



THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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

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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 (*see Attachment A*). 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 (*see Attachment B*). 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 identify 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.

ATTACHMENT A

PROCEEDINGS OF A WORKSHOP JOINTLY ORGANIZED BY THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING, THE APEC BUSINESS ADVISORY COUNCIL, THE ASIAN DEVELOPMENT BANK INSTITUTE AND THE ALLIANCE FOR FINANCIAL INCLUSION
IN COLLABORATION WITH THE FOUNDATION FOR DEVELOPMENT COOPERATION, THE INTER-AMERICAN DEVELOPMENT BANK AND THE INTERNATIONAL FINANCE CORPORATION

PROMOTING FINANCIAL INCLUSION THROUGH INNOVATIVE POLICIES

31 March – 3 April 2009
Asian Development Bank Institute
Tokyo, Japan

EXECUTIVE SUMMARY

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.

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This four-day workshop aimed to assist policy makers develop innovative policies in six key areas, to provide an enabling policy environment for financial inclusion, particularly through microfinance. These six key areas, presented by the Alliance for Financial Inclusion (AFI) were identified as crucial at a workshop co-organized by ABAC and the Advisory Group on APEC Financial System Capacity-Building in Jakarta, Indonesia on 23 January 2008, and were as follows:

- **Agent banking:** This refers to policies and regulations governing correspondent banking agents, or agents from the non-bank sector such as retail commercial outlets including lottery kiosks, pharmacies, post offices and the like, which establish partnerships with banks to provide distribution outlets for financial services.
- **Mobile phone banking:** This involves policies that lower transaction cost and increase access to financial services through mobile technologies and services. Mobile phone banking may provide a host of features, such as cash deposits and withdrawals, third-party deposits into a user account, retail purchases, over-the-air prepaid top-ups using cash in the user's account, transfer of cash or airtime credits between user accounts and bill payments. Mobile phone banking presents challenges to regulatory capacity, as it cuts across various regulatory domains including banking, telecommunications, payments systems and anti-money laundering.
- **Diversifying providers:** This deals with policies that lower the regulatory barriers for start-ups and for offering savings and insurance products for low-income clients, such as through rural banks (Indonesia) and microinsurance mutuals (the Philippines).
- **Reforming public banks:** This relates to policies that improve the governance and management of state banks to help them provide more effective financial services, including commercially sustainable financial services.
- **Financial identity regulations:** This refers to policies that endow clients with a financial identity, by transforming their transaction history into a financial asset, which they can use to leverage access to credit and other banking services. Regulatory frameworks would need to adopt a flexible approach to supporting the generation of financial identity, facilitating information sharing in the initial stages of development and introducing protective measures during the later stages that involve large-scale information processing.

Tuesday, 31 March 2009

OPENING SESSION

Session Chair:

Mr Worapot Manupipatpong, *Director Capacity-Building and Training, Asian Development Bank Institute*

Welcome Remarks

Mr. Yoshihiro Watanabe, Chair, ABAC Finance and Economics Working Group and Managing Director, Institute for International Monetary Affairs.

After words of welcome from Mr Worapot, Mr. Watanabe acknowledged the organisers of the workshop. He introduced participants to the work of the APEC Business Advisory Council, its monitoring of the current financial crisis and economic recession, and its periodic communications on the subject to APEC Economic Leaders. Mr Watanabe noted that financial inclusion is an important part of ABAC's current agenda, the more so because of the effect of the crisis in diminishing the flow of capital to developing economies, with consequent negative consequences for the poor. He compared microfinance lending favourably with 'the widespread irresponsible lending that created the subprime mortgage crisis. Microfinance, by contrast, has 'tremendous potential to promote social equity and broad-based economic growth', a potential that will be realised with the assistance of innovation and technology. For this reason, leaders in policy reform in a wide range of countries have been invited to attend this workshop. Apart from immediate measures to ameliorate the consequences of current economic difficulties, ABAC sees the need for medium- and long-term measures to ensure stable and sustained growth in the Asia-Pacific region. Financial inclusion should be part of such a longer-term agenda.

OPENING REMARKS

Mr. Gempachiro Aihara, *Co-Chair, APEC Business Advisory Council (ABAC) and Counselor, Mitsui & Co., Ltd.*

Mr Aihara briefly sketched out ABAC's current concerns across the spectrum of economic issues, describing the global situation as the worst in ABAC's experience. Financial inclusion has an important role in ABAC's broader agenda of financial sector issues. Giving it greater prominence will validate ABAC's view that enterprise is the key to regional prosperity.

Dr. Twatchai Yongkittikul, *Co-Chair, Advisory Group on APEC Financial System Capacity-Building; Co-Chair, ABAC Finance Working Group and Secretary-General, Thai Bankers' Association*

Dr Twatchai remarked that capacity-building to develop financial markets and systems is very important, especially in the face of their globalisation. In that context, financial inclusion enables greater economic opportunity and equity, providing appropriate regulatory and policy environments are put in place. ABAC's Advisory Group on Financial Sector Capacity-Building has been active in this field since 2003. The current workshop is an outcome of an Advisory Group meeting in Jakarta in January 2008 (the report of which is circulated at this meeting) and the group will pursue the matter further at a meeting of central bank regulators to be conducted in Hanoi in July 2009.

Dr. Alfred Hannig, *Executive Director, Alliance for Financial Inclusion*

Dr Hannig informed participants of the broad-ranging nature of this workshop, both in terms of the backgrounds of contributors and their geographic spread. Particularly notable were representatives of some countries beyond the Asia-Pacific region, chosen because of the example they present of 'South-South' collaboration in the field of policy and regulation. Thus Bolivia and Uganda are represented because of their track record of fruitful cooperation, with Bolivia having provided sustained technical assistance to Uganda, with such success that Uganda is now itself a 'champion' of microfinance well beyond its own boundaries. In fact, less developed countries have developed

and pioneered many 'solutions' to particular problems in providing sustainable financial services to the excluded.

Dr Hannig gave participants an overview of the agenda and scope of the Alliance for Financial Inclusion (AFI), which is particularly concerned to facilitate 'South-South' collaboration and technical exchange of the type exemplified by Uganda and Bolivia. AFI is to be a network, commencing with the recruitment of central banks and ministries of finance and widening its membership over time. It was unexpected that AFI should have commenced operating under such disturbed world economic conditions, but these conditions increase the importance of its work.

Keynote Address

Mr. Nobumitsu Hayashi, *Deputy Vice Minister for International Affairs, Ministry of Finance, Government of Japan*

Mr Hayashi expressed his pleasure at the opportunity to address this audience, some of whose members he described as representing an 'innocent' financial sector. This 'innocent sector' contrasts sharply with an 'overblown financial sector [which] has not only collapsed itself into a crisis, but dragged the world economy into the most severe recession in decades'. He described the two current and correlated problems of credit and demand which must be solved, how much we know about solutions, and how limitations of fiscal resources and political capital stand in the way.

Since the Asian crisis of 1997, arrangements of mutual financial cooperation and support have been building among the economies of East and Southeast Asia and APEC has played a role in securing these. Deputy Vice Minister Hayashi noted that 'in the APEC Finance Ministers' process in particular, there have been made important discussions on building more efficient and durable money and capital markets in order to support sustained economic growth and to heighten the resilience against the possible financial strain'. However the emerging economies 'cannot hope to have a solidly and stably based economic growth unless the capital markets and the banking sector are accessible to every part of their society. Only such accessibility will insure more business chances, broaden development opportunities, and bring about sustained economic growth'. Hence it is unfortunate to see that a majority of populations in many Asian countries are not provided with access to financial services.

