTURE REFORMS TO PROMOTE FINANCE**

Well-defined legal systems with effective enforcement mechanisms expand funding and lower borrowing costs, especially for SMEs, as well as for projects that require foreign financing, by providing a highly predictable environment that reduces non-commercial risks faced by lenders and investors. Measures in the areas of secured lending (particularly in relation to security interest creation, perfection and enforcement, floating charges and accounts receivable financing) and insolvency, where lenders and investors in the region face major issues, will significantly benefit member economies.

- ***The Advisory Group proposes the endorsement by APEC Finance Ministers of the documents “Elements of a Model Code of Security Interest Creation, Perfection and Enforcement” to guide reforms in member economies and the “Asia Pacific Informal Workout Guidelines for Promoting Corporate Restructuring in the Region” and “Model Agreement to Promote Company Restructuring.”***<sup>2</sup>

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<sup>2</sup> To view these documents, please refer to the following pages on the Advisory Group section of the ABAC website:

- Elements of a Model Code of Security Interest Creation, Perfection and Enforcement: <https://www.abaconline.org/v4/download.php?ContentID=22611282>
- Asia-Pacific Informal Workout Guidelines for Promoting Corporate Restructuring in the Region and Model Agreement to Promote Corporate Restructuring: <https://www.abaconline.org/v4/download.php?ContentID=22611283>

## **ENHANCING THE POTENTIAL OF CREDIT RATING AGENCIES TO FACILITATE CROSS-BORDER INVESTMENT IN LOCAL CURRENCY BOND MARKETS**

Robust and reliable credit ratings that are comparable across markets can promote cross-border bond investments and greater market depth and liquidity. Much remains to be done to create favorable conditions for domestic credit rating agencies (CRAs), the dominant industry players in the region's emerging bond markets, to provide such ratings. Key challenges are divergent rating practices; the technical difficulty of using domestic ratings to compare issues across borders; varying levels of development, accounting standards, disclosure practices and legal and regulatory regimes; and insufficient trust of investors in relatively young domestic CRAs.

- *The Advisory Group recommends that APEC Finance Ministers endorse a project to develop a regional guidebook on common basic rating methodologies and basic rating criteria for key industries and sectors with the collaboration of the Association of Credit Rating Agencies in Asia; convergence of accreditation criteria for CRAs across markets; and convergence of financial standards and regulations to facilitate comparable credit ratings across markets.*

## **CATALYZING INVESTMENT IN INNOVATIVE ENTERPRISES**

Government and private sector collaboration is needed to establish a thriving and sustainable innovation ecosystem, with the role of government focused on mobilizing angel and venture capital through effective support programs, providing enabling environments for financing business activities across various stages of innovation, and ensuring the fundamental conditions for entrepreneurship and innovation. APEC can play a role in promoting the development of regional innovation by exploring the creation of APEC-oriented funds-of-funds that are public-private partnerships investing in private sector-led venture funds operating in the region and specializing in the various sectors where there are significant potential for innovation.

- *The Advisory Group recommends the development of government-encouraged funds of funds within APEC for seeding and growing a private sector-led angel and venture capital ecosystem in the region and that interested economies and multilateral institutions collaborate with ABAC and private sector firms to initiate this process.*

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Building on the core message of its previous reports, the Advisory Group continues to advocate measures to address fundamental issues underlying internal and external imbalances in advanced and developing economies that have led to the current difficult global economic situation. The Advisory Group's discussions over the past several years have led to the conclusion that ensuring continued robust global economic growth would require expanding the world economy's growth potential, particularly through increased consumption and business activity in emerging markets. Developing APEC member economies, in particular, have significant potential to turn the region into a major engine of more sustained global economic growth.

In order to do so, however, they would need to address the underlying factors that constrain growth of domestic consumption and investment. Among these are underdeveloped financial markets and institutions, in particular those that can channel savings into long-term investment; inadequate access of small enterprises and the large low-income segment of the population to financial services; and policy, institutional and financial obstacles to expanded private investment in infrastructure and innovative enterprises. Capacity building has an important role to play in addressing these constraints.

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 six sections: (a) creating a platform for public-private collaboration to develop the region's financial markets; (b) establishing a regional framework to promote private financing of infrastructure; (c) harnessing innovation to expand financial access of low-income households and small enterprises; (d) undertaking legal architecture reforms to promote finance; (e) enhancing the potential of credit rating agencies to accelerate cross-border investments in local currency bond markets; and (f) catalyzing investment in innovative enterprises.

**I. CREATING A PLATFORM FOR PUBLIC-PRIVATE COLLABORATION TO DEVELOP THE REGION'S FINANCIAL MARKETS**

In 2012, the APEC Business Advisory Council (ABAC) proposed the establishment of an Asia-Pacific Financial Forum (APFF), a regional platform for enhanced public-private collaboration to accelerate the development of robust and integrated financial markets in the Asia-Pacific. At their meeting in Moscow, the APEC Finance Ministers welcomed the idea behind this proposal and supported the holding of a symposium to explore the creation of the APFF and the Australian Treasury's offer to host the event.

The symposium was co-organized by ABAC through the Advisory Group on APEC Financial System Capacity Building and hosted by the Australian Government in Sydney on 10-11 April 2013. A total of 98 participants representing a wide spectrum of organizations in the region's public and private sectors as well as international institutions, standard-setting bodies and academic and research institutions attended the event. *(To view the full report, please refer to <https://www.abaonline.org/v4/download.php?ContentID=22611284>.)*

Participants discussed the state and evolution of Asia-Pacific financial markets, their role in the region's development agenda, and the regulatory frameworks and market infrastructure that are needed to accelerate the development and integration of these markets. Participants discussed how the proposed APFF can add value to ongoing domestic and regional initiatives, what priority issues would be useful to include in its work program, and the kind of structure and process that would be most effective in advancing its work.

In the context of the current global economic situation, governments and the private sector in the Asia-Pacific region bear a serious responsibility for the future of the global economy. While comprising roughly a third of global GDP, the region is now responsible for half of global economic growth. As the ability of traditional consumer markets in Europe and North America to continue absorbing the finished goods exports of the region's emerging markets wanes, economies in the region will need to shift away from the export-dependent economic growth model. Rebalancing toward a model that is increasingly driven by domestic and regional demand will require significant increases in domestic consumption supported by strong investment growth.

