



THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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2009 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS

Office of the Advisory Group Chair



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Summary of Recommendations

This year, the Advisory Group on APEC Financial System Capacity-Building focused its work on strengthening financial systems and promoting recovery in the region in the aftermath of the global economic crisis. This work builds on continuing efforts since the Advisory Group's establishment in 2003 to identify collaborative capacity-building initiatives that the public and private sectors could undertake under the APEC framework. Working closely with the APEC Business Advisory Council (ABAC), the Advisory Group has reviewed various ideas during discussions with various key international institutions and organizations, which are now reflected in the following conclusions and recommendations.

Promoting financial inclusion through innovative policies. Microfinance has emerged as a potent tool to address this issue, and its ability to do so has grown in recent years with the expanded use of technology and financial innovation, increasing sophistication of microfinance institutions, and policy reforms. The development of microfinance remains uneven across the region, and there is very significant potential in regional cooperation to assist economies in providing a favorable environment for promoting financial inclusion through microfinance by identifying, developing and disseminating best practices on innovative policies in key areas.

- *The Advisory Group recommends that APEC Finance Ministers undertake a financial inclusion initiative as part of the broader APEC agenda to promote inclusive growth. Such an initiative should focus on promoting legal, policy and regulatory reforms that will provide an enabling environment for microfinance and sharing best practices in undertaking these reforms, particularly in (a) agent banking, (b) mobile phone banking, (c) diversity of microfinance service providers, (d) governance and management of state-owned banks with microfinance operations, (e) financial identity and (f) consumer protection.*

Facilitating the growth of local currency bond markets and broadening the institutional investor base. While the region's bond markets have undergone significant development in recent years, emerging bond markets are still far from adequate in meeting the financing needs of the private sector. Supply constraints related to depth and liquidity, market infrastructure and the legal, policy and regulatory framework continue to pose significant obstacles to market development.

Economies also need to meet the challenges in broadening the institutional investor base.

The Advisory Group recommends the following:

- *Developing member economies should strengthen laws to foster and enforce transparency and fair play, provide adequate creditor protection and recovery processes; further develop market regulations and supervision to encourage the expansion of both local and foreign investment in local currency bond markets; promote investor education; and facilitate the establishment and operations of credit guarantee institutions and markets for hedging instruments.*
- *Economies should review their tax regimes and address the negative impact of taxes on bond markets, including capital gains and withholding taxes, stamp duties, disparities in treatment of local and foreign investors and double taxation, and consider incentives to promote demand for new assets that can help broaden the investor base.*
- *APEC should undertake bold steps to take bond market development in the region to the next level, with emphasis on promoting the growth of corporate bond markets and financial integration, through initiatives that address such issues as credit ratings and settlement systems to facilitate cross-border investment, and collaborate with the Advisory Group and ABAC in advancing the bond market development agenda, including the holding of the 4th APEC Public-Private Sector Forum on Bond Market Development in 2010.*

Enhancing the environment for public-private partnership in infrastructure development.

There is a huge potential for public-private partnership (PPP) to contribute to the development of much-needed infrastructure in the region. However, a number of underlying issues remain to be addressed, particularly those that relate to the lack of an environment for constructive and confidential dialogue between governments and industry, the need to develop broader and deeper capital markets, and the need to promote a more active role for international financial institutions in the provision of long-term funds in local currencies. A multilateral approach such as the proposed Asia Infrastructure Partnership could help address these issues and provide effective ways of bringing skills and financial resources to developing economies.

- *The Advisory Group recommends that APEC launch a regional infrastructure partnership among governments, international financial institutions and the private sector that will produce a list of major projects that represent regional priorities based on extensive consultations and actively identify ways of building up the range of financing options offered by capital markets through addressing policy and regulatory impediments to further innovation and greater market participation.*

Improving the region's credit reporting systems. One of the recommendations made by the Advisory Group in 2008 was the promotion of full-file, comprehensive reporting to private credit bureaus that address concerns about privacy, identity and restricted distribution of confidential data. This year, the Advisory Group focused on assessing the reporting systems currently in use, identifying ways of promoting reforms in individual economies and developing ideas on initial steps toward a regional framework. APEC is well-positioned to drive the development of a regional standard for credit reporting and the emergence of a regional credit information

regime. Such an initiative would have to involve convergence of actor norms, values, principles and expectations and the development of private credit bureaus throughout the region, and address legal and regulatory as well as technical issues.

- *The Advisory Group recommends that APEC initiate a policy initiative to promote full-file, comprehensive reporting to private credit bureaus, including sharing of best practices in implementing reforms and eventually moving toward the establishment of a region-wide credit reporting regime.*

Strengthening financial systems in response to the global financial crisis. The crisis has underscored the interconnection between monetary authorities' financial stability and price stability mandates. It has also underscored the importance of addressing systemic risks. Governance failures in financial institutions played an important role in the genesis of the crisis, particularly with respect to compensation and risk management policies. International coordination and cooperation among regulatory authorities need to be improved to effectively address systemic risks, as well as to ensure that compliance requirements for financial institutions do not unduly increase the costs of delivering financial services and restrict innovation. Efforts by policy makers and regulators in the region toward improving guidelines for valuation of financial instruments would need to be seen in the broader context surrounding the implementation of IAS 39, and should be broadened to address the challenges the region faces in implementing IFRS.

- *The Advisory Group recommends that APEC Finance Ministers and regulators in the region support capacity-building measures to help emerging markets in the region in undertaking policy and regulatory reforms arising from the crisis. These measures must address various issues, including the capacity of regulators to ensure financial stability, the availability and quality of data, and capacity of regulators and market players to ensure establishment of effective corporate governance mechanisms and the successful implementation of accounting standards. APEC should also play a role in substantially improving international cooperation and coordination among policy makers and regulators, and in strengthening regional inputs into global regulatory reform efforts.*
- *APEC Finance Ministers should promote more extensive dialogue between the public sector and the region's financial industry in the design and implementation of regulatory reforms, particularly under the current economic environment.*

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Since the completion of the Advisory Group's previous Report in August 2008, the global economic crisis has deepened and its reach has extended to affect economies worldwide through its impact on trade and financial markets. Amidst tentative signs of recovery, prospects for the second half of 2009 and beyond remain uncertain. While advanced markets suffered the brunt of the downturn, developing economies have also been seriously affected as demand from their traditional export markets and capital inflows significantly contracted. Developing APEC member economies remain especially vulnerable to any further deterioration of global economic conditions, given their relatively high levels of trade and financial integration with the rest of the world.