In consequence, 'we have to seriously consider ways to widen financial inclusion, where microfinance has emerged as a promising tool, as it bridges the needs and opportunities at the base of the economic pyramid with the resources and appetites of the banking sector and capital markets'. In relation to the task of the workshop, Mr Hayashi said that 'the challenge before us is to foster better environment for further popularization of microfinance. The six key areas have been identified by the ABAC and they will be discussed in the workshop to facilitate the necessary policy reforms'. He added that 'the workshop can also make an important feedback on promotion of microfinance to the APEC process, especially to its Finance Ministers' Meeting, where microfinance is not at all a new issue. Back in 2002, when Mexico chaired the APEC meetings, microfinance and SMEs was taken up as an agenda. But microfinance has developed tremendously since then and we see the need to renew our discussion'.

Despite our current preoccupation with crisis, 'it is high time that the world community stand up together for truly global causes, especially to alleviate and safeguard the most affected, those who gained little from globalization but [were] thrown to poverty in the economic downturn'. Noting that 'APEC Finance Ministers have discussed above all on how to foster capital market development' he expressed the view that 'microfinance has a potential to enrich capital markets and broaden the base of economic developments' among APEC economies. Mr Hayashi challenged participants to ensure that 2009 would not be remembered simply as a year of crisis, but also a fruitful year in the development of financial inclusion and microfinance.

SESSION ONE OVERVIEW

Questions and issues explored during this session included:

- Recent developments in microfinance and their implications on policies and the role of government in promoting financial inclusion.
- Challenges in identifying appropriate financial inclusion policies and policy tools to facilitate access to finance.
- Lessons from successful experiences in developing economies, particularly in Latin America.
- The development of micro-remittance, its potential for benefiting migrant workers in the Asia-Pacific and policy implications.
- Possible roles that APEC can play in promoting financial inclusion in the Asia-Pacific region.

Session Chair:

Mr. Yoshihiro Watanabe, *Chair, ABAC Finance and Economics Working Group; Advisor, The Bank of Tokyo-Mitsubishi UFJ, Ltd.; and Managing Director, Institute for International Monetary Affairs*

FINANCIAL INCLUSION: AN OVERVIEW OF ISSUES

Dr. Alfred Hannig, *Executive Director, Alliance for Financial Inclusion*

Dr Hannig commenced by offering insights into the close correlation existing between access to finance and GNI per capita across the globe and the scale of the problem of financial exclusion worldwide. He noted the wide geographic spread of the problem and the existence of three major obstacles to its solution. First, local efforts to counter financial exclusion have thrown up a range of innovative solutions in widely dispersed countries in the 'Global South'. These have occurred, for example, in countries such as Mexico, Peru, Bolivia and Brazil (in the Americas) Kenya, South Africa and Uganda (on the African continent) and in India, Indonesia, Malaysia and the Philippines (in Asia). However this scattering of knowledge in pockets around the globe poses the challenge of disseminating useful information. This situation suggests that facilitating 'South-South' collaboration and information exchange will be a positive contribution to achieving global financial inclusion. AFI has adopted South-South cooperation as a major plank in its operations.

Secondly, policymakers in countries suffering significant exclusion face a bewildering choice of potential development partners. The choice of partners has crucial implications for the path to be followed. Thirdly, there is still a lack of evidence concerning crucial questions asked by policymakers: What works and what does not? How are solutions put into action? How effective are the solutions, and who benefits? Do we have the data to judge impacts? How can the political economy of particular situations be managed, apart from the choice of technical and managerial solutions? How best can learnings and policy insights be exchanged, and how can genuine and effective 'South-South' collaboration occur?

AFI has identified six key policy areas that appear to offer the best prospects for answering such questions. These are: (1) agent banking, (2) mobile phone banking, (3) diversification of savings and insurance providers, (4) the reform of public banks, (5) financial identity development for low-income clients, and (6) consumer protection in financial services. It has recruited 15 partners (mostly official agencies so far) and is actively expanding this membership. These six areas of reform and action, which have been adopted by ABAC as the themes for its work in this area, provide a template for work programs aimed at systematic and sustainable improvements in financial inclusion. Among the earliest work to be supported by AFI under this framework will be an action research project on creating financial identities for the poor in Indonesia, to be conducted by that country's central bank. Dr Hannig concluded by appealing for support from participants and their organisations for AFI's work program and for constructive suggestions as to its directions and activities.

Microfinance: The Latin American Experience

Ms. Sandra H. Darville, *Senior Investment Officer, Multilateral Investment Fund, Inter-American Development Bank*

Work done by IDB suggests that there are some 70 million 'enterprises' in Latin America and the Caribbean, that there is a 'funding gap' of perhaps \$250 billion, representing the unmet demand for financial services of enterprises, and that this market, while underserved, is in no sense a 'subprime' sector. IDB is active in providing technical assistance to the sector and a range of funding sources and instruments, together with direct equity investment and the creation of a variety of investment vehicles.

While projects for urban micro-enterprise finance, relying on grants and soft loans, date back to the 1970s, private commercial banks have long since entered the market and provided a growing share of micro-financial services. Regulated institutions account for some 70% of loan portfolio across the region. These include significant lending 'downscaled' banking operations as well as by 'upgraded' MFIs and 'greenfield' operations created specifically for the sector. Latin American microfinance is the most profitable, the fastest-growing and the least risky of all world microfinance sectors. It is also, in general, well-integrated with domestic financial sectors. Under current conditions, where foreign sources of funding have diminished, microfinance institutions that are well-connected locally are faring relatively well.

The maturity of the sector is shown by the fact that 31 of the top 100 world MFIs, rated on criteria of outreach, efficiency and transparency, are in the region. Meanwhile, based on criteria such as regulatory environment, investment climate and institutional development, there are substantial inter-country variations in performance within the region. Nonetheless in almost all countries bankers report higher returns on microfinance portfolios than on their more conventional portfolios, while industry associations acknowledge the evolution of microfinance and SME lending as mainstream banking products. The interest of commercial bankers has been stimulated by these products' relatively good performance in adverse economic conditions, pressure on bank profits from competition in other segments, and the diversification of portfolio risk and greater utilisation of banking capacity that is possible. Surveys suggest that 70% of commercial banks in the region expect to become involved in the sector within the short- to medium-term (compared with 30% at present).

Meanwhile the international financial crisis has had some impacts, including reduced access to external credit lines, higher funding costs and reduced margins, some portfolio deterioration, greater focus on existing clients and greater attention to domestic deposit mobilisation. Micro-enterprise clients in turn face higher interest rates and stricter criteria, shorter loan terms, lower loan amounts and a more limited supply of financial services. The IDB has been able to assist some MFIs by providing access to an 'Emergency Liquidity Facility' (ELF) set up some years ago to support institutions suffering problems due to external shocks.

THE NEED FOR AN INCLUSIVE FINANCIAL INFRASTRUCTURE -- CHALLENGES FOR JAPAN IN THE COMING YEARS

Mr. Hideo Kazusa, *General Manager, Transaction Services Division, Bank of Tokyo-Mitsubishi UFJ, Ltd. and Board Member, Society for Worldwide Interbank Financial Telecommunication (SWIFT)*

Mr Kazusa noted that Japan is a 'world leader' in terms of the demographic challenge arising from the aging and decline of its working age population. This has strong implications for labour supply and the demand for foreign workers. Thus, from a dependency ratio of 3.0 (population over 65 as a proportion of population 20-64) in 2005, Japan will move to ratios of 1.7 in 2030 and 1.2 in 2055. So far, migrant workers have been concentrated in the manufacturing sector, enjoy limited employment mobility within Japan and return home after completion of their engagements. The numbers of 'legitimate' migrants and their families are still relatively small (2.0 m in 2005 in a total population of 120m, or less than 2%, as compared with 10% in Germany) although the implication is that these numbers must increase.

Foreign workers in Japan were responsible for some Yen 400bn in officially recorded remittances (approx. \$4bn) in 2007. However estimates of the total (including remittances sent via unofficial channels) are as high as a trillion yen (say, \$10bn) suggesting a massive gap between the services provided by authorised financial institutions (which until this year have been limited to commercial banks) and the real requirements of remitters. Migrant workers are inadequately provided with other financial services during their residence in Japan. For example, consumer loans, insurance and investment options for them and their resident family members are ill-developed and expensive. Further, there is a lack of services that would enable Japanese resident workers to manage their financial affairs back home.