Financial markets have an important role to play in this transformation. Before they can do so, however, they need to evolve from the current structure that remains excessively reliant on bank funding to one that provides greater diversity of financing sources, with a larger role to be played by deep and liquid capital markets and institutions that can provide long-term finance, especially for infrastructure development. Financial systems also need to become more inclusive in order to economically empower larger portions of the population and create a broad-based economy that can ensure sustained economic growth.

Financial markets require strong foundations in order to develop in a sustained way and avoid instability. Sound legal and regulatory frameworks that allow markets to develop and encourage financial market players to contribute to broader economic development goals, cost-effective and efficient market infrastructure that supports intermediation, risk management and related market activities, and an environment that fosters good governance are basic requirements that need to be put in place.

In conjunction with these necessary requirements, regional financial integration – including greater competition, convergence of regulations and market practices and greater connectivity across markets and market infrastructure – will enable the region's financial markets to achieve economies of scale and greater depth and liquidity. It will enable market participants to become more efficient, innovative and competitive. It will enable households and individuals to have more and better choices for their financial services needs, including savings, insurance, investment and payments. It will enable enterprises to have better access to finance at lower costs.

Putting all these elements in place within a time frame that satisfies the urgency of the task is a great challenge that requires much cooperation among a variety of institutions and agencies and the private sector within and across economies, in collaboration with relevant multilateral and standard setting bodies and other institutions that can provide expertise. While a number



of collaborative initiatives to develop and strengthen markets such as those under the ASEAN, ASEAN+3, EMEAP and APEC frameworks are already under way, they are not yet sufficient to address all the important issues.

This is a challenge for the region, but also an opportunity for APEC to make a significant contribution. APEC can leverage its unique arrangements for close collaboration between public and private sectors, and in particular the partnership among finance ministries, ABAC and international organizations within the framework of the APEC Finance Ministers' Process (FMP). These collaborative arrangements, which have evolved over time through cooperation in various fields such as bond market development, financial inclusion and infrastructure finance, have given rise to a flexible and effective second-track approach to generating useful advice to governments that can operate without the constraints that official structures often have to contend with.

As an informal, inclusive and advisory public-private platform managed by the private sector, the APFF can focus on important issues cutting across the variety of regional and international initiatives and institutions. Through this process, APFF can help design policies that will encourage and enable market participants to direct their business and commercial activities to the development and integration of the region's financial markets. In this context, the APFF has the potential to become a bridge among many institutions and organizations that are striving toward the same goal and to facilitate synergy among them.

Participants agreed on a number of priorities for consideration as part of the proposed APFF work program. Priorities were selected based on their expected impact on the development and integration of the region's financial markets and their complementarity with ongoing initiatives and existing institutions. Participants also selected priorities that may realistically be dealt with through initiatives that could yield tangible results within a short- to medium-term time frame harnessing the Advisory Group's network and resources that are or can reasonably be assumed to be available. Following are the priority issues that emerged from these discussions:

- *Development of the region's insurance industry as a provider of long-term investments.* More efforts are needed to enable the insurance industry to play its proper role of supporting long-term financial stability, economic and infrastructure development, trade expansion and social stability and inclusion, particularly by examining more closely how regulatory requirements affect this role. Collaborative action can be helpful in developing common approaches to global regulatory, accounting and other relevant standards and regulations that discourage insurers from acting as long-term investors. Another area where efforts may be focused is promoting harmonized interpretation of macro-prudential insurance regulatory requirements, taking into account differences in characteristics, needs and levels of development among jurisdictions and recognizing the specific nature of insurance.
- *Development of retirement income policies.* This aims to respond to needs arising from demographic trends (aging) and to promote accumulation of long-term funds and their investment in government and corporate sectors and long-life infrastructure assets. Efforts should cover the range of relevant public and private institutions and structures, including sovereign wealth funds, official off-budget and on-budget structures, pension funds, insurance companies, self-funded retirement and investment in bonds and enterprise annuities. Activities should focus on providing advice on a number of key issues. These include development and funding of retirement systems. They

include suitable and practical design, structure and regulation that can foster sustainable, stable and trusted institutions, as well as support economic incentives. They should also include public-private sector financial literacy initiatives that encourage long-term savings.

- *Facilitating full-file, comprehensive and accessible credit reporting systems.* This responds to the need for promoting expanded financial access of households and small businesses in conjunction with sound, risk-based credit decisions and responsible credit behavior. Efforts should aim to help policy makers introduce full-file and comprehensive credit reporting systems and encourage the establishment and expansion of private credit bureaus. These should be done in conjunction with advice on the development of legal and regulatory frameworks to protect consumers and privacy, and converging approaches to data privacy protection and cross-border data flows that promote regional integration.
- *Improving legal frameworks for secured financing.* Measures are needed to address gaps in the legal regime for secured lending, which create disincentives for creditors to extend loans to mid-market companies, resulting in increased cost and decreased availability of credit. Addressing this requires enhanced certainty and transparency in the legal regime, through such measures as unified collateral registrations systems, elimination of hidden liens, expanded definitions of eligible collateral, and assignability of claims, among others. Focus will need to be given to improving the ease, predictability and transparency of security interest creation, perfection and netting enforcement by identifying model elements and on the basis of these, developing a secured lending model code that can help guide legal reforms in the region's economies. These will require dialogues among relevant authorities, especially those with direct responsibility over these issues, as well as capacity building to promote deeper understanding and support for legal reforms in this area.
- *Facilitating trade finance.* There is a need to address the gap in trade finance in the region arising from the scaling back of Asian operations by European banks, which are major players in this business, as a result of challenging economic conditions at home and consequent pressures on them to reduce their balance sheets, increase their capital and repatriate their assets. Work is needed to address regulatory issues, particularly minimum capital requirements that require more regulatory capital to be set aside to back trade finance transactions, affecting the availability and cost of trade finance. Attention also needs to be directed to the promotion of collaborative undertakings among the public and private sectors, multilateral institutions and regional organizations to ensure availability of adequate financial support to trade.
- *Addressing market infrastructure issues to facilitate cross-border investment flows.* Issues concerning trading, clearing and settlement infrastructure across markets in the region need to be addressed to improve efficiency and price discovery and reduce trading costs in bond and equity markets. Undertakings will need to focus on promoting cross-border investment flows with collateral, standards and platforms that can harmonize local market practices, improve the inter-operability, liquidity and connectivity of domestic and cross-border financial markets, and reduce systemic risks. The proliferation of clearing venues within the region, which threatens to increase fragmentation across markets and collateral requirements, also needs to be addressed through collective efforts to resolve differences and harmonize approaches with

respect to clearing, collateral management, trade repositories and development of electronic exchange venues.