One key issue that has emerged from the crisis is how to enhance the capacity of the region to achieve economic recovery. Over the years, developing Asia-Pacific economies have grown rapidly through an export-oriented strategy that was supported by robust consumption growth in advanced markets, particularly in North America. Expansionary fiscal and monetary measures have temporarily blunted the adverse impact of the crisis, but as these measures are not meant to be sustained over a long period, full economic recovery will hinge on the re-emergence of demand from households and firms.

The capacity of advanced economies to soon revert back to their previous roles as principal providers of final demand for the global economy is now in doubt, with consumers expected to undergo a long process of de-leveraging to rebuild savings, while the corporate sector re-sizes and restructures in the face of changing patterns of demand and banks repair their balance sheets. Continuing growth of unemployment amidst uncertainty over the sustained recovery of asset prices over the coming months will likely exacerbate these trends. Given these prospects, developing economies will need to seriously re-examine their strategies, as the export-driven growth model becomes less viable under current conditions.

There is considerable potential for inducing the growth of domestic demand in developing economies, particularly in Asia, where there is a considerable pool of savings and financial systems remain relatively healthy. In many of these economies, however, domestic consumption and investment are constrained by various factors.

Unlocking the region's huge savings will require reforms and capacity-building in a number of areas to broaden the economic base, expand consumer finance, facilitate the growth of infrastructure and mobilize domestic savings to provide more local-currency funding for public projects and corporate expansion. The success of this undertaking will not only promote recovery, but will also help address the imbalances that have led to trade frictions in the region and provide a more sustainable basis for global economic growth in the future.

A second key issue is how financial systems in the region can be further strengthened within the context of changes in regulatory frameworks being undertaken in the aftermath of the crisis. Various initiatives are currently under way to address gaps and weaknesses in financial regulation and supervision that have contributed to the outbreak of the crisis, including initiatives being undertaken within the framework of the G-20 and the Financial Stability Board. Many of these proposed changes will need to be examined in consideration of the region's current situation, including continuing efforts to develop capital markets.

This year, the Advisory Group on APEC Financial System Capacity-Building focused its work on issues closely related to these concerns. This work builds on continuing efforts since the Advisory Group's establishment in 2003 to identify capacity-building initiatives that the public and private sectors could undertake in cooperation with each other under the APEC framework to strengthen and develop emerging financial markets in the region. Working closely with the APEC Business Advisory Council (ABAC), the Advisory Group has reviewed various ideas during discussions with various key international institutions and organizations, which are now reflected in the proposals contained in this report.

This report is divided into five major sections. These deal with (a) promoting financial inclusion through innovative policies; (b) facilitating the growth of local currency bond markets, particularly through the broadening of the region's institutional investor base; (c) enhancing the environment for public-private partnership in infrastructure development; (d) improving the region's credit reporting systems; and (e) strengthening financial systems in response to the global financial crisis.

I. PROMOTING FINANCIAL INCLUSION THROUGH INNOVATIVE POLICIES

In its 2008 Report, the Advisory Group noted that in many developing economies, a majority of the adult population remain without access to financial services. Microfinance has emerged as a potent tool to address this issue, and its ability to do so has grown in recent years with the expanded use of technology and financial innovation, increasing sophistication of microfinance institutions, and policy reforms. The development of microfinance remains uneven across the region, and there is very significant potential in regional cooperation to assist economies in providing a favorable environment for promoting financial inclusion through microfinance.

This year, the Advisory Group, together with ABAC, the Asian Development Bank Institute (ADBI) and the Alliance for Financial Inclusion (AFI), and in collaboration with the International Finance Corporation (IFC), Inter-American Development Bank (IDB) and the Foundation for Development Cooperation (FDC), organized a workshop on how APEC can help promote an enabling environment for financial inclusion in the region. This workshop, held on 31 March – 3 April at the ADB Institute in Tokyo, generated a report identifying best practices in introducing

innovative policies in the six key areas endorsed by the Advisory Group in its 2008 Report to promote financial inclusion. Its key messages are as follows.

- Agent banking is becoming an important vehicle for banks to conduct microfinance without incurring high operating costs and reputational risks that would result from opening many small branches offering limited services. However, developing agent banking especially to include deposit services requires a balanced and realistic legal and regulatory framework. Ideally, such a framework should help build strong principal-agent relationships, allow innovation and the use of new technologies, permit data to be transmitted in a safe and cost-effective manner and provide appropriate transparency, accountability and customer protection. Financial literacy is also important in promoting the growth of agent banking.
- Mobile phone banking (m-banking) has proven to be a very effective vehicle for financial inclusion. In the Philippines, for example, where 40% of municipalities do not have banking services, it has grown rapidly and is now used by around 10% of the population. It has also substantially lowered the cost of microfinance services. However, it poses challenges to regulators, because it requires a seamless regulatory framework that allows convergence of financial services, information technology and telecommunications, while maintaining financial system integrity and consumer protection. In Cambodia, m-banking is still experimental and unregulated, while in the Philippines it has benefited from a combination of branching deregulation, the spread of mobile technology and strategic partnerships among banks and agent networks. Dialogue between financial regulators and mobile operators is also important, especially in moving customers up the value chain of services, linking risks with proportionate regulation. Experiences highlight the need for regulation to follow the market, allow greater competition among banks and non-banks, and avoid overregulation of low-value payments that are not likely to be used for money laundering.
- The emergence of new models and new service providers has expanded the usefulness and scope of microfinance to such activities as short-term loans, money transfers and micro-insurance. In Uganda, for example, deposit-taking MFIs have brought many savers into the formal sector. In the Philippines, regulation has encouraged MFIs to branch out into micro-insurance. Various experiences underscore the need for a coherent legal and policy framework for regulating microfinance as a line of business. An effective framework focuses on products rather than institutions, is based on stakeholder consultation and collaboration and takes into account the costs of prudential regulation (in particular premature regulation, attempts to regulate what cannot be supervised, and requirements, for example AML, that may not be appropriate for low-income clients). It has to be flexible in order to allow space for innovation. In addition, the framework should be complemented by improved technical capacity and knowledge of supervisors and strong governance and internal controls in MFIs.
- Public banks can play a positive role that governments can harness. For example, Union Bank of India (a state bank) responded to liberalized entry of new competitors by networking its 2,600 branches, introducing new technology and harnessing agents – including milk collection agents wielding biometric identity cards. Through these, it was able to expand its micro-savings, credit, remittance and insurance business in rural areas. In Mongolia, the government reformed and