These deficiencies will only become more glaring in future, as the numbers of affected workers increase, unless the Japanese financial system can meet the challenge of providing the needed services. While it is evident that commercial banks alone cannot bridge the gap, the banks themselves must recognise resident foreigners as a market segment, overcome language and information issues, and develop relationships with correspondent banks and new non-bank partners to serve this segment. From 2009, payments services may be provided by non-bank service providers and a variety of remittance service-providers are being permitted to operate. Japanese banks are in need of partners able to provide links to the many foreign recipients who do not have bank accounts. While legislation may seek to remove barriers, administrative impediments may still occur. These may arise from official concerns regarding 'AML/KYC' considerations, the need for 100% security of funds transmitted and the verification of identity in accordance with GoJ standards. The approach taken to such issues may impose layers of expense and complexity to new procedures intended to facilitate transmission of remittances. It will be important for authorities to keep such issues under review to assure the financial inclusion of Japan's migrant worker population.

Report of the ABAC/Advisory Group Workshop on Commercially Sustainable Microfinance: A Strategy for Promoting Financial Inclusion in APEC

Dr. Julius Caesar Parreñas, *Coordinator, Advisory Group on APEC Financial System Capacity-Building and Senior Advisor, Chinatrust Financial Holding Co., Ltd.*

Dr. Parreñas summarized the outcomes of a workshop that ABAC and the Advisory Group held in January 2008 in Jakarta. Financial inclusion is an important issue for APEC. Within the Asia-Pacific region, huge portions of the population in developing economies do not have access to financial services. At the same time, this also presents an opportunity, given the benefits to the financial sector, the economy and society that can be realized, if these huge numbers of people can be brought into the economic mainstream and become regular consumers of financial services. Microfinance has attracted growing attention as a tool to make this happen with its ability to reach the financially excluded.

In 2002, under the Mexican chairmanship, APEC undertook a major initiative on microfinance. Being an advisory group to APEC Leaders, ABAC was called upon to give its views. At that time, ABAC put forward four recommendations. The first was that APEC promote an environment conducive to the development of micro-enterprises and MFIs. Second, ABAC proposed that policy reforms be accompanied by capacity-building measures, supported by multilateral financial institutions. Third, ABAC called on commercial institutions to support lending to microfinance. ABAC was keen to

emphasize that whenever done as part of commercial lending, it should be based on commercial principles. Finally, ABAC called for appropriate regulations for bank lending to MFIs.

Unfortunately, there was little further work undertaken in APEC after that, until last year when ABAC decided to revisit the issue. In the intervening years, several developments have changed the landscape of financial inclusion. Over the previous half-decade, microfinance has grown significantly, expanding its client base and its linkages to banking systems and capital markets. This rapid transformation has changed many people's views about the commercial viability of microfinance. This reassessment focuses on several characteristics that define microfinance today.

First, microfinance has proven to be profitable. During the past few years, a growing number of MFIs have become regulated deposit-taking institutions. Measured by return on assets, these institutions have outperformed the commercial banking sector in much of the developing world. Second, microfinance has become very attractive. Commercial banks use a wide range of options to engage in microfinance: front and back office functions, wholesale lending, equity, and loan service companies, in addition to specializing in microfinance. Microfinance investment vehicles began to attract a growing number of investors, offering geographic diversification with low volatility, low correlation and high asset quality.

Third, the scope of microfinance has considerably expanded. MFIs now offer a wide range of services, such as consumer and housing loans, savings accounts, life and health insurance, utility bills payments and international money transfers. Behind this transformation lie a number of key factors –technology, innovation, evolution, and policy reforms. MFIs have been quick to take advantage of IT connectivity, ATM, point-of-sale and mobile technology, smart cards and biometric information to reach a wider clientele. Today, clients can access financing through loan service agents, lottery agents, traders and processors, point-of sale networks including retail stores, ATMs and mobile phones. MFIs are evolving from their early origins to become licensed financial institutions that are now serving as bridges between large investors and low-income borrowers. Finally, policymakers now realize that an enabling environment is more effective than government credit and guarantee programs in promoting commercially sustainable microfinance.

There has been a growing realization that government's role should be to address legal, policy and regulatory barriers in order to facilitate the development of microfinance and increase its access to commercial funds. Progress toward financial inclusion can be accelerated by identifying the most critical policy solutions. Last year, ABAC and the Advisory Group considered the study by GTZ on alternative policy measures to promote financial inclusion and eventually endorsed the six policy solutions that have been chosen for discussion in greater detail in this workshop.

The attempt made in 2002 to tackle microfinance as part of APEC's agenda did not succeed because microfinance was not treated as a policy tool to address financial exclusion. It was seen at that time primarily as a social welfare measure to address the issue of poverty. Consequently, it did not attract the right audience and the right expertise that would have helped address the key issues. It also struggled unsuccessfully to fit into the SME development agenda, which required a totally different approach. However, current circumstances now favor giving microfinance a fresh start in APEC, as a tool for promoting financial inclusion and as part of the Finance Ministers' agenda.

The Jakarta workshop concluded with a number of recommendations. First, APEC should promote financial inclusion by incorporating it in its agenda. On account of financial inclusion being a central task of financial sector development, and the role that financial regulation and financial institutions would have to play in this process, its appropriate place should be within the APEC Finance Ministers' Process. Second, an APEC financial inclusion initiative should focus on providing an enabling legal, policy and regulatory environment. This initiative should include a research component, policy dialogue, sharing of experiences, and capacity-building activities. Finally, private sector collaboration is important for the successful design and implementation of critical measures.

ABAC has offered to work with APEC finance officials to realize this initiative. Through the Advisory Group, ABAC is collaborating with a number of interested institutions for this purpose. This workshop is the first fruit of that growing cooperation. Going forward, ABAC and the Advisory Group are keen to work with APEC finance officials to design a regional initiative that will add value to both global and

domestic efforts.

SESSION TWO

BEYOND BRANCHES: AGENT BANKING AND FINANCIAL INCLUSION

Questions and issues explored during this session included:

- Incorporating agent banking into policy and supervisory frameworks, such as rules regarding deposit taking, branching, cash handling, outsourcing, customer due diligence, and consumer protection.
- Using agents to increase the functionality of mainstream bank accounts.
- Expanding the range of agent services beyond pure payments.
- Optimal contracts between banks and agents; risk-sharing arrangements between agents and banks that balance safety and service expansion.
- Cooperation and communication between public and private partners.

Session Chair:

Mr. Hiroshi Toyoda, *Special Advisor for Asia, Inter-American Development Bank (IDB)*

Introduction by the Session Chair

Opening the session, Mr Toyoda remarked on the current grim world economic outlook and the negative impact of this on MFIs whose growth has been fuelled by cross-border capital flows. However he saw promise in the possibility that domestic banks may be energised to mobilise local deposits, including from the poor, in reaction to this situation. In this context, the discussion of agent banking is of particular relevance as a means of extending services more widely.

Agent Banking: Overview of Developments and Policy and Regulatory Issues

Mr. Ernesto Aguirre, *Financial System Advisor, CGAP and Former Superintendent of Banks of the Republic of Colombia*

Mr Aguirre stated his concern as determining the essential elements to be put in place to achieve agent banking networks in national economies. This must involve moving beyond the frontiers of traditional banking to achieve higher levels of ‘bancarisation’ among excluded populations. However if banks attempt outreach by establishing ‘light’ branches (that is small, and offering a limited range of services) they may incur high operating costs, as well as reputational risk associated with inability to honour commitments, perhaps due to cash handling and other difficulties. Conducting microfinance is quite expensive enough without such extra costs.