- *Enhancing capital market integrity.* Common standards and high quality of corporate governance across economies in the region are vital for attracting investors to the region and raising funds across asset classes. This involves the development of standards for fair, transparent and predictable resolution regimes, benchmarking issuer governance standards for market entry, and improving the transparency of information for investors through a concrete undertaking to help promote consistency of accounting rules and credit culture.
- *Improving capital market quality.* Asian markets have made significant progress in this area since the Asian Financial Crisis, as proven by the limited impact that the GFC has had on the region. However, much work remains to be done to help develop corporate bond markets and expand cross-border transactions. Key issues involved in this undertaking include (a) the development of classic repo markets and hedging structures for both government and corporate bonds; (b) the development of a roadmap toward a regional funds passport through harmonization of access requirements to local markets and standardization of platforms; and (c) the development of a platform for providing standardized market information to fund managers, such as through development of indexes.
- *Responding to the extra-territorial impact of new regulations in major markets on Asia-Pacific capital market development.* Legal and policy measures that have extra-territorial impact are a source of concern across markets and asset classes in the region, and require collective efforts among governments to address their implications. This will involve discussions to identify those extra-territorial effects that significantly affect the development of the region's capital markets and develop appropriate and effective responses to cope with them at the domestic and regional levels and to initiate fruitful dialogues at the global level. Examples of these issues are the new US and European OTC derivatives rules which may encourage the withdrawal of participants from markets and negatively affect the ability of end-users to hedge risks.

Symposium participants explicitly confirmed the need for establishing the APFF. They identified the needs and aspirations of the region's economies and the ongoing processes that characterize the development of the region's financial markets. They identified the principal challenge as building the institutions and structures through which savings can be channeled into the kind of investments, particularly long-term investments, which will meet the most important needs of the region.

Participants agreed on a basic initial structure for the APFF and the cast of institutions and players who need to be involved in its development. They agreed to propose that ABAC, utilizing the Advisory Group's network, be responsible for developing its activities under the institutional structure of the APEC FMP, in collaboration with interested ministries and institutions that play important roles in the development of policies and regulations affecting the various components of financial markets.

The Advisory Group also notes the progress of the Asia Region Funds Passport (ARFP) initiative, which it has recommended to APEC Finance Ministers in 2010. Preparations are under way to submit for Finance Ministers' approval in this year's annual meeting a

framework document setting out the principles, implementation and governance of the ARFP, and to have a statement of intent signed by economies deciding to participate.

Finally, the Advisory Group discussed this year the role of valuation in financial markets. Its importance as the basis for investment decisions, measuring performance and disclosure in financial reporting has been growing, most especially since the publication of new International Valuation Standards in 2011, covering a range of asset types including intangibles, real estate, business interest and financial instruments.

The contribution of valuation to the development and stability of financial systems can be increased by addressing important challenges – a fragmented professional and regulatory landscape, the multiplicity of bodies producing regulations related to valuation and the lack of professional infrastructure and common benchmark for the profession. The Advisory Group hopes to devote more attention in the future to examining how the public and private sectors can collaborate in APEC to support the development of high quality valuation, ethical, educational and related quality assurance and disciplinary standards based on global benchmarks.

*The Advisory Group recommends that APEC Finance Ministers endorse the launch of the Asia-Pacific Financial Forum (APFF) based on the work program priorities proposed in the report of the Sydney Symposium.*

*The Advisory Group commends the development of the Asia Region Funds Passport (ARFP) and recommends that officials increase their engagement with market participants as the initiative is progressed.*

## **II. ESTABLISHING A REGIONAL FRAMEWORK TO PROMOTE PRIVATE FINANCING OF INFRASTRUCTURE**

Promoting greater private sector participation in infrastructure is important due to the benefits of additional financing to supplement inadequate public sector resources, mobilizing the know-how and technology in the private sector to increase the efficiency of infrastructure, and creating the long-term assets to match the investment needs of aging societies. Achieving this requires generating infrastructure projects that are not only cost-effective and have significant impact on economic development, but also provide attractive risk-adjusted returns to lenders and investors.

Many of the region's emerging markets, where there is a considerable need for infrastructure to sustain economic growth, face a number of challenges in providing a conducive environment for private financing of infrastructure. The Asia-Pacific Infrastructure Partnership (APIP) was established in 2011 upon the recommendation of the Advisory Group and ABAC to provide a regional platform for collaboration among the public and private sectors and multilateral institutions in addressing these challenges and creating a favorable environment in the region for Public-Private Partnerships (PPP).

Since its establishment, the APIP has undertaken several high-level dialogues with a number of economies – with Mexico, Peru and the Philippines in 2011, Vietnam and Indonesia in 2012, and the Philippines (follow-up dialogue) and Thailand in 2013. These dialogues have highlighted several key issues. Among these are:

- lack of capacity to prepare bankable projects that can provide a robust pipeline, as well as capacity for policy reforms and planning;

- the need to better understand risks, which parties are best able to take on which risks in which sectors, and how best to allocate these risks among public, private, multilaterals and other relevant institutions;
- the need to have a transparent and efficient legal and regulatory environment that can reduce risks to the minimum possible;
- need for mechanisms to mitigate risks that the private sector cannot cover;
- lack of long-term local currency finance;
- need for more coordinated and coherent public sector approach to PPPs; and
- importance of having credible and creditworthy public counter parties

These issues revolve around three challenges: capacity, collaboration and financial markets.