privatized the Agricultural Bank (a failing state bank) with the help of USAID and the World Bank. Being the only bank operating in rural Mongolia, it successfully introduced ATMs, point of sale technology and phone banking to become the country's largest and most profitable bank. Looking at various experiences, ingredients for success include strong political commitment by the government and independent management, supported by improvements in financial literacy, international support and adequate funding.

- Lack of financial identity is a major obstacle for many people to effectively access financial services. Creating financial identities involves a number of issues. First is in relation to standards for KYC procedures – the way this has been dealt with in many cases was to use simplified requirements at the lowest levels that increase as a client passes over a series of thresholds, for example to permit low-risk customers to open a basic bank account, normal customers to engage in standard transactions, and high-risk customers to access more sophisticated services. Second is the use of innovations such as biometrics. Third is data protection, including design of optimal privacy protocols and improved consumer education on privacy issues. Fourth is creating incentives for people to obtain financial identities.
- Protection of consumers at the bottom of the pyramid is an important element of financial inclusion. Promoting consumer protection involves promoting financial literacy; transparent provision of financial services; fairness of contracts; fair and transparent compensation of customers when there are failures of agents, outsourced services or IT systems; fair recovery practices; and a system for redress of client concerns.

Looking ahead, there is tremendous potential for regional public-private partnership. A huge number of ongoing activities are being undertaken to promote financial inclusion, involving a wide variety of public and private institutions. Although there are overlaps in their activities, there is very significant potential for complementation among these institutions, given their varying memberships, levels and nature of financial and technical resources and geographical reach.

An APEC initiative would add great value to ongoing efforts to improve financial inclusion, especially given the composition of the regional grouping's membership, the active participation of multilateral bodies and an existing infrastructure for policy dialogue, capacity-building and research within APEC. APEC would be an excellent forum for sharing of best practices, as some of these have been established in member economies. Such an initiative would represent the logical financial sector component of APEC's work on promoting inclusive growth. It could also contribute significantly to the agenda of the APEC finance ministers' process (FMP), particularly with regard to promoting broad-based development and financial deepening.

The goal of the initiative would be to increase access to finance while maintaining the safety and soundness of financial systems in APEC economies. It should address issues at three levels. At the lowest level, it could focus on progressively expanding coverage to those who are still financially excluded, particularly through the six key policy solutions mentioned earlier. At the middle level, APEC could focus on facilitating the broader participation of commercial banks in microfinance, strengthening and upgrading MFIs through the promotion of sound practices, professionalization and commercialization, and promoting the use of technology to lower processing and distribution costs. At a higher level, APEC could focus on how

to deepen the integration of microfinance into the formal financial sector through expanded access to capital markets.

The initiative would follow a strategy consisting of the following key components: helping identify and disseminate best practices; promoting institutional capacity-building; assisting governments through learning and exchange of knowledge; and developing a system to monitor progress. Activities under the initiative could include policy dialogues focusing on identifying what constitutes an enabling environment; a structured capacity-building program to define and disseminate best practices, assist economies to attain these standards and allow them to demonstrate measurable progress toward agreed goals; advocacy and awareness-raising to promote support among policy-makers, legislators and opinion leaders; and research, monitoring and evaluation activities to clarify definitions, improve the availability and quality of data, monitor progress and evaluate the impact of measures.

The initiative would be a multi-year effort and involve various institutions with varying levels of commitment depending on their resources, how it fits into their existing programs and how they would prefer to be involved. It should ideally involve major private sector firms that are involved in microfinance, including banks, telecommunications and technology companies, among others. Collaboration among participating institutions could take various forms, including funding of research, policy dialogues and study tours, provision of technical experts and access to networks, making available meeting and video-conferencing facilities, and rendering of secretariat and coordination services.

As to how an APEC financial inclusion initiative might be organized, APEC senior finance officials might consider an option with several key features. The initiative could be open to wide participation, including public and private organizations, international institutions and private foundations. It would be championed in the FMP and led by one or several member finance ministries, with the support of ABAC and other interested institutions that participate in the FMP. It would be helpful to have one institution play a coordinating or secretariat role. This may be limited to monitoring and reporting functions within a decentralized structure, or could be given more responsibilities as needed. ABAC, interested finance ministries and participating institutions could exercise oversight and regular monitoring through the regular meetings of the Advisory Group on APEC Financial System Capacity-Building. ABAC could take care of submitting progress reports to SFOM and the FMM on a regular basis.

With respect to resources, participating institutions could share or divide among themselves funding for travel, consultants, publications, hosting, logistics and provision of technical expertise. Public sector international development institutions and IFIs could also provide support for certain activities. APEC finance ministries could make a very important contribution, which is to provide access to data, information and officials (as needed) as well as hosting of activities and meetings.

The Advisory Group recommends that APEC Finance Ministers undertake a financial inclusion initiative as part of the broader APEC agenda to promote inclusive growth. Such an initiative should focus on promoting legal, policy and regulatory reforms that will provide an enabling environment for microfinance and sharing best practices in undertaking these reforms, particularly in (a) agent banking, (b) mobile phone banking, (c) diversity of microfinance service

providers, (d) governance and management of state-owned banks with microfinance operations, (e) financial identity and (f) consumer protection.

II. FACILITATING THE GROWTH OF LOCAL CURRENCY BOND MARKETS AND BROADENING THE INSTITUTIONAL INVESTOR BASE

The region's bond markets have undergone significant development in recent years. In Asia, regional cooperation initiatives such as the Asian Bond Market Initiative (ABMI) and the Asian Bond Fund (ABF) played important roles in this process. In Latin America, private sector cross-border investment and issuance related to foreign investment have driven the development and integration of local currency bond markets. Nevertheless, developing economies' bond markets are still far from adequate in meeting the financing needs of the private sector.