Banks may prefer instead to externalise these costs and risks by appointing agents. But the outsourcing of bank functions may be forbidden in some jurisdictions or at least lack a clear legal framework. This applies particularly to the acceptance of deposits. It may be desirable for the regulation and practice of agent banking to be developed in stages, with deposit-taking allowed eventually. Without being permitted to go this far, ‘bancarisation’ will be limited to payments services. Consequently, preliminary analysis is necessary to establish whether a legal basis exists for full agent banking, quite apart from determining whether the business case for it exists. Whether the business case can be established depends on the circumstances of each country and should not be taken for granted.

Permitted agency operations should be as wide as possible, to offset cash balances and minimise cash-handling and associated risk. Technologies employed should be appropriate to the agency role while safety arrangements should be adequate, but realistic in terms of conditions in the field. Regulations should be non-prescriptive though comprehensive, covering essential elements in the principal/agent relationship. ‘Tiered’ relationships may offer administrative advantages to banks, with an intermediate level of agents or ‘administrators’ inserted to deal with retail agents. However, while costs may be externalised by agency and tier relationships, in the final analysis the bank, as principal, is responsible to clients for the integrity of systems and the handling of their cash.

In regard to ML/CTF issues, the applicable regulations must be adapted to the circumstances of bank agencies with limited financial and technical capabilities and must keep in mind the very weak position of the bulk of clients who lack financial literacy. Limits on transactions and balances should be realistic and

financial ID requirements should be flexible. Achieving appropriate transparency, accountability and customer protection will require a regulatory framework that represents the constructive interaction of public and private sector interests. Effective systems for receiving complaints, resolving problems and redressing grievances are necessary, while improving the financial literacy of affected populations is the underlying need. Competition issues must also be addressed.

Branchless banking models may be devised for both banks and non-banks. Technologies including M-banking and POS devices and plastic cards are available; the essential requirement of technology is that it should permit data to be transmitted safely and cheaply, allowing branchless banking to be conducted within acceptable margins of risk. Regulation should be 'proportional', facilitating progress towards profitable operation and permitting innovation. It should also be 'balanced', that is, resulting from co-ordination between all relevant authorities. It is the responsibility of the private sector to make the business case; without that branchless banking simply will not fly.

Agent Banking: Case Study from Russia

Mr. Mikhail Mamuta, *President, Russian Microfinance Center*

Russia is a huge country in physical terms and at the end of the Soviet era it was left with underdeveloped banking infrastructure. It now has about 45% of population either unbanked or underbanked, with wide regional variations in coverage. The crisis has shown the banking system to be excessively reliant on foreign funding and to have neglected domestic savings mobilisation. It has also resulted in substantial branch closures. While agency facilities are widely spread, there are great disparities in the availability of services. For example, agencies cannot take deposits and while perhaps 95% of the population have access to payment services (largely via agencies) very low proportions have access to time deposits or consumer and mortgage loans.

A wide range of agency services are available: these include both bank and non-bank models, with services offered including payments and transfers as well as disbursements and repayments. In terms of modes of service, there are B2P services (using terminals), B2P services (collectors, credit brokers, credit cards distributed via the postal service), P2P (money transfers, including via post offices) and G2P (cards for social entitlements, pension payments via post offices). ATMs and terminals sit in bank branches, while banks maintain POS networks. Payments are made and received via post offices in a non-bank environment, while payment acceptance points are found in both bank and non-bank environments. Web-based payments facilities are set up by non-banks while bank-based 'mobile wallets' are provided via mobile phone operators. The Russian postal service is a legacy of the Soviet era which is now greatly underused, but plans are in train for its revival as a medium for financial services. For other service providers the very lack of regulation in Russia encourages innovation, although coverage is still very uneven and the range of services presently available is limited. Since 2003 both banks and non-banks have expanded the availability of a simple and inexpensive 'cash-in, cash-out' terminal which marks an advance over physical agents in terms of quality and convenience of service.

The legal framework for agency transactions is a patchwork of laws and regulations derived from the banking act, the postal law, the civil code and central bank regulations. The boundary between banking, post, agent and communication services has become blurred with the advent of e-money. Many legal restrictions and barriers exist to the flexibility of agency transactions. These include inflexible application of identification rules even for small payments, blurred division of responsibilities between banks and agents, inability of individuals to use electronic signatures, absence of a legal definition of e-money and vague and incomplete provision for consumer protection (as well as for agents).

New initiatives in legislation for and regulation of branchless banking are in preparation, however, and need to address a number of 'open questions'. These include transparency of pricing, how and to whom complaints should be directed, issues raised by the use of 'surrogate e-money', the lack of a single authority to regulate agency services and uniform national treatment of payments services. Finally, there is the question of whether policy or the market is the catalyst for change and innovation. Policy has lagged behind market innovation in the case of payment terminals, collection services and consumer credit; government has had to accept these developments and regulate accordingly. By contrast, policy

has led the market in providing privacy and consumer protection safeguards (as for example in the Credit Bureau law of 2004).

Brief Commentaries:

Mr. Raul Hernandez-Coss, *Director General for Access to Finance, National Banking and Securities Commission (Mexico)*

Sr. Hernandez-Coss provided an overview of the operations of agent banking in Mexico, which has an overall financial inclusion rate of 25% with low penetration and narrow distribution of bank branches. The banking system is highly concentrated (seven banks holding almost 90% of deposits) while competition is lacking and service costs remain high. New regulations for banking agents provide great potential for increasing competition through alternative channels to serve the unbanked. Both bank and non-bank models are possible. Since 2005 new banks tied to retail chains have emerged with a new banking model, including deposit-taking on retail premises. Deposit transactions are conducted electronically in real-time via agents and the banks assume responsibility for transactions, assuring consumer protection and trust. Most strong retail chains are urban and even in urban areas their coverage is uneven. Nonetheless the potential for catalytic development exists, as service points are multiplied and more of the unbanked gain access to services in the familiar surroundings of retail stores. Client transaction costs are reduced and competitive pressures in the banking industry are increased. Banks find a wider client base and face lower infrastructure costs of expansion. Retail premises attract custom by offering financial services and achieve a more loyal customer base.

Some lessons are emerging from this experience. Deeply-entrenched interests emerge to oppose change, including the dominant banks with their branch networks. It has been necessary to define objectives of the agency model clearly and to identify necessary legislative and regulatory changes for their achievement. Keeping customer deposits safe at all times is essential for the system to work. Making regulation too complex may prejudice the usefulness of the model in providing basic banking services, while coordination with all other relevant authorities is essential to achieve the inclusiveness and effectiveness of regulations. Efforts to educate legislators and other regulatory agencies may be necessary to achieve these ends. Finally, there is no such thing as an unequivocal set of guidelines for introducing banking agents; careful study of international experience and the application of this to local conditions are necessary to achieve a tailored solution.

Ms. Juanita Woodward, *Director, Customer Relations for Asia Pacific, Eurogiro*

In discussing the potential for agent banking in the region it would be wise not to forget the potential for agency services residing in the public sector, and especially in postal organisations. Eurogiro is a good example as a global payments network connecting 60 public and private sector organisations - mainly postal organisations and posts banks, along with commercial banks - in some 50 countries. It regards payments and remittance services, its core business, as a catalyst for financial inclusion.

Postal organisations have tremendous geographic reach in city and rural areas through their domestic branch networks. With so many access points, postal organisations are well suited to offer remittances across international borders as seen from the Eurogiro network remittance service relationship between Korea Post and the National Savings Bank (NSB) of Sri Lanka. NSB operates via Sri Lanka Post, and also provides other microfinance services - accounts, credit, and insurance to Sri Lankans.

A relatively sophisticated example is the suite of financial services offered through Singapore Post to Singapore residents including foreign workers. For remittances, SingPost partners with banks and other financial service providers in a number of countries. SingPost also offers consumer loan services, insurance and investment products through agent relationships with banks, as well as finance, insurance and investment management companies.