- *Capacity:* In many economies, there is a need for more capacity to prepare bankable projects and a pipeline of such projects, capacity to effectively undertake long-term infrastructure planning and transactions, and capacity to improve the credibility, creditworthiness, governance and management of counter parties and institutions in the public sector.
- *Collaboration:* There is a need to bring closer together relevant parties to collaborate and dialogue in order to bridge information asymmetry and design effective solutions. These relevant parties are, from the public sector, relevant ministries, line agencies, off takers, public financial institutions and local governments. From the private sector, they include investors, lenders, operators, developers, and relevant legal and academic experts. Others are multilateral institutions, export credit and development assistance agencies, and local communities. It is important for these parties to be brought together to have a better understanding of risks and how they may be most effectively allocated and mitigated, to better design tax systems, legal and regulatory frameworks, procurement policies and land policies, and to identify the areas where resources for capacity building could be focused with maximum results.
- *Financial markets.* The lack of long-term local currency financing is a major bottleneck in a number of economies. The long-term solution to this is the development of the insurance and pension fund industries, robust legal and regulatory frameworks and market infrastructure and practices. In the meantime, multilateral institutions, export credit agencies and local institutions need to work together to make more funding available for specific projects.

APEC can make significant contributions to meeting these challenges. First, it can help establish a regional platform that can help bridge information asymmetries and help member economies design effective policies and projects. This regional platform may take the form of a regional infrastructure panel under the APEC FMP that can bring together finance ministries, relevant public sector agencies and bodies, multilateral institutions and the private sector. APEC can engage APIP to promote effective private sector participation in this regional platform, expanding its role beyond the current focus of dialogues with individual governments.

Second, APEC can help economies build capacity for long-term planning and for managing transactions through a multi-year infrastructure policy initiative under the APEC FMP. Such an initiative can provide synergy among various efforts already being or being planned to be undertaken by multilateral bodies, export credit agencies, private financial institutions and academic centers. It would also provide an opportunity to systematically share experiences among member economies and compile best practices. One important area identified as

crucial in several APIP dialogues that can be a focus of initial activities is the development of PPP centers at the domestic and regional level.

*The Advisory Group recommends that APEC Finance Ministers establish a regional framework under a multi-year initiative to coordinate capacity building and sharing of best practices in infrastructure finance, with the collaboration of the APIP.*

### **III. HARNESSING INNOVATION TO EXPAND FINANCIAL ACCESS OF LOW-INCOME HOUSEHOLDS AND SMALL ENTERPRISES**

Innovation promotes financial inclusion by significantly reducing the costs and increasing the efficiency of financial services being offered to low-income households and small enterprises. The 2013 Asia-Pacific Financial Inclusion Forum hosted by the Indonesian Government and convened through the Advisory Group by ABAC, ADB Institute and the Foundation for Development Cooperation in collaboration with various partner institutions<sup>3</sup> identified various measures that can help governments harness innovation to promote financial inclusion.

The published full report of the Forum will be distributed separately to APEC Finance Ministers and other relevant officials and regulators. The following are its key messages:

*Mobile and Branchless Banking.* Branchless and mobile banking solve one of the key challenges for banks to drive financial inclusion by increasing their reach, lowering costs and extending the product mix to new consumers. Partnerships with third party distribution networks (agents) are critical to extend beyond the traditional branch based distribution model. Banks should explore innovative ways and alternative data to assess risk and extend lending products to the poor and the unbanked, beyond basic payments services. In order to succeed, banks must think of unique processes and systems to cater to this segment different from their traditional way of doing business.

Mobile and branchless banking is a key enabler to increase access to financial products and services and represents a significant opportunity to bank the unbanked. However, it is a multidimensional issue involving several elements such as: domestic policies for financial inclusion, financial products and services development, regulatory frameworks, cooperation amongst stakeholders and consumer perspectives. As such, the development of mobile and branchless banking services requires a holistic approach to address challenges from multiple angles and perspectives.

Mobile and branchless banking systems involve a greater number of stakeholders who are not traditionally involved with the financial sector or in providing access to the un-banked (e.g. Mobile Network Operators (MNOs), agent aggregators, payment companies, technology companies, etc). A greater effort needs to be made to include these stakeholders in the conversations and programs; and furthermore, a greater amount of coordination is required to facilitate the cooperation amongst each of the players.

Much has been done throughout the region to progress and develop mobile and branchless banking opportunities. There is a need for private actors and for policy makers to assess the environment and identify what has and has not worked well with the aim of identifying what could be “best-practice.” A “one-size-fits-all” model is not realistic, however, as the

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<sup>3</sup> These included CGAP, the International Finance Corporation (IFC), the Association of Development Financing Institutions in the Asia-Pacific (ADFIAP), the Asia-Pacific Credit Coalition (APCC) and the Banking With the Poor Network (BWTP). The forum was sponsored by Citi Foundation.

needs of the poor in each economy varies significantly. Therefore each economy will have to adapt these best practices according to the local stakeholder needs.

While mobile and branchless banking represents significant opportunity to assist the poor, serious challenges remain. One crucial challenge to overcome is the number of inactive clients currently found within many cases of implementations. This is mainly due to a lack of in-depth understanding of the needs of different consumer segments within the unbanked and underserved population. By better analyzing the specific demand of these segments, banks, MNOs and other key actors would be able to customize their product value propositions and marketing approach. A greater emphasis is needed across all stakeholders on understanding the needs of the consumer in order to ensure that appropriate products are developed.

Under certain scenarios, policy makers in the government can take steps to encourage interoperability between payment schemes to encourage further scaling of the programs (e.g. Bank Negara in Malaysia spurred the establishment of “MyMobile”, an interoperable mobile financial services program which has participation from three MNOs and three banks).

*Retail Payment Systems.* Distribution channels, communication technology and e-money products and services will support product innovation and client and risk analysis, thus leading to new value propositions on financial services. Retail payment systems have the potential to broaden financial inclusion; however, this potential is limited to how well the needs and demands of clients are understood. Stakeholders need to put more effort into understanding the needs of their clients in order to maximize the potential impact retail payment systems have for financial inclusion.

There are currently too many independent entities operating within the retail payment space which is resulting in inefficiencies and disruptive practices. Greater collaboration is needed and stakeholders should look to each other as potential partners rather than attempting to operate independently.

*Remittances.* Innovation in remittances is continuing at a rapid pace, indicated by new sending mechanisms and enhanced services that are benefiting more customers. The market for mobile-based remittances is expanding with consumers becoming more accustomed to the services, a growing number of partnerships among stakeholders, and customer benefits being proven.

Financial viability of remittance related products and services is still an issue, but long-term prospects are attractive in view of the growth of the remittance market and its business potential. Flows from developed to developing economies currently predominate, but the case of Latin America shows that the share of remittance flows among developing economies are increasing. As such, significant growth of intra-regional flows should be expected in the future.