This year, the Advisory Group coordinated the program and preparations for the Third APEC Public-Private Sector Forum on Bond Market Development, which was held in Singapore on 16 July 2009 in conjunction with the Sixth APEC Senior Finance Officials' Meeting. This third forum followed up on the results of the previous two forums. The first was held on 8 May 2007 in Melbourne, Australia, and focused on the bond markets of Indonesia, the Philippines and Vietnam. The second was held on 9 July 2008 in Cusco, Peru and dealt with the bond markets of Chile, Mexico and Peru.

Key conclusions of the first and second forums are as follows:

- Supply constraints represent the key obstacle to market development. They fall broadly into three major categories – depth and liquidity; market infrastructure and architecture; and the legal, policy and regulatory framework.
- Promoting liquidity of corporate bond markets would require diversification of financial instruments and maturities and the development of secondary markets. Key issues are the generally limited size of issuances; the buy-and-hold attitude of investors; the lack of price signals in the market and the lack of repo markets.
- Enhancing depth requires addressing issues of concentration in both the issuer and investor base. Key issues are under-developed market infrastructure; inadequate corporate governance, disclosure and financial information; high costs of issuance through charges and taxation; and uncoordinated regulatory and supervisory frameworks.
- With respect to corporate bond market infrastructure, constraints on market making and price discovery are the primary impediments. Key issues are building benchmark yield curves; strengthening disclosure laws, listing requirements, and accounting standards; improving transparency; building post-trading information structures, and providing a clearance and settlement infrastructure that is free, transparent and involves minimal administration costs. Effective comparison of credit ratings across economies requires consistency in application of methodologies and derivatives markets need to be developed to enhance investors' ability to reduce risk.
- Investors and issuers in the region are confronted with challenges related to the regulatory, supervisory, legal, and taxation environment. These include creating a level playing field, improving legal protection and legal infrastructure, a market-friendly tax environment, coordination and collaboration among domestic

regulatory agencies, further liberalization of capital markets, exchange rate policy and the development of derivatives and repo markets

- Looking ahead, continued regional cooperation in capacity-building is important. To sustain efforts in the face of innovations and financial stress, institutional arrangements that ensure continued reforms and improvements on a long-term basis are needed. Developed economies and international institutions can play an important role in promoting policies that lead to market development in developing economies. Within APEC, there is a need to deepen connectivity between international initiatives and the actual implementation of reforms in member economies.

The third Forum widened its focus to include the issue of how to broaden the institutional investor base, in addition to a review of developments in selected emerging markets. It included discussions on international financial institutions' perspectives on capital markets, the development of the Malaysian and Thai bond markets, challenges in broadening the institutional investor base, and capacity-building and public-private sector collaboration. Key conclusions are as follows:

- Discussions on the Malaysian and Thai bond markets underscored the importance of giving clear priority to bond market development in order to meet the financing needs of the private sector. In the case of Malaysia, the government identified and pursued key building blocs, which included a reliable and efficient benchmark yield curve, an efficient process for issuing corporate bonds, secondary market liquidity, risk management instruments and widening the issuer and investor base. In the case of Thailand, the strategy focused on maintaining the level of regular benchmark bonds, reducing liquidity mismatch for investors, issuing longer-term bonds and establishing new products.
- Legal and regulatory systems need to be strengthened to attract investors to the market. To make it safe and easy to trade and invest, governments should focus on securities and corporation laws that foster and enforce transparency and fair play, provide adequate creditor protection and recovery processes, market regulations that allow efficient bond transactions, standardized custodial and settlement practices designed with the lowest operational risks possible, and anti-money laundering and know-your-customer protocols backed by law that engender confidence and define the market participants.
- Taxation is a key issue, as investors look at total return. Governments should avoid taxing capital-raising, trading and investing transactions at a level that decreases the efficiency of capital markets and increases the cost of capital-raising and capital management. Tax and other incentives should be considered in expanding the investor base, and the impact of double taxation, capital gains taxes, withholding taxes and stamp duties, among others, should be re-examined with respect to their impact on the development of bond markets.
- Investors should be assured of the quality of requirements for issuance and adequate disclosure, and should have sufficient access to market information. Among ways to improve access to information that can be considered are making bond issuer documentation available to investors on regulatory agencies' websites, promoting continuous post-issuance disclosure by issuers, advisers and trustees, and making available fair value prices of local currency bonds by bond pricing agencies and rating announcements by credit rating agencies.

- Adequate market surveillance is needed to ensure compliance of market players and intermediaries (including credit rating agencies, bond trustees and bond pricing agencies) with relevant guidelines and should cover primary and secondary markets to detect abuses and deter misconduct.
- Derivatives and repo markets that enable investors to hedge, such as through interest rate and currency swaps, are necessary for investors to manage underlying risks in their portfolios.
- Credit guarantee institutions could be helpful in facilitating access to long-term capital-raising by local companies in the local bond market, by providing financial guarantee insurance and protecting bond holders against missed payments or defaults.
- Investor education is important in developing a credit culture, which is key to greater market activity. Investors need to develop a credit and risk-taking culture they understand and can work with. They also need to be encouraged to allow institutional investors to manage their funds to promote greater efficiency.
- Supporting new asset classes through incentives is useful in promoting local demand for new assets, such as savings bonds or Islamic financial instruments, which have a wider investor base.
- Although local investors are the most knowledgeable buyers of local currency bonds, it is important to diversify the investor base. The onshore private and individual savings pool could be mobilized to add to the existing public and corporate asset pools. Foreign investors can serve as a stable diversifying funding base for issuers, and should be provided the right conditions to enter the market.
- Promoting cross-border investment within the region will significantly contribute to the deepening of bond markets. In relation to this, further steps are needed to provide regional investors in local currency bonds with useful and comparable credit ratings for bonds across the region's emerging markets, as well as an efficient bond settlement system that can serve the needs of such investors.

The Advisory Group recommends the following:

(a) Developing member economies should strengthen laws to foster and enforce transparency and fair play, provide adequate creditor protection and recovery processes; further develop market regulations and supervision to encourage the expansion of both local and foreign investment in local currency bond markets; promote investor education; and facilitate the establishment and operations of credit guarantee institutions and markets for hedging instruments.