Across the globe and especially in developing countries, postal organisations are a trusted brand, and provide a welcoming environment to the unbanked. Private and government banks see great value to partner with postal organisations, to reach customers in rural areas and especially expand their core payments business.

In terms of the rich variety of experience described above, there is a clear need for regulatory frameworks to take advantage of the potential residing in postal networks. In doing so, it is important for authorities to avoid setting 'exclusivity' arrangements in place, since these have been shown to reduce innovation and price competition.

Mr Vishwavir Saran Das, *Executive Director, Reserve Bank of India.*

India, like the moon, has both a bright and a dark side. While on the one hand, the country has been the second fastest growing economy in the world, on the other, there is around 26 percent of the population which is below the poverty line. Banking policy has often mirrored changes in broader economic policy. Thus bank nationalisations in 1969 engineered an historic shift from 'class' banking to 'mass' banking, a change which made possible the more recent phenomenon of the Self-Help Group. Even so, by 2003 only 59% of the population had access to bank accounts. In 2005 the Reserve Bank, India's central bank, called on the banking sector to 'scale up' its outreach and permitted them to use field agents (called business correspondents or facilitators) many of whom come from the social sector. Agents are permitted to accept small deposits, make payments and process loan applications. They are encouraged to use technology, such as biometric 'smart' cards, and a range of experiments has trialled innovations, with agents providing the 'last mile of connectivity'. The Reserve Bank asked banks to offer 'no frills' accounts from 2006 and there are now some 16 million of these. However surveys suggest a high rate of 'dormancy' of these accounts, suggesting that many holders do not know how to use their accounts, perhaps due to limited financial literacy. India has more than 150 thousand post office branches and the Reserve Bank encourages the banks to use these as agencies. India also has some 360 million mobile phone subscribers and the potential is obvious. The RBI has recently issued guidelines to banks on mobile banking for making payments for small sums of money within the country on behalf of customers. There is, however, no law permitting RBI to regulate TELCOs, should they decide to branch into financial services in advance of regulation. Social backwardness and limited sensitivity observed on the part of some banks at the grassroot level act as impediments for financial inclusion due to which progress has been less rapid than was initially hoped.

SESSION THREE

ACCESS CALLING: MOBILE PHONE BANKING AND FINANCIAL INCLUSION

Questions and issues to be explored during this session include:

- Finding the appropriate regulatory space for mobile phone banking activities, covering issues such as deposit taking, electronic money, payment systems, data privacy and security, consumer protection, and customer due diligence.
- Coordinating policy mandates at this unique intersection of financial services and telecommunications.
- Issue of competition and interoperability.
- Balancing protection with experimentation needed to get mobile phone banking models off the ground.
- Expanding the range of applications used beyond payments.

Session Chair:

Mr. Craig Wilson, *Executive Director, Foundation for Development Cooperation*

Case Study: Mobile phone banking and financial inclusion in the Philippines

Mr. Nestor Espenilla, *Deputy Governor, Bangko Sentral ng Pilipinas*

In terms of conventional retail banking and financial infrastructure, the Philippines has almost 8000 bank branch offices and some 6000 financial cooperatives. Around 7700 ATMs are in commission. There is a concentration of facilities in higher income urban areas and a significant proportion of the low income population remains unserved. Indeed some 40% of municipalities do not have any banking offices. In response BsP, the central bank, has adopted the explicit corporate objective of expanding institutions that use multi-channels to deliver a wider range of financial services to reach more people. Existing branch networks will be expanded, technology will be employed to find new ways to deliver financial services and non-bank retail institutions will be used to extend service networks.

With respect to the uptake of technology, BsP has sanctioned two e-money products. The first, and simpler regulatory challenge, was 'Smart Money', the product of a major commercial bank. At Smart Money's launch, in 2004, existing BsP circulars governing electronic banking and outsourcing were judged adequate to the task. The second, and more difficult regulatory challenge, was 'G-cash', which is not a bank product. Its provider was ultimately licensed by BsP as a 'remittance agent'. This followed a careful process of examining the product and consulting with the service provider. Issues such as consumer protection, money-laundering and the soundness of the product itself were considered. Given its potential scale, BSP felt it better to accept responsibility for the product rather than allowing it to proceed unregulated. Subsequently the central bank has worked through a range of issues arising from the e-banking phenomenon and issued circulars on topics such as registration for AML compliance, technology risk management and consumer protection. Most recently (2009) it has issued comprehensive regulations for issuance of electronic money. These are generalised to deal with the further development of the industry.

The impact of e-money has been substantial. Some eight million people use one or other of the two products, while the numbers of banks involved is growing. Apart from the larger commercial banks, increasing numbers of small rural banks are participating. Some banks have lowered interest rates, by up to 50bps/month, on microfinance loans administered via the phone repayment platform. Lower cost remittance channels have seen remittance costs fall markedly. These advances are opening the way for concerted action to increase financial inclusion through an integrated system of e-money. This will require the convergence of mobile technology, e-money and the traditional brick-and-mortar networks of financial institutions. It will involve bank and non-bank partnerships and require an integrated and seamless regulatory framework under the guidance of the BsP. The act of creating e-money will be decoupled from banking transactions, while 'non-exclusive' third party agent networks will be enabled to handle all transactions other than retail deposits, which will remain the province of regulated banks.

Proportionate regulation will be necessary to avoid stifling innovation and to permit market growth. E-banking and e-money cannot be permitted to challenge the integrity of the financial system or the rights of consumers and appropriate regulation and supervision are essential. There will need to be clear delineation of deposit-taking transactions as against receipt of funds for other purposes and the proportionate regulation of each. Financial inclusion can be deepened by simple and convenient deposit and fund transfer products that can mature into more value-generating relationships. The reach of banking services can be leveraged by the combination of a liberalised branching regime, mobile banking technology and strategic partnerships with third party non-bank agent networks. Sound internal governance arrangements for all players are essential, both to complement a proportionate scheme of regulation and to maintain order and discipline in potentially large new financial ecosystems.

Mobile Phone Banking: Policy and Regulatory Issues

Ms. Marina Solin, *Programme Director, GSM Association*

The GSM Association is a global industry association for mobile communications, representing some 740 member entities with around 200 associated entities. With funding from the Gates Foundation it is conducting an initiative, 'Mobile Money for the Unbanked'. This aims by 2011 to provide mobile money services to 20 million new unbanked customers living under \$2 a day. Additionally, it has the goals: 1) to have mobile money accepted by mobile operators as mainstream business 2) to have the product available extensively to formerly unbanked people, and 3) to extend reach and reduce costs of formal services, including savings, insurance and credit. An initial concern is to identify regulatory change of most utility for its goals. Regulation must help to leverage non-bank distribution chains, must enable easier registration of unbanked customers (thus requiring proportionate KYC provisions) and should regulate products rather than players (such as payments regulation for non-banks).

Convergence between financial services and Telecoms requires financial regulators to become more comfortable dealing with mobile operators providing mobile money. This will flow from dialogue and the exchange of international experience, the study of success stories, and efforts to recognise risks and to find ways to mitigate them effectively. It is necessary to see how regulation can help mobile network operators to reach the unbanked. They need payments as a first step, so we start from there to explore the capability of mobile money to serve them in an effective and proportionate regulatory environment. From

there a road map is needed to show regulators and operators how to move customers up the value chain of services in a market-led process. The road map should link risks with proportionate regulation. Attention should focus on topics (eg, KYC, agency and payment regulation for non-banks) whose appropriate and proportionate regulation offers most scope for outreach to the unbanked. Industry/regulator dialogue should aim to build understanding of the issues and trust between players.