Regulatory environment, market infrastructure and customer education are major challenges for the growth and expansion of the remittances market. Innovations are providing significant benefits to migrant families through lower prices; however, the impact varies across regions with Asia, and to a lesser extent Latin America, relatively behind other parts of the world in bringing down the cost of remittances.

There is a great opportunity to harness remittances to achieve greater financial inclusion for

the unbanked and more work needs to be done to promote and enhance its benefits including: facilitating access to services, providing financial education and supporting the expansion of services of banks and other financial institutions.

More dialogue is needed between the public and private sectors to develop an appropriate policy and regulatory environment that will support the development of the remittance market. These discussions should focus on developing an understanding of the remittance environment, constraints and development needs of the market infrastructure, identifying and understanding the roles of various stakeholders and effective business models.

*Financial Infrastructure: Legal Frameworks for Secured Lending.* Unlocking the value of movable assets (“movables”) through financing will help to increase financial inclusion to the unserved and underserved clients, especially small and medium enterprises (SMEs). Increasing access to credit in turn achieves a greater purpose i.e. to create employment and alleviate poverty by developing a sustainable conduit for social and economic development. These will require a number of reforms to the legal system which enables secured transactions--the taking of movable assets as collateral for credit. In the unreformed economies, secured transactions reform (STR) typically entails the development or revision of secured transactions law, the establishment or improvement of collateral registry, and the development of movables-based lending practice.

Secured transactions reforms, aiming to create a more inclusive financial eco-system, can produce significant benefits including increased transparency, enforceable laws, and providing incentives to both lenders and borrowers. Throughout the process of such reforms, it is crucial to capture the perspectives of the market to ensure that the proposed reform measures are meeting the needs of lenders and borrowers so that any framework for secured financing can, indeed, lead to greater access to financial services for the unserved and under-served segments of the economies, such as rural clients, micro businesses and SMEs. These priority clients often do not have real estate collaterals that are acceptable to the lenders; but, they all have some movable assets (accounts receivable, inventory, equipment, intangible property, etc.) which can be used as the basis for borrowing.

Based on the experience of a number of APEC economies (e.g., Vietnam, China, Mexico), legal reform and the development of collateral registry alone are not sufficient to create a viable movables lending market. Among others, the government authorities and regulators can be more active in creating an enabling environment; lenders need to build up capacities in movables businesses; collateral management companies and other service providers should be developed; and some movables financing electronic platforms linking up the lenders and borrowers (including suppliers, buyers and services providers along value chains) can be set up.

*Financial Infrastructure: Financial Identity and Data Flows.* Traditional data taken from bank loans or retail credit is limited in that it only applies to borrowers that are already in the system. Alternative or non-traditional data provides an additional assessment angle based on the client’s reputation and makes it possible to provide identity profiling for the financially excluded through validation of consistent identity over time. By substituting reputation for collateral, basic asymmetries of lending can be overcome and lending can be expanded to many currently excluded categories. Examples of alternative data include: post payments such as energy and water utility payments, landline and wireless phone bills; remittance payments and stored value cards; prepayments on cell phones, utilities or education expenses; and agricultural production and transaction.



Establishing a financial identity has many potential benefits which could lead to significant impact on poverty alleviation through increased access to financial services. Some of these potential benefits include: decline in accounts in arrears; improving cash flow; reducing costs; increasing credit access; enabling lenders to evaluate credit risk more accurately; enhancing borrower discipline; and facilitating equitable lending to underserved communities.

When considering the options for establishing financial identity, policy makers must achieve a delicate balance that includes consumer rights and protection, creation of an environment that attracts and sustains investment and the choice between a gradual or rapid change approach. A “one-size fits all” approach is not possible and so frameworks used in other economies will need to be adapted appropriately. Policy makers should also be encouraged to be creative and take chances in addressing problems faced and ensure that they manage an appropriate balance between prudential risk and consumer protection.

*Innovative Institutional Frameworks.* A “best-practice” institutional framework requires both technology-driven efficiency and solutions to leverage local knowledge. This local knowledge is the strength of traditional microfinance institutions that keep close relationships with poor clients and understand their behavior.

While applying new technologies to delivery channels for inclusive financial services, less attention has been given to the development of financial products which are suitable to the poor. To achieve greater financial inclusion product development needs to be based upon further learning from the poor and their behaviors as well as possible financial viability for providers.

A holistic approach to clients’ livelihoods and linkage formulation are key elements for an innovative institutional framework. Financial services are one of the indispensable means to livelihood improvement and should be combined with other means, such as capacity building, market development and rural infrastructure, in a mutually enhancing manner. Linkage formulation refers to connectivity development among clients’ organizations such as cooperative federations, financial services providers, government agencies, private businesses and others, and among stakeholders through a value chain in an industry. These linkages are important to empower the poor and enhance their creditworthiness, to achieve a business case by scaling-up and to create affordable and reliable financial services to both poor households and MSMEs.

Consumer protection is of paramount importance within institutional frameworks, especially with technology-driven financial services which are quite new to consumers both in emerging and developed economies.

*Financial Education and Consumer Protection.* Financial sector complaints are on the rise. This highlights the need for common consumer protection principles. However, the current range of established principles fall short with regard to transparency and disclosures which are crucial for meeting the needs of adequate consumer protection. Thus, principles aiming to support this need to be clear and comprehensible. Furthermore, while global principles and standards for consumer protection are useful, economy specific principles are also needed to ensure that the local context is being appropriately met.

Financial education has a significant role in achieving greater financial inclusion as it enables behavioral changes of the targeted groups resulting in their capable use of financial products and services. Financial education is a life-long initiative, however, and it is

interlocked with other important aspects such as consumer protection and access.

Financial innovations require consumer protection to be dynamic, especially with regard to security of payments. There is a direct correlation between consumer protection and uptake/usage of financial innovations, particularly among low-income clients, with stronger consumer protection measures, including better redress mechanisms, resulting in increased uptake.

Regulation should not limit financial innovation, but rather should be used to create incentives to support the development of new services. The strengthening of an appropriate policy and regulatory framework will promote greater financial education and consumer protection. In this regard, regulators, consumers, and protection agencies need to be dynamic and resilient in order to respond to the rapidly changing environment, including the challenges of financial innovation that are arising from new technological developments.