(b) Economies should review their tax regimes and address the negative impact of taxes on bond markets, including capital gains and withholding taxes, stamp duties, disparities in treatment of local and foreign investors and double taxation, and consider incentives to promote demand for new assets that can help broaden the investor base.

(c) APEC should undertake bold steps to take bond market development in the region to the next level, with emphasis on promoting the growth of corporate bond markets and financial integration, through initiatives that address such issues as credit ratings and settlement systems to facilitate cross-border investment, and collaborate with the Advisory Group and ABAC in advancing

the bond market development agenda, including the holding of the 4th APEC Public-Private Sector Forum on Bond Market Development in 2010.

III. ENHANCING THE ENVIRONMENT FOR PUBLIC-PRIVATE PARTNERSHIP IN INFRASTRUCTURE DEVELOPMENT

In its 2008 report, the Advisory Group noted the important role of private investment in the development of infrastructure and the huge potential for public-private partnership (PPP) to contribute to this objective in a way that will benefit governments, the private sector and the public at large. The adoption by the APEC Finance Ministers of the common principles for formulating guidelines for PPP in 2008 is an important initial step toward greater APEC involvement in promoting PPP in the region. Initiatives to promote PPP have also been undertaken in various bodies, including the Asian Development Bank (ADB), World Bank and the Asian Development Bank Institute (ADBI), which ABAC and other private sector groups actively support.

A number of underlying issues remain to be addressed. The first is the information asymmetry between the public and private sectors, with the private sector having a considerable information advantage, which has had the effect of discouraging the public sector from engaging more broadly in infrastructure partnerships. Given this situation, it would be important to foster an environment where governments can be reassured of a constructive and confidential dialogue and industry can provide input and perspective without risk of loss of financial benefit or intellectual property.

The second is the need to develop broader and deeper capital markets, given that infrastructure projects are generally long-life assets earning revenues in local currencies. While Asia has the capability and financial depth to fund infrastructure, the dominance of bank finance has encouraged a short-term perspective on construction, without adequate regard for long-term risk management over the very long life of infrastructure assets, and prevented the proper valuation of infrastructure and the apportionment of risk to parties most capable of managing it. Deeper and more liquid bond markets and the formation of a yield curve with coverage and depth going beyond short- and medium-term government bonds will entail the development of a broad issuer base.

The third is how to promote a more active role for IFIs in the provision of long-term funds in local currencies, for example by combining their robust credit standing to raise long-term debt and by promoting long-term swap markets to help refresh local balance sheets and eliminate currency mismatch of infrastructure revenues generated in local currencies.

While there are ongoing bilateral efforts to address infrastructure-related issues, there is a need to move toward a multilateral approach to provide effective ways of bringing skills and financial resources to developing economies. APEC could play an important role in promoting initiatives that could provide models for regional cooperation to be undertaken by interested member economies and later evaluated and considered for adoption on a wider scale. One such initiative is the proposed Asia Infrastructure Partnership, the key features of which are as follows:

- The Asia Infrastructure Partnership will forge a framework that addresses the essential ingredients towards infrastructure planning and project execution through genuine partnership among governments, international financial

institutions and the private sector. This will involve a clear articulation of regional infrastructure adequacy and identification of critical areas to be addressed. This process will ultimately produce a list of major projects that represent regional priorities based on extensive consultation and participation of international financial institutions, regional governments and private sector participants. Governance arrangements for the Partnership, including its financing and management, will need to be developed.

- The Asia Infrastructure Partnership must actively identify ways of building up the range of financing options offered by capital markets through addressing policy and regulatory impediments to further innovation and even greater market participation. Creating alternatives to commercial bank lending is an imperative, such as for example local currency denominated bonds and asset backed securities. The objective is to attract more investors from within the region and ultimately from international markets.
- Activities of such a regional infrastructure partnership could include the following: (a) commissioning an infrastructure adequacy assessment of the region and identifying gaps and major investment requirements, along with a framework for private sector participation in infrastructure; (b) working with governments to address the shortage of ‘private finance friendly’ infrastructure projects through comprehensive infrastructure adequacy assessments based on rigorous and independent feasibility analysis to better support market-based judgments on suitability of private sector participation along with appropriate debt and equity structures; (c) advocating and engaging governments and stakeholders to implement policies that further enhance domestic savings pools in the region through development of long-term savings institutions and best practice governance structures for pension funds and insurance institutions; (d) establishing a working partnership among government, business and IFIs to develop viable alternatives to commercial bank lending for long-term investment in the region; and (e) engaging governments, community stakeholders, media, non-government organizations and the private sector on the dissemination of case studies and international experiences on the respective roles of public and private capital and expertise, when and how it can be best deployed towards achieving the best possible public policy outcomes.

The Advisory Group recommends that APEC launch a regional infrastructure partnership among governments, international financial institutions and the private sector that will produce a list of major projects that represent regional priorities based on extensive consultations and actively identify ways of building up the range of financing options offered by capital markets through addressing policy and regulatory impediments to further innovation and greater market participation.

IV. IMPROVING THE REGION’S CREDIT REPORTING SYSTEMS

Strengthening credit reporting systems is an important issue related to consumer finance. One of the recommendations made by the Advisory Group in 2008 was the promotion of full-file, comprehensive reporting to private credit bureaus that address concerns about privacy, identity and restricted distribution of confidential data. This year, the Advisory Group focused on assessing the reporting systems currently in use,

identifying ways of promoting reforms in individual economies and developing ideas on initial steps toward a regional framework.

Assessment of current credit reporting systems

There are various reporting systems currently in use, which include the following:

- Negative reporting system (as used in Australia and New Zealand): This encompasses applications (not approvals), delinquencies (over 60 days), defaults and bankruptcies. The system is purged every 5-7 years and is used only for credit assessment.
- Fair file reporting system (the Dun & Bradstreet model): This includes all negative data, account type, lender, date opened and credit limit. Like negative reporting systems, it is used only for credit assessment.
- Full-file credit reporting system (as used in the US): This includes all negative data, all fair file data, account balance, number inquiries, debt ratios (revolving to total debt), average age of account, delinquencies (over 30 days) and portion of accounts repossessed or written off. The data is public record and becomes obsolete in 7-10 years. The system is used both for credit assessment and for marketing purposes.