The question of interoperability between service providers is complex, since network effects differ greatly between situations of interoperability and exclusivity. There is no straightforward 'template' solution for all situations since considerations of market power and strategic positioning affect the behaviour and political stances of players. Without interoperability, market behaviour may be very competitive, with benefits for consumers in terms of services available and prices. If interoperability is introduced, the stimulus to competition is likely to be reduced. Attitudes to its introduction on the part of players are influenced by their size and positioning. A dominant player can be expected to oppose interoperability and to 'stonewall' against its introduction. The point at which a regulator might intervene most effectively is not simple to determine either. Different considerations apply in (for example) start-up markets as opposed to established markets with firms of similar market power. Again, in situations where 'asymmetric' firms exist there is typically a threshold market share for the large firm below which it will agree to interconnect and above which it will refuse. Regulators may assist in resolving difficult situations by foreshadowing the introduction of interconnection at some point and according to certain criteria.

Brief Commentaries:

Mr. Hourn Thy, *Project Manager, Access to Finance, International Finance Corporation*

Cambodia is a small (14 million+), poor economy with low banking penetration (about 5%) and a cash-based, highly dollarised economy. Mobile phone penetration is 28% with three operators, the dominant one having 69% market share. This case study concerns 'Wing', a mobile payments service provider and subsidiary of the Australian ANZ banking group. Wing, now operating in an experimental and 'pre-regulation' mode, is the product of collaboration between ANZ and the IFC. The latter took part in the feasibility study and is collaborating in developing and refining the Wing business model. Since January 2009 Wing has enabled customers and businesses to transfer money within Cambodia, and deposit or withdraw, via mobile phones (any phone, any carrier). Customers may make payment for transactions with eligible merchants. There is no monthly fee for holding a Wing m-wallet and customer funds are held in a regulated bank. Wing has an arrangement with an MFI for rural distribution, and persons without phones may use the service, via agents. Arrangements with garment factories permit workers' pay to be credited direct to their m-wallets, where balances are measured in airtime. Apart from garment workers, university students and convenience store owners are immediate market-segments of interest, with farmers targeted for growth over time.

In terms of regulation, the service is available only in the Cambodian *Riel* which is the medium of exchange for only a small proportion of transactions in Cambodia at present. It is planned to revisit this matter quite soon. Authorities are receiving international technical assistance to consider the regulatory issues involved in dollar transactions. There is no regulation on m-banking in Cambodia at present, although Wing has central bank permission to operate on an experimental basis. There is close communication between Wing, ANZ and the central bank on developing the regulatory framework. IFC and experts from a World Bank unit concerned with payments systems are also involved in the process. Wing is thus a work-in-progress but already appears to be a promising 'experiment'.

Mr Taiji Inui, *Senior Manager, Financial Planning and Administration Department, NTT Data Corporation Japan*

Mr Inui reported on Japanese experience with electronic retail payment systems and a wide range of initiatives underway. Electronic money is already very common in Japan and substantial public and commercial infrastructures exist to support activities. NTT Data, a technical support provider to the industry, has been cooperating with service providers as a partner. Electronic money can be in stored value form on IC (smart) cards including 'contactless' cards from many providers in pre-paid form. An example of the pre-paid form is the Transport Smart Card, with stored value. Post-pay form based on credit cards is also available in a way similar to pre-paid form and regarded as electronic money in

general. Some providers allow using electronic money with mobile phones (about 10 million phones). Innovation based on mobile phone technology sending “stored value” as an alternative method of international remittance is also discussed since the remittances from foreign workers based in Japan are significant and will grow. Some 80 million chip-based cards (electronic purses) are in use in Japan with total value outstanding of JPY77bn (say USD 770bn) and annual transactions value of JPY 564bn (some 800 million transactions). He pointed out that coins have been decreasing possibly replaced by electronic money in Japan. Having said that, since electronic money in circulation is still only equivalent to 0.007% of M3, it has no implications for monetary policy implementation for the time being. Mr Inui also shared technologies paying a variety of bills, including for tax, utility, and internet shopping using mobile phones or without having bank accounts from bank counters or convenient stores. He commented that, though Japanese service providers have yet to meet the challenges of international remittance and microfinance, advanced technologies in Japan including solutions under development may contribute to the global society and hopefully more people can get benefit of such convenient technologies. He was conscious of ‘preaching to Buddha’ with this workshop audience.

Open Forum

In response to questions, speakers made the following additional points:

Deputy Governor Espenilla clarified that since demand in the Philippines focuses on payments, the central bank concentrated initially on regulating that area of activity. BsP does not regard stored value as a deposit; it is a payments instrument backed by money in a bank account. Careful attention is given to the governance and internal controls of entities offering this service. However, the Bank sees no sense in heavy regulation for low-value payments which are not likely to be used for money laundering. Even in the case where third party agents are used to accept ‘deposits’ it still feels that light regulation is appropriate.

Ms Solin dealt with the issue of ‘proportionate’ regulation in relation to risks. Dialogue with regulators is necessary to agree on the nature of particular risks. Most commonly regulators are concerned with AML issues so it is necessary to agree how this risk may be ruled out. Agency risks are another concern of regulators while how service providers manage their stored value ‘float’ is an obvious concern. It is necessary to work with regulators to examine each contingency and to see how risk may be mitigated. However it is an important principle that regulation should ‘follow the market’ (rather than copying the unfortunate example provided by the EU, which imposed an *a priori* regulatory framework on an immature industry). Similarly, to focus regulation only on banks constrains competition and innovation. Ideally regulation should allow for the possibility of bank vs. non-bank vs. ‘third-party player’ competition.

Welcome dinner

Speaker: Mr Raul Hernandez-Coss, *Director-General for Access to Finance, National Banking and Securities Commission, Mexico*

Mr Hernandez-Coss wanted ‘to share with you some thoughts on the journey that Mexico is taking towards financial inclusion’. Mexico believes that economic development without financial inclusion is impossible and is very pleased to have a role in AFI’s start-up committee. AFI is an important opportunity for Mexico. First, because ‘we want to learn ... from those countries that are taking the front seat on branchless banking, payment systems regulations, mobile financial services and other effective policy solutions for financial inclusion ... We want to learn from those that are determined to move from the theoretical approaches to implementing innovative practices, regulations and schemes... However we want to tailor those lessons to our own context. We don’t want recipes, we want ingredients!’

‘Second, we want to share’: ‘with policymakers, regulators and international organisations the challenges that we have faced, but also the success stories that we are expecting to witness’. And third, ‘we want support’ in the task of ‘designing and implementing a national strategy for financial inclusion’ [because] ‘being a part of AFI will push for the design of public policies for financial inclusion in our country’.

For these three purposes we need

- A good diagnostic to tell us where we are in terms of financial inclusion

- A common framework to design policies to promote access
 - Better coordination among agencies and with the private sector
 - New products and services for those outside the mainstream
 - Effective methodology to measure policy impact, including solid data
- ‘I see AFI as a policy network, owned by policymakers, all of us here’.

Wednesday, 1 April 2009

SESSION FOUR

NEW MODELS, NEW PROVIDERS: INCREASING THE DIVERSITY OF MICROFINANCE SERVICE PROVISION

Questions and issues explored during this session included:

- Policy choices governing alternative providers of financial services, including tiered license regimes and proportionate regulation of lower-risk deposit takers and micro-insurance providers.
- Balance costs and benefits of regulation and supervision (e.g. make sure that there are sufficient licensable MFIs, introduction of regulation including capacity building is time and resource consuming)
- Regulatory requirements that are best suited to induce scale of micro-insurance business models.
- Leveling the playing field in terms of subsidized funding to encourage deposit mobilization and commercially sustainable operations.
- Dealing with large groups of unregulated providers (e.g. burial societies, cooperative societies that take deposits).
- Fiscal policies that promote new entrants and models without distorting the market.
- Policy instruments that are most effective in crowding in private investment and market development.