The Advisory Group also supported the holding of a training program hosted by the Australian APEC Study Centre at RMIT University on best practice proposals on policy and regulatory measures to promote financial inclusion in the region's banking and securities systems, including providing support for technology and innovation, compliance with various financial regulatory requirements, consumer protection and the maintenance of financial system stability.<sup>4</sup>

Key findings of the program included the following:

- To broaden financial services, there should be more emphasis on women (and households) as account holders, particularly in Asian economies.
- Remittance flows between urban and rural centers are extremely important drivers and more work is needed to provide secure remittance services.
- Financial system regulators are generally taking a light touch to oversee electronic services and this is to be commended as it allows space for technology applications to develop and for innovation in service delivery.
- Telecommunications services regulators should provide fair and equitable access to financial service providers.
- A collaborative framework is needed in economies to ensure technology platforms provide interconnectedness between different service providers.
- Tensions between banks which wish to provide mobile network services and Mobile Network Operators who can and do, through pricing arrangements, keep banks out of the delivery system limits the reach of technology to the under-served. This tension presents a serious challenge to governments wishing to implement financial inclusion policies.
- An increasingly important aspect of public policy should be to require finance system regulators and telecom regulators to cooperate to encourage the use of technology in the delivery of financial services – a whole of government approach is required.

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<sup>4</sup> The program was funded by AusAID through the Public Sector Linkages Program. The ADBI, ADFIAP and CGAP cooperated in the design of the program. 21 participants from the Asia Pacific region attended and the course involved presenters from international organizations, business groups, academics and senior representatives of financial policy and regulatory agencies from the region.

- Regulations to handle anti-money laundering and Financial Action Task Force requirements are generally in place and the main focus now ought to be in relation to concerns on data privacy and competition practices; a key concern for consumers is data collection and the use of data by people who collect it.
- Security of customer data is vital to sustain consumer confidence in the industry.
- Agent banking is a banking strategy beneficial for geographically isolated regions to help drive down delivery costs.

The Advisory Group encourages relevant officials to study the conclusions of the training program, by visiting <http://www.apec.org.au/event2.asp?event=91>.

*The Advisory Group proposes that APEC economies commit to policy reforms to facilitate the delivery of mobile and branchless banking and remittances and to improve the market infrastructure, particularly payment and credit reporting systems and secured lending frameworks; and to undertake capacity building to promote innovative approaches and effective financial education and consumer protection regimes.*

#### **IV. UNDERTAKING LEGAL ARCHITECTURE REFORMS TO PROMOTE FINANCE**

As advanced economies go through an extended period of economic adjustment, the continued rapid growth of emerging markets is needed for the world economy to avoid a painful retrenchment and to continue moving toward greater prosperity. This will require among others making more finance available to enterprises, especially small- and medium scale firms that are key to job creation, as well as to infrastructure projects in developing economies.

Experience has shown that providing attractive environments for lenders and investors requires well-defined legal systems with effective enforcement mechanisms. Such systems provide a highly predictable environment that reduces non-commercial risks faced by lenders and investors and leads to lower financing costs. An important area where reforms can have a major impact on finance is commercial law, which sets the rules governing various stages of the relationship between lenders and investors, on one hand, and borrowers, on the other.

Many of the region's emerging markets stand to greatly benefit from such reforms, particularly in the areas of secured lending and insolvency regimes, which form a single integrated body of law representing the backbone of modern commercial legal systems.

*Secured lending.* For many mid-market companies, access to asset-based lending products is an important component of liquidity, allowing them to use inventory, movables, accounts and trade receivables and other intangibles as collateral. However, in many economies in the region, gaps in the legal regime for secured lending create disincentives to creditors to extend loans to such borrowers, resulting in increased cost of credit, or even inability to access credit, in the face of perceived risks. Promoting enhanced certainty and transparency in the legal regime, including through such measures as unified collateral registrations systems, elimination of hidden liens, expanded definitions of eligible collateral, and enabling assignability of claims, among others, can promote a more varied and affordable set of financing options for SMEs.

*Insolvency and informal workouts.* In the Asia-Pacific region, the number of multinational enterprises owing debts to multinational financial creditors has grown and continues to grow dramatically. There are considerable challenges presented by the difficulty of

harmonizing insolvency and reorganization laws across economies, especially in the Asia-Pacific region where different legal traditions co-exist. One way of alleviating the problem in the absence of harmonized statutes is through the development of global informal workout rules supported by the global financial community.

In 2007, the Advisory Group and ABAC endorsed a set of regional guidelines on informal workouts and a model agreement to promote corporate restructuring by informal workout developed by the ADB and supported by the region's banking industry. The guidelines and model agreement need to be updated to take into account new developments in the market. This represents an opportunity to promote the updated guidelines and model agreement for wider adoption not only within the region, but globally.

To advance work on these issues, the Advisory Group undertook to develop key elements of a Model Code of Security Interest Creation, Perfection and Enforcement to guide reforms in member economies and update the existing regional guidelines for promoting corporate restructuring and the model agreement for endorsement by APEC Finance Ministers. These documents were discussed and reviewed by legal experts in a workshop held by the Advisory Group and ABAC on 9 July 2013 in Kyoto, which examined how APEC can contribute to promoting these reforms.

The text of these documents may be viewed and downloaded from the Advisory Group section of the ABAC website.

- Elements of a Model Code of Security Interest Creation, Perfection and Enforcement: (<https://www.abaconline.org/v4/download.php?ContentID=22611282>)
- Asia Pacific Informal Workout Guidelines for Promoting Corporate Restructuring in the Region and Model Agreement to Promote Corporate Restructuring: A Model Adaptable for Use Regionally, by a Jurisdiction, or for a Particular Debtor (<https://www.abaconline.org/v4/download.php?ContentID=22611283>).