Fair credit reporting benefits consumers, lenders and the economy as a whole. Consumers benefit from reduced probability of over-extending, fairer prices, reduced credit discrimination and credit offers that reflect credit risk and credit capacity. Lenders benefit from reduced delinquencies and defaults under Basel II and sustainable and affordable growth into new markets. The economy benefits from better financial services efficiencies and affordable growth in domestic consumption.

There has been extensive research on credit reporting encompassing three generations of studies. The first generation (WorldBank, IDB, Pagano and Jappelli) explained how the existence of credit bureaus increases private sector lending and lowers national financial sector risk. The second (Barron/Staten, IDB, Miller and Galindo) confirmed that comprehensive data leads to wider lending but lower default rates than negative only data, and that wider lending is particularly beneficial to small business. The third generation (Information Policy Institute) established that broader participation by lenders and comprehensive data improves financial performance.

Various studies, including studies on credit card interest rates, home ownership, mortgage rates, debt profile, performance target trade-off and default rates in the US; loan delinquencies in Japan; default rates in Brazil, Argentina, Colombia and Hong Kong; fairness of access in the US and Colombia; and capital productivity in Australia have generated the following conclusions:

- Better information results in better lending, lower defaults rates and better access, for both developed and emerging economies.
- Comprehensive data improves economic growth.
- Comprehensive data reduces discrimination in lending and improves mainstream access for the under-served both in developed and emerging economies.
- Non-financial data helps the young access mainstream credit on a fairer basis.
- The D&B model has no impact on privacy or identity fraud.

Promoting reforms: The Australian case

Australia's path to positive credit reporting provides a case study on effective ways of promoting reforms in individual economies. In 2004, a campaign was initiated to reform Australia's consumer credit reporting laws, recognizing the significant benefits to borrowers and credit providers arising from positive credit reporting. Those benefits include improved access to credit for under-served sections of the community, including small and medium sized enterprises, a capacity to both increase lending and reduce default rates, and increased competition in both credit reporting and lending industries reducing the overall cost of credit to borrowers.

In response, the Australian Attorney-General referred the matter to the Australian Law Reform Commission (ALRC) for review. After extensive stakeholder consultation the ALRC recommended that Australia shift to a positive credit reporting model. The ALRC model would increase the number of data elements held by a consumer credit report but limit permissible purposes to credit assessment. The Australian Government is currently considering the ALRC recommendations and issues related to implementation. Key lessons from this process are as follows:

- Lesson 1 – Shift in focus from over-indebtedness to free flow of credit: The primary concern of legislators and regulators in the current environment is the need to get sustainable credit flowing. This is a significant shift from concerns that were focused on perceived consumer over-indebtedness and the role of positive reporting in driving further credit growth. The changed environment reflects a unique opportunity to highlight the urgency of shifting to a positive credit reporting model and its value in responding to the current credit contraction in member economies.
- Lesson 2 – Convince established domestic lenders of the benefits: One of the core groups initially nervous about a shift to positive reporting in Australia were the established domestic banks. While each organisation had its own unique perspective, generally there was a concern that positive reporting would enable global banks to enter the Australian market and make use of bureau data to target the domestic banks' most profitable customers. There are two responses to this concern. Firstly, by ensuring the permissible use of the data extends only to credit assessment, and not marketing, lenders are prohibited from accessing bureau data to identify potential customers. Secondly, extensive data demonstrates that positive reporting increases the overall level of lending. While this may impact market share figures, the aggregate impact is to increase lending for all organisations, including domestic banks. In Australia the domestic banks have now recognised these two realities and are active proponents of positive credit reporting through the Australian Retail Credit Association (ARCA).
- Lesson 3 – Demonstrate the benefit to small business: Small and medium sized enterprises are significant winners from positive reporting due to the reliance by many small businesses on consumer credit to finance business growth. Recent studies in the United States illustrate this point. Both government and lenders are currently focused on the need to improve access to, and the price of, small business credit. Both groups in Australia have come to recognise the role positive reporting can play in assisting small business credit access and this has become a major driver of the need for reform.

- Lesson 4 – Engage stakeholders: There are a number of stakeholders that have concerns about a shift to positive credit reporting. While each of their concerns can be addressed it is important to do so through a process that seeks to build consensus. Such an approach ensures that all views have been tested and appropriate strategies developed. A consultative process also assists government by clearly identifying challenges before they become critical political issues.
- Lesson 5 – Empirical based approach: There are many claims and counter-claims about the benefits of positive credit reporting. The role of empirical research to support arguments has been critical in convincing the lending community and government of both the need for, and benefits of positive reporting. In Australia, research studies have been critical in advancing the debate. The first provided evidence of the benefits of positive reporting. The second provided insight into the challenges arising from the implementation process; in effect providing a roadmap to reform. The use of this research has provided confidence to key decision-makers that the arguments in favor of reform have been well tested and documented.

A number of key findings from research undertaken in support of the reform initiative have been helpful:

- The “valley of transition”: Transitions from negative to positive reporting are usually associated with short-term reductions in lending and increase in defaults as lenders deal with newly available data. However, lending returns to normal levels and increases in time, as lending to traditionally underserved sections of the community is expanded, thus providing a broader base across which risk is spread and improving the stability of the financial system.
- Small business as key beneficiary: Positive reporting facilitates credit scoring, which is the preferred decision-making tool used by large lenders in assessing small loan applications.
- Preventing identity theft and fraud: More data provides a stronger base from which to detect identity theft and fraud. At the basic level, recording of accounts on credit reports allows the monitoring of unusual credit behavior. At a more sophisticated level, positive reporting comes with increased levels of automation that improves identity verification and data quality and matching.
- Importance of community support: The speed of implementing reforms reflects a number of factors, including technology, regulation, organizational culture and societal values. However, where there is a poor understanding of credit reporting systems, gradual reform could allow more time to enhance community understanding and support.
- Importance of additional information, no matter how limited: The addition of new information to credit reports can have real benefits. The inclusion of credit accounts allows lenders to have a better understanding of existing commitments and greatly assist with detecting identity theft and fraud.
- Number of data sharers: A large number is critical to overall performance of a positive reporting system. It would have a significant impact on acceptance and default rates.