Session Chair:

Mr. Eric Duflos, *Senior Microfinance Specialist, CGAP*

Introduction by the Session Chair

In his introduction, Mr Duflos referred to definitions relevant to this session of the workshop. These are promulgated by CGAP, which has offered them as standards for the industry. See ‘Guiding principles on regulation and supervision of microfinance’, available at http://www.cgap.org/gm/document-1.9.2787/Guideline_RegSup.pdf

Innovative Policy Choices Governing Pro-Poor Financial Service Providers: Case Study from Uganda

Ms Clare Wavamunno, *Consultant, aikan Uganda*

For background, Uganda enjoyed a decade of 6% GDP growth from 1997, with low inflation for most of that period and substantial declines in the incidence of both poverty and HIV. Population growth is very high at 3.4%, while almost 60% of population continue to rely on agriculture and the financial inclusion rate is 38% (21% formal, 17% informal). Financial sector legislation covers banks and regulated financial institutions, financial cooperatives and moneylenders, while NGO/MFIs and other community-based entities are covered by an NGO statute and are not permitted to take deposits. Legislation in 2003 created a new class of ‘microfinance deposit-taking institutions’ (MDIs). This regularised the status of large and dynamic informal institutions that had emerged to meet the demand for micro-financial services. There are four such institutions and apart from savings facilities they offer short term loans, money transfers and micro-insurance.

The legislation of 2003 had some positive outcomes: the new deposit-taking institutions gained status and public confidence, their ownership and governance structures were clarified and they have been able to invest in HRD and Ugandan leadership, while donor coordination in meeting their capacity-building

needs has been facilitated. They are subject to the discipline of standardized reporting and increased competition and better services are evident. On the other hand, compliance imposes high costs and is time-consuming. Relatively few institutions have been able to attain the standards required under the MDI Act. They face stiff competition from non-deposit-taking institutions, which are more lightly regulated and among which malpractice is rife. The Act is now facing a challenge, because the existing MDIs aspire to upgrade to commercial bank status while the best-qualified MFIs operating at the lower level are reluctant to upgrade to MDI status, perceiving MDIs as over-regulated and constrained in their capacity to react to market opportunities. Some of the best performers may even aspire to transform directly into commercial banks. This apparent impasse, which may lead to an institutional vacuum in the MDI 'space', holds broader significance for efforts to legislate for financial inclusion in comparable countries.

The largest number of poor clients in rural areas is still served by MFIs and SACCOs at the lower level where institutional weakness is rife. Most recently, government has reacted to this situation with a new initiative at that level. It has imposed interest rate ceilings and initiated a 'Prosperity for All' program led by financial extension workers. A credit facility is to be delivered down to the sub-county level using SACCOs and with Post Bank as the linking institution. New legislation and supervision for SACCOs and non-deposit-taking MFIs is promised. The stance is one of re-exerting control due to excesses and strong electoral pressure for grass roots financial service facilities. Meanwhile the impasse affecting the MDIs remains. Nonetheless there are positives from the experience of institution-building in Uganda, with the integration of microfinance products into the business models of a wide range of financial institutions. Policy will continue to ebb and flow and the need for active policy dialogue to avoid negative outcomes has never been more evident.

In question-time, and in relation to regulation as a 'blunt instrument', Ms Wavamunno was asked to consider whether it would have been more effective to legislate for linkage and/or agency relationships rather than creating new regulated MF institutions. She defended the path taken by regulators, who made it clear what the rules were and how they could be taken advantage of. The new MDIs brought many savers into the formal sector and institutions have found this a profitable niche. Concerning linkages: these do operate and MDIs are involved in relationships with commercial banks. Concerning the newly imposed interest rate caps, the government has set up a wholesale fund to direct subsidized funds to MFIs via Post Bank, allowing a maximum spread of 4%

Brief Commentary

Ms. Gabriela Braun, Director, *Alliance for Financial Inclusion*

Ms Braun commented, in relation to the Ugandan case, that even where the direct effects of regulation are disappointing, there may be helpful secondary effects such as drawing the commercial banks into the sector. More generally, it is best to regard microfinance regulation as an integral part of a coherent policy framework for financial inclusion. Legislation should be framed with understanding of the realities of microfinance and especially the risk profile typical of the sector. It should not be a 'cut and paste' job using regulations drawn from other countries. Regulation should embody the understanding that microfinance is 'a line of business' with regulators focusing on products rather than the institutions providing them. Concepts must be clarified and roles defined prior to drafting a law. In this process stakeholder consultation and collaboration are crucial.

The costs of prudential regulation should not be underestimated and the scope of regulation should be defined accordingly. Guiding principles include avoiding premature prudential regulation; there must be a critical mass of 'licensable' MFIs. Also, authorities should not regulate what they cannot supervise. Supervisors should be adequately prepared and equipped for their work. Authorities need to take enough time to get the framework right and should be convinced that the benefits of access to domestic savings justify the extra costs imposed on supervisors and the supervised. Supervisors will require strong technical capacity and in-depth knowledge of microfinance. The supervision of SACCOs is also an issue, due to their typically weak internal controls and the large numbers of small institutions involved. Challenges for regulated MFIs include constraints on their rural outreach due to the costs of opening branches (although agency arrangements may help in this regard) and the high costs of transforming themselves to meet the required standards. In general, there is a danger of politicization, due to the high

level of attention given to microfinance when legislation is proposed. This applies particularly when creating a separate law for microfinance.

Comment: Mr Kim Vada, *Deputy Director General, National Bank of Cambodia*

Mr Vada commenced with some comparisons between Uganda and Cambodia. Cambodia has a more credit-focused microfinance industry, with ACLEDA bank transforming from an NGO rural credit operator to the deposit-taking institution, as so-called, the best-known microfinance bank. With a total population of around 13.5 million, Cambodia has been able to provide financial access to around a million households and government sees microfinance as its most powerful tool against poverty. In regard to development policy, government is permissive in regard to foreign ownership and investment and favours a liberal interest rate regime. Thus with regard to microfinance, foreign sources of funding are important, as is foreign ownership of institutions, while interest rates are unregulated and government is not interventionist towards the industry. As seen in the case of the mobile banking provider Wing (session 3, above) National Bank of Cambodia (NBC, the central bank) has a positive attitude to mobile banking, seeing it as providing more widespread access than either ATMs or internet banking, especially given the inability of commercial banks to reach the rural poor. Since 2001, when a *Law on Banking and Financial Institutions* and associated regulations came into effect, there has been quite rapid development in the industry, with borrower numbers more than doubling while loans outstanding have grown nine-fold to \$277m (excluding ACLEDA bank). However deposits are insignificant at \$5.4m and the number of depositors has actually declined somewhat. Currently, microfinance businesses are conducted by 18 licensed MFIs, 25 registered NGOs as rural credit operators and around 60 other unregistered NGOs operating in rural areas. The legal framework requires MF operators operating above certain thresholds either to register with NBC or to become licensed by it. Credit MF operators must apply for registration and a license to the NBC when they have loan portfolio outstanding more than \$25,000 and \$250,000, respectively. Savings are limited to the compulsory deposits of members or clients.

However in 2007 NBC established a new institutional category eligible for existing licensed MFIs to mobilize savings from the public, the Microfinance Deposit-Taking Institution (MDI). This new regulation includes some criteria and conditions for existing MFIs to comply with (i.e. minimum paid up capital of around USD2.5 million). Five applications for this status are under review at present. This is a considerable step-up from the minimum capital of \$62,500 for a licensed MFI. For comparison, specialized banks require a minimum \$7.5m capital and full-service commercial banks around \$38m. The eligibility criteria for MDI are microfinance operating experience, good performance on NBC's own rating system, an effective MIS and implementation of the NBC chart of accounts, as well as past profitability. Once operating they will be subject to prudential norms, such as now apply to licensed MFIs, including CAR equal to 15% of risk-adjusted assets and a capital guarantee deposit at the central bank. Loan classification and provisioning norms will apply, as also limits on large exposures and related party transactions, minimum liquidity and reserve requirements related to volume of deposits held and maximum net open currency positions. In terms of off-site supervision, licensed MFIs observe a strict monthly reporting regime, while registered MFIs report quarterly and to less demanding requirements. All licensed MFIs are subjected to on-site supervision over a 12 to 18 month cycle. NBC aims to achieve the linkage of banking and microfinance in the national financial system, and to develop appropriate financial infrastructure including a wholesale national payments system, and money and inter-bank markets including short-term government securities. It aims for similar treatment of entities providing similar financial services and to provide an environment in which non-banks may conduct banking activities. NBC intends to increase access for the excluded, to diversify the range of institutions and to support their sustainability and commerciality with a flexible regulatory and supervisory regime.