***The Advisory Group proposes the endorsement by APEC Finance Ministers of the documents “Elements of a Model Code of Security Interest Creation, Perfection and Enforcement” to guide reforms in member economies and the “Asia Pacific Informal Workout Guidelines for Promoting Corporate Restructuring in the Region” and “Model Agreement to Promote Corporate Restructuring.”***

## **V. ENHANCING THE POTENTIAL OF CREDIT RATING AGENCIES TO FACILITATE CROSS-BORDER INVESTMENT IN LOCAL CURRENCY BOND MARKETS**

This year, the Advisory Group revisited its previous work on credit rating agencies in light of the new developments in the region's bond markets, including the growth of the region's credit rating industry.<sup>5</sup>

Credit rating systems can play an important role in promoting cross-border investment in local currency bonds across the region. Given high-quality credit ratings for bond issues that can be compared across markets with a sufficient level of reliability, investors can be encouraged to expand their bond investments in the region. This will significantly contribute

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<sup>5</sup> The work of the Advisory Group in this area has benefited from a recent study undertaken by the Institute for International Monetary Affairs (IIMA) as part of the ASEAN+3 Research Group on “The International Discussions on the Credit Rating Agencies and Enhancing Infrastructure to Strengthen the Regional Credit Rating Capacity in the ASEAN+3 Region”

to the development of local currency bond markets, as more investments undertaken by a wider range of investors and institutions inject more depth and liquidity into markets, which in turn will make them more attractive to more investors and thus initiate a virtuous cycle.

Under the current situation, much remains to be done to create favorable conditions for credit rating agencies to play this role in the context of the region's local currency bond markets. A number of key challenges need to be addressed, among which are the following:

- Domestic CRAs (DCRAs) are the dominant industry players in the region's emerging local currency bond markets. Divergent rating practices among DCRAs across the region, which to a large extent are also due to differences in the local environment, pose a serious problem for cross-market comparability. Major areas of divergence include default definitions, rating principles, frequency of rating reviews, transparency of rating methodology and criteria, standard of disclosure in rating reports and timeliness in rating actions.
- The local ratings currently used by DCRAs for domestic bonds are based on relative scales and not on absolute scales that are used in global ratings, which are meant to be comparable across markets. These local ratings represent relative ranking of creditworthiness within a particular market and are intended for use by investors in relation solely to their exposure to this market. This problem is exacerbated by the wide divergence among sovereign ratings of economies in the region, on which the local scale ratings are based.
- Local currency bond markets across the region differ in terms of levels of development, financial reporting standards, disclosure practices, legal and regulatory regimes and legal protection for investors. Consequently, it is very difficult for investors without a clear understanding of these differences to use credit ratings to compare the riskiness of financial instruments across these markets.
- Investors have yet to develop sufficient trust in ratings issued by most emerging market DCRAs in the region, many of which have been only established in the 1990s or later. Global credit rating agencies have accumulated more than a century of performance experience over a number of economic cycles in the advanced markets behind them. In contrast, DCRAs in the region's emerging markets are still very much in the process of developing robust and proven methodologies, as their markets and instruments have not yet been in existence for a sufficiently long period and much relevant data is not yet available.
- While local currency bond markets will need a robust and trusted credit rating industry in order to grow, the development of the credit rating industry in most of the region's emerging markets, including its viability as a business and ability to attract and retain talent is, in turn, dependent on the growth of these markets.

Addressing these challenges in a way that supports sound market mechanisms will involve a long-term evolutionary process, whose direction is still difficult to discern at this point, given the still early stage of development of financial markets and cross-border financial cooperation and integration processes and structures within the region. As the value of CRAs to investors lies in their independence to rate according to each one's stated criteria and methodology, it is important to carefully design interventions by government and public institutions in promoting the development of the credit rating industry, so as to enable CRAs

to retain such independence.

Market competition is also important in promoting a healthy industry and the continuous development and enhancement of rating methodologies and practices that will benefit investors and issuers. For this reason, it is important that measures to promote robust credit rating systems with increased cross-border investment in the region's local currency bonds in mind be designed to allow a natural evolution of the market for credit ratings, while creating conditions that would be conducive to this market's development.

Such an approach could be attained by focusing on the development of *building blocks* that will support the natural growth and evolution of robust credit rating systems. To develop such building blocks, the following recommendations are proposed:

*Development of a guidebook for basic rating methodologies and basic rating criteria for selected industries and business sectors*

To help DCRAAs across the region develop rating methodologies and criteria that will make their ratings more comparable, it is proposed that a project be undertaken to develop a guidebook on common basic rating methodologies and basic rating criteria that a large number of the region's DCRAAs can voluntarily adopt. The guidebook could establish minimum standards for the credit rating process and for transparency in this process, including the methodology and criteria used in formulating credit opinion. Given that rating methodologies and criteria differ with the peculiarities of each particular industry or business sector, the guidebook should address these different industries and sectors in separate chapters.

The project would best be carried out in cooperation with the Association of Credit Rating Agencies in Asia (ACRAA) and a consultant, preferably with the financial and technical support of a multilateral institution. This project could have the following components:

- A conference to identify, select and prioritize the industries and business sectors for which methodologies and criteria are to be developed.
- Compilation of published methodologies and rating criteria of ACRAA members in these industries and sectors for comparative study.
- A series of workshops, each one featuring a number of the selected industries, to focus on updating of basic knowledge of and current developments in each selected industry and sector, describing the nature and peculiarities of each industry and sector, their products and services, their markets and competition and their regulatory environment. Industry and sector experts will be invited to make the presentations with a view to making comparisons across markets. These workshops would address three principal questions:
  - What are the key drivers of viability and profitability of companies operating in the industry or sector?
  - What is the nature and peculiarities of the business risks specific to the industry or sector, and how are these translated into credit risks?
  - How are these business and credit risks mitigated or avoided?
- The output of the workshops and the published methodologies and criteria collected from ACRAA members would be used to draft a Guidebook on Basic Rating Methodologies and Basic Rating Criteria.
- The guidebook would be reviewed by a panel and editorial board including ACRAA members and relevant experts, finalized in a conference and presented for adoption by ACRAA members. It will be published, disseminated and also promoted for adoption

by other DCRAAs in the region.

*Promoting convergence of accreditation criteria for CRAs across emerging markets in the region*

Significant work has been done on regulatory issues related to CRAs, rating processes and practices by various international bodies such as the BIS, IMF, IOSCO and APEC. Building on these foundations, economies in the region could convene a forum for regulators to look at best practices and develop a set of minimum standards in the region for the accreditation of CRAs, which can be adopted by member economies on a voluntary basis.<sup>6</sup>

Economies may consider going further and develop a mechanism whereby the minimum standards could be used to issue to any CRA meeting those standards a regional designation as a regionally recognized issuer of credible and reliable ratings, providing a seal of quality that investors can rely upon. While individual governments can issue designations, consideration may be given to an independent committee of regulatory bodies' representatives across the region to issue the designation, to ensure that the same standards are used in issuing such designations and consequently, the trust of investors in the regional designation.