- Benefits and costs: Credit providers who contribute data have realized that the benefits accrued outweigh the costs of investing in information technology and other system changes.

Toward a regional framework

APEC is well-positioned to drive the development of a regional standard for credit reporting and the emergence of a regional credit information regime. Such an initiative would have to involve convergence of actor norms, values, principles and expectations and the development of private credit bureaus throughout the region. Any effort to develop a regional credit reporting system would have to address (a) the legal and regulatory framework; and (b) technical issues.

The legal and regulatory framework is important because a number of important procedures would need to be defined, including the type of information that can be collected, the rights of data subjects (access, notification, dispute resolution and redress), acceptable uses of information, data security requirements and obligations of credit bureaus, data furnishers and data users.

- An important element of an effective legal and regulatory framework is the specification of requirements regarding information contained in credit files. These requirements include (a) protection of consumer rights; (b) information privacy, referring to limitations and regulation of access to consumer information; (c) use of public record information; (d) the periodicity of reporting (e.g., 30 or 60 days); (e) data expiration regulation (data are usually expunged after a number of years, e.g., 7 years in the case of certain economies); (f) provisions for the sharing of both positive and negative information; (g) noting disputed information or suspected fraudulent activity; and (h) equal treatment of reporting financial and non-financial industries. Given the wide diversity among APEC member economies, how each of these requirements is addressed will vary across the region.
- Another important element is the determination of data subject rights and protections and the obligations of data furnishers and credit bureaus. (a) Data subject rights and protections would involve such issues as control over third-party access to credit files, right to access the credit file, procedures for consumer disputes and re-verification, redress for harms and notification of adverse actions and dispute rights. (b) Data furnisher obligations would involve the regular reporting of accurate data, timely responses to consumer disputes, correcting and updating inaccurate information, reporting the status of accounts (whether open, closed or delinquent), and responding to suspected identity fraud. (c) Credit bureau obligations would involve maintaining data quality standards, disclosures to data subjects, dispute resolution procedures, data privacy and security (including in the case of third-party verification), and inclusion of financial, governance and security standards.
- The Organization for Economic Co-operation and Development (OECD) Fair Information Practice Principles provide a useful reference point in efforts to develop the legal and regulatory framework. The Principles cover a number of areas, including limitations related to data collection (what is collected, means of collection, source of data, knowledge and consent of data subject and scope of application of the principle); data quality; permissible purposes or use limitation (control against original purposes, exceptions and disclosure mechanisms);

security safeguards; openness; individual participation (the right of the subject to know about the existence of data, right to access data; right of challenge and provision of reasons for refusal; and subject challenge to data); and accountability.

- Dispute and grievance resolution mechanisms are important for safeguarding rights of data subjects, improving data quality and enhancing system legitimacy. An effective mechanism would address issues in each of the four basic phases of grievance resolution. (a) With respect to personal information, credit bureaus must be able to immediately release information to consumers and release all information in the consumer file. (b) With respect to the receipt of grievance (when a consumer contests the information), credit bureaus must provide consumers easy access to customer service and a clear framework for the resolution of each case should be in place. (c) Credit bureaus must have a system to verify data. (d) With respect to consumer rights in notice and follow up of grievance procedure, data subjects must be notified of the results of their case and a system of appeals should be in place in case the consumer refutes the resolution.

With regard to technical issues that need to be addressed in the process of developing a regional credit reporting regime, there are four key domains that remain important irrespective of variations in methods and technical wherewithal as well as changes in technology, which are (a) data formatting standards (common standards of reporting make it easier to collect and use information and allow portability of data across borders); (b) identity verification (to help in matching information, improving accuracy and protection against financial identity fraud; (c) data security; and (d) disaster recovery (preservation of the information to help preserve the financial structure).

Options that may be considered as elements of an APEC initiative could include:

- Development of common credit reporting standards that will facilitate the collection and use of information across economies.
- Capacity-building to develop alternative data bureaus and promote mobile microfinance.
- Undertaking lender risk/reward analysis to build the business case on the product level to encourage creditors to fully report to private bureaus.

Regarding synergy with other regional initiatives, there is scope for simultaneously pursuing initiatives on regional credit reporting and financial inclusion, given their interrelationship. Efforts to develop a regional framework should also take into account the huge diversity within the region, which presents a challenge. In some developing economies, moving to full-file and comprehensive credit reporting would involve considerable effort given the very restrictive regimes currently in place, for example, with regard to the scope of information that can be reported. Other member economies either have or are putting in place legislation to conform to the OECD Fair Information Practice Principles, for example, in the case of Chile, which is intending to join the OECD.

Three related issues remain, where systematic examination and analysis can assist policymakers in initiating policies to develop full-file, comprehensive reporting in the APEC region. Clarification of and reform in these issues can further enhance the value of full-file, comprehensive reporting system and expand financial inclusion.

- First, identity verification is a key element for enabling information sharing and fraud detection, as noted. It is therefore important to explore how economies without national identification numbers or their functional equivalents can proceed and have proceeded with the matching that is necessary for a well-functioning system. These findings can help economies without public identification numbers learn how to overcome hurdles to financial identity.
- Second, as cross-national labor mobility in the region increases, it becomes ever more important to examine best practices and standards for the cross-border sharing of information and the portability of financial identity and financial histories. Models of how this information can be shared or carried by the data subject are also intimately tied to common credit reporting standards and formats. A closer examination of viable models can increase access to finance for the growing cross border labor force in the region.
- Third, increased financial inclusion can be facilitated by a deeper examination of how different models of information sharing can be structured with respect to information that is not easily accommodated by standard models that transfer data to credit bureaus. For example, wage and income data from unemployment insurance systems can greatly reduce the cost of underwriting and increase financial inclusion. The information is unlikely to be transferred to a third party. But a third party such as a credit bureau can serve as an interface with the financial sector, helping to transfer data when the data subject provides consent. Another area to examine is how the value of social collateral as captured by cell phone systems can be aggregated and transferred for risk assessment in small value loans such as found in microfinance. A wider examination of models of information sharing that is consistent with and can be supported by full-file, comprehensive credit reporting agencies can greatly help identity means of expanding financial inclusion.