*Promoting convergence of financial standards and regulations to facilitate comparable credit ratings across markets*

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<sup>6</sup> Examples of criteria that may be considered are the following:

- *Structure, size and quality of organization.* This criterion is to determine the organization's capability to thoroughly and competently evaluate an issuer's credit. The quality of the rating agency's staff is the important component of the rating process. Since rating is always an opinion, the more experienced and qualified the personnel, the better the opinion quality generally.
- *Financial resources and independence.* This determines whether a CRA is able to operate independently of financial and political pressure. The financial resources of the company would determine how capable the company is to withstand economic and financial pressures. A company which is financially weak may lower its standards in order to attract more issuers who desire higher ratings. The financial health of the organization would also have a direct correlation with the quality of its analyst, since it is able to hire and retain more qualified personnel.
- *Systematic rating procedures.* This criterion ensures that there are systematic procedures and consistency of ratings across the board. Proper and systematic rating procedures would ensure that the quality of ratings produced does not vary considerably from one issue to another. A good process would also mean that the organization would not suffer too greatly from a loss of key personnel since the knowledge would have been implicitly integrated within the rating process.
- *Internal compliance procedures.* This criterion ensures that there are internal procedures to prevent the misuse of nonpublic information and to determine if these procedures are followed. Client confidentiality is extremely important in the ratings industry. Access to management accounts and inside information is necessary to construct an accurate assessment of the company risk profile. Any violation of the implicit or explicit trust that the client has on the ratings organization would have drastic impact on not just that organization but may become reflective of the entire industry as a whole. Thus this criteria helps safeguard the industry's reputation.
- *Rating scales that are comparable with other GCRAAs.* Comparable rating scales with other GCRAAs are important to avoid market confusion. To encourage cross border flows, rating comparability is important.
- *Public disclosure of rating methodology and rationale.* Rating agencies are an integral component of market development in view of the transparency they bring. It is only proper that rating agencies set an example by being transparent about their rating process. Full disclosure of the methodology and rationales serves as good start to the process.
- *Full disclosure on any possible conflict of interest.* There must be proper disclosure of possible conflict of interests. In the event that members of senior management of the rating agency concurrently holds a significant position in a clients company. This should be revealed and disclosed to the public through the rationales or any public media.
- *A proven track record via default studies.* An objective method of determining credibility of a credit rating agency is to have published default studies. Ideally, although not required, DCRAAs should aim for default rates that are comparable to the GCRAAs worldwide.
- *Independence from political pressures and ownership pressure.* It is very important the market perceives the rating agency to be independent of these pressures. Thus measures must be undertaken to push this perception to the marketplace. Rating agency management should be allowed to perform its duties without facing strong opposition from its owners who may have vested interest. Many rating agencies ensure this by having a large number of shareholders and that no one shareholder has a majority control or controls a substantial block.

Comparability of credit ratings across markets will be promoted by undertaking measures such as the convergence of financial reporting standards and disclosure rules across the region, in conjunction with the promotion of a high level of transparency and information flows from governments and firms, as well as relevant legal and regulatory regimes and legal frameworks for investor protection. Such measures would be best undertaken within a broader regional framework in order to benefit from wider engagement of investors and financial institutions both within and outside the circle of member economies.

***The Advisory Group recommends that APEC Finance Ministers endorse a project to develop a regional guidebook on common basic rating methodologies and basic rating criteria for key industries and sectors with the collaboration of the Association of Credit Rating Agencies in Asia; convergence of accreditation criteria for CRAs across markets; and convergence of financial standards and regulations to facilitate comparable credit ratings across markets.***

## **VI. CREATING A SUSTAINABLE VENTURE CAPITAL ECOSYSTEM IN THE APEC REGION**

Government and private sector collaboration is needed to establish a thriving and sustainable innovation ecosystem, with the role of government focused on mobilizing angel and venture capital through effective support programs, providing enabling environments for financing business activities across various stages of innovation, and ensuring the fundamental conditions for entrepreneurship and innovation.

APEC can play a role in promoting the development of regional innovation by exploring the creation of APEC-oriented funds-of-funds with a view to spurring the development of sustainable venture capital systems. The funds-of-funds is envisioned to be public-private partnerships that leverage government and private investments through investment in private sector-led venture funds operating in the region and specializing in the various sectors where there are significant potential for innovation.

The premise for APEC-oriented funds-of-funds is based on the following:

- Effective support programs and enabling environments are necessary to finance business activities across various stages of innovation, and to ensure the fundamental conditions for entrepreneurship and innovation in key sectors of the various economies.
- The overall financing ecosystem includes angel and venture capital in the early stages, progressing to bank and trade financing as companies emerge. An effective overall ecosystem can play an important role in the development of local, regional and global innovation; however, angel and venture capital frameworks are at present relatively underdeveloped in most APEC economies. Developed venture ecosystems have established funds specializing in the various sectors of the economy and technological innovation critical for driving innovation and technological progress.
- Evidence suggests that sustainable angel and venture capital could considerably benefit from close cooperation between government and the private sector, along with government support in seeding the development of a private sector led venture capital ecosystem that can then specialize in the key economic sectors and technological innovations needed in the APEC region.

Following are basic principles that may be considered in establishing an APEC-oriented fund-of-funds:



- Government support is used to create a fund-of-funds and to leverage contributions from multilateral development banks, commercial banks, private funds and investors and large corporations.
- To seed, secure and incentivize private sector participation, government funds should allow for upside leverage allowing the private sector to buy out government funding at a reasonably attractive interest rate and to provide downside protection, such as by offering to take a major portion of any losses.
- Increased participation from institutional investors, endowments and corporations into venture capital should be encouraged through the establishment of privately managed funds-of-funds that can select portfolios of individual venture funds to invest in.
- To ensure healthy competition, the goal should be to operate a number of funds-of-funds throughout the APEC region.
- Fund managers should be selected by an experienced selection committee based on past experience in managing a funds-of-funds and through the use of requests for proposals.

***The Advisory Group recommends the development of government-encouraged funds of funds within APEC for seeding and growing a private sector-led angel and venture capital ecosystem in the region and that interested economies and multilateral institutions collaborate with ABAC and private sector firms to initiate this process.***