The Advisory Group recommends that APEC initiate a policy initiative to promote full-file, comprehensive reporting to private credit bureaus, including sharing of best practices in implementing reforms and eventually moving toward the establishment of a region-wide credit reporting regime.

V. STRENGTHENING FINANCIAL SYSTEMS IN RESPONSE TO THE GLOBAL FINANCIAL CRISIS

Building on the ongoing work with the South East Asian Central Banks (SEACEN) Research and Training Centre and financial regulators in the region to strengthen financial systems, the Advisory Group coordinated the program and preparations of the 5th SEACEN-ABAC-ABA-PECC Public-Private Dialogue for the Asia-Pacific Region, which was held on 27-28 July 2009 in Bangkok, Thailand. This year's dialogue, which dealt with the theme *Responding to the Challenges of the Global Financial Crisis*, examined current proposals being discussed in the G-20 to reform regulatory frameworks in response to the lessons of the crisis.

As in previous years, the dialogue provided important contributions to the Advisory Group's views on the situation of financial systems in the region and how they may be strengthened. The key messages are as follows:

- The crisis has underscored the interconnection between monetary authorities' financial stability and price stability mandates. In particular, it has led to a re-

evaluation of current approaches to deal with asset price bubbles. Until the crisis, the prevailing sentiment was against intervention, in view of potential costs of deflating a false bubble, given the difficulties in ascertaining its existence. The crisis has demonstrated that bubbles may not deflate in an orderly way and can cause much damage when they do so. Consequently, monetary authorities are beginning to consider a paradigm shift on whether it might be necessary to act against possible bubbles without having to wait until full information becomes available.

- The crisis has also underscored the importance of addressing systemic risks. Financial regulatory authorities are being encouraged to strengthen both macro-prudential (focused on the system) and micro-prudential (focused on individual institutions) policy frameworks. Efforts are underway to ensure that regulation covers systemically important institutions, markets and instruments, improve prudential standards on capital and liquidity, better coordinate international standards to ensure a common coherent international framework, and enhance supporting policies and infrastructure (accounting standards, credit ratings, compensation schemes).
- Governance failures in financial institutions played an important role in the genesis of the crisis, particularly with respect to compensation and risk management policies. Regulators and the financial industry are focusing on addressing four key structural gaps: weak compensation governance (limited board oversight, limited links between risk and compensation, insufficient bottom-up risk controls to limit excessive risk-taking, and limited public disclosure around compensation practices); poorly designed compensation systems (mismatch between front office and middle/back office control functions and lack of linkage to firm-wide results); limited use of risk adjustments in determining compensation (limited risk adjustments in bonus pool sizing and allocation and lack of long-term risk accountability in performance measurement); and weaknesses in payout mechanisms (such as use of short-term metrics used in long-term incentive programs, mismatch between deferral horizon and risk-holding periods, and limited ability for claw backs on deferrals). However, caution is needed in introducing regulations (such as compensation caps) that could result in increased risk-taking in unregulated or lightly regulated sectors as rewards are shifted to those sectors or regulations that are too complex for institutions to comply with.
- International coordination and cooperation among regulatory authorities need to be improved to effectively address systemic risks, as well as to ensure that compliance requirements for financial institutions do not unduly increase the costs of delivering financial services and restrict innovation. However, while coordinated international responses should be consistently applied on a global basis, mechanisms should be identified and put in place to allow more effective regional contributions to regulatory arrangements that reflect assessments of region-specific prudential interests.
- Cooperation and dialogue with the private sector is important in designing new regulations in a way that achieves a balance between promoting stability of financial systems and ensuring the efficient delivery of financial services and continued innovation in the financial sector. Such cooperation is especially needed under current conditions of continued financial system fragility and

uncertainty about the sustainability of economic recovery, where the introduction of measures such as increased capital requirements and other regulations that would have the effect of further restricting bank lending could undercut efforts to revive financial markets and stimulate economic activity.

- Valuation of complex securities and illiquid products during times of stress became an important issue as markets for certain securities were significantly affected by the crisis. This has resulted in calls for global accounting standard-setting bodies to enhance guidelines for valuation of financial instruments, especially illiquid products. Efforts toward this objective would need to be seen in the broader context surrounding the implementation of IAS 39 (establishing principles for recognizing and measuring financial assets and liabilities as well as contracts to buy or sell non-financial items), as this involves governance (particularly the roles, responsibilities and accountabilities around the function of risk management), system changes in both sources and consolidation, and the need to develop integrated reporting approaches and effective decision-making. It impacts the way companies recognize, measure and present their financial instruments.
- Within the region, financial institutions face various challenges in the implementation of IAS 39. These include the challenges of coping with general requirements, such as sufficient disclosure standards on valuation techniques and the need to reduce complexity of accounting standards and improve presentation standards to make them useful to users of financial statements. They also include significant challenges for banks in the region owing to particular conditions in Asian emerging markets, such as those related to using the fair value option for embedded derivatives, impairment measurement of loans in economies with high inflation, the high base costs of implementation for small banks, tax regimes that will result in higher taxes with IFRS implementation, and lack of knowledge and skills among banking practitioners, external auditors and regulators. Finally there are challenges in the transition to fair value accounting, where unfavorable economic conditions could have substantial impacts on balance sheets of banks and the perception of depositors with insufficient understanding of the impact of changes in accounting standards on the presentation of profits and losses.

The Advisory Group recommends the following:

- (a) APEC Finance Ministers and regulators in the region should support capacity-building measures to help emerging markets in the region in undertaking policy and regulatory reforms arising from the crisis. These measures must address various issues, including the capacity of regulators to ensure financial stability, the availability and quality of data, and capacity of regulators and market players to ensure establishment of effective corporate governance mechanisms and the successful implementation of accounting standard reforms. APEC should also play a role in substantially improving international cooperation and coordination among policy makers and regulators, and in strengthening regional inputs into global regulatory reform efforts.**
- (b) APEC Finance Ministers should promote more extensive dialogue between the public sector and the region's financial industry in the design and implementation of regulatory reforms, particularly under the current economic environment.**