Comment: Mr Khairul Anwar, *Head of Bureau, SME Development Bureau, Bank Indonesia.*

Mr Anwar's presentation was titled **Strategy and Policy of Indonesian Microfinance Development**

Some 40 million micro- and small enterprises are served by a range of financial institutions, a number of them unique to Indonesia. They include service providers regulated by the central bank, (rural banks, the well-known BRI units, and the BKD or village credit agencies) other formally regulated institutions such

as financial cooperatives (both conventional and Islamic), pawnshops and the locally-owned LDKPs (village fund and credit institutions). In addition there is a host of non-formal financial service providers, including NGOs and self-help groups, many of them affiliated with one or another of Indonesia's numerous government credit programs. Non-bank entities are regulated and supervised by government agencies, including sectoral and provincial authorities. Deposits in commercial banks and rural banks are partially secured by deposit guarantees, while credit insurance facilities apply to certain government programs targeting micro-, small and medium-sized enterprises. One such is the KUR (credit for people's activities) administered by Bank Indonesia, the central bank. This involves channeling funds from commercial banks to MFIs for enterprise lending. For example, at the micro-level, loans range up to IR5 million (\$500) with a maximum annual interest rate of 24%. Banks receive favourable treatment in terms of the risk-weighting attached to such credits and also receive credit insurance cover up to 70% from another government agency. With GTZ technical assistance, Bank Indonesia has devoted a lot of attention to its system of around 2,700 small 'rural banks'. These regulated local institutions are seen as occupying a strategic position in relation to micro- and small enterprise financing. Recognising the diversity and range of capacities in this sector, Bank Indonesia has adopted a 'stratification' for these banks with levels of regulation and supervision based on each bank's position. It plans to establish an apex institution to strengthen the capacity and financial stability of the system as a whole. There are also plans for a comprehensive microfinance law to deal with the host of institutions not regulated by Bank Indonesia. Under discussion since 2001, this law has not yet been presented to the legislature.

Micro-insurance: Policy and Regulatory Issues

Mr. Arup Chatterjee, *Principal Administrator, International Association of Insurance Supervisors (IAIS)*

The International Association of Insurance Supervisors (IAIS) is the international standard setter for insurance regulation. In 2006-07 it teamed with CGAP Working Group on Microinsurance to prepare an authoritative statement on issues in the regulation and supervision of microinsurance. Mr Chatterjee sees a clear distinction between microfinance and microinsurance, summed up by the aphorism, 'microfinance helps people improve, but microinsurance helps them protect the gains'. So poverty reduction requires not just the generation of incomes but also protecting income through effective risk management.

Microinsurance is defined as insurance accessed by low-income people, provided by a variety of institutions, run in accordance with accepted insurance principles and funded by premiums. Typically it consists of risk-pooling products designed to be appropriate for the low-income market in relation to cost, terms, coverage and delivery mechanisms. It allows families to move beyond informal risk-sharing arrangements, common in traditional societies, to transferring risks formally. This may be done as policy-holders of regulated insurers (a market-led approach) or as citizen-members of government-financed social protection schemes (a social security approach). The presentation was concerned primarily with market approaches, consistent with the emphasis on commerciality and sustainability in microfinance more generally.

Factors affecting the development of microinsurance include the proportion of population in the low-income categories. Microinsurance development is certainly appropriate when the proportion is high, although the limited discretionary income available for insurance is a hurdle. When insurance in general has low penetration the scope for take-up of microinsurance appears correspondingly limited. When low-income communities develop informal pooling mechanisms to cope with risk events this suggests a demand not being satisfied by the formal market and perhaps also the existence of regulatory and other impediments to the formalisation of insurance mechanisms. The adoption of financial inclusion policies can give a 'push' to microinsurance by incorporating it into the inclusion framework. This also helps to provide a clear mandate to regulators and supervisors to support market development. The level of demand provides a 'pull' factor, in the sense that long-term growth and scale depend on the financial viability of each market.

Sound macroeconomic policies, robust market infrastructure and a strong transparent legal framework are keys for a broader participation from long-term social and commercial investors. Microinsurance can develop in the absence of regulation but uncertainty will prevail, affecting both providers and customers. Where regulation exists, uncertainty as to its application also undermines microinsurance development. Regulatory approaches may be either proactive or reactive and they may be facilitative or exclusionary.

Regulatory burden is a potentially significant constraint on market development, with issues of compliance costs and the pressure for exclusions from regulation. Achieving a low-burden regime reduces the need for special dispensations while high burden regimes combined with limited regulatory capacity (a common enough situation) provide incentives for informality and constrain market development. While recognising the diversity of insurance activities and markets, from the regulatory stand point the focus is primarily on consistent application of the principle of proportionality based on the nature, scale and complexity of risk which an insurer may be exposed to. Most potential national insurance markets are in the early (dormant) stages of development. As a corollary, this is also true with respect to microinsurance. The external environment for market development, in terms of political stability, property rights and contract enforcement may still be deficient, while industry-specific building blocks (including insurance law, regulatory and supervisory framework, data collection and government capacity for risk management) may still be inadequate. Sound macroeconomic management and financially inclusive policies, adoption of international insurance principles and standards coupled with capacity development of both local market participants and regulators will provide a launch pad for microinsurance market development. The ongoing collaborative work program of IAIS and MIN (the Microinsurance Network) on an 'Access to Insurance Initiative' deserves continuing support.

Brief Commentaries:

Mr. Gil Beltran, *Undersecretary, Department of Finance, and Chairman, National Credit Council, Republic of the Philippines*

The Philippines, with some 27 million of its 90 million population under the poverty threshold, has a relatively sophisticated banking system and a small insurance industry with significant room for growth. There is an embryonic microinsurance sector covering perhaps 2.9m people (little more than 5% of adult population). Of these about 60% have coverage from formal institutions (corporates including banks, mutuals, life insurance associated with credit, etc) and 40% from informal sources such as cooperatives and unincorporated mutuals. A 'National Strategy for Microfinance', which is supported by political will and a relatively strong infrastructure of service providers, has incorporated microinsurance into its program. The regulatory environment of the Philippines also supports financial inclusion and facilitates the growth of microinsurance institutions and products. Specifically, it has defined microinsurance and related premiums and benefits to the minimum wage as benchmarks, facilitated the entry of mutual benefit associations wholly engaged in microinsurance, required the simplification of documentation for microinsurance products, minimised 'know your customer' requirements in relation to AML provisions and permitted major banks to market insurance products on bank premises.

Regulation has played a positive role in that the successes of mainstream microfinance have encouraged operators to branch into insurance. Financial inclusion policy, embodied in the national microfinance strategy, has prompted the regulator to take a proactive stance in regard to microinsurance, while the explicit inclusion of insurance in the regulatory regime has stirred awareness in the industry. Finally, regulatory flexibility has allowed space for innovation. However barriers remain, including the absence of an effective regulatory environment for cooperatives, some of which have unregulated in-house insurance schemes and many of which are weak and prone to failure. There is also a degree of regulatory ambiguity affecting 'pre-need' and health care plans, while well-publicised failures of some pre-need companies have inhibited growth in this area. There is an absence of regulatory incentive to persuade large commercial insurers to offer microinsurance (apart from group life policies) in the low-income market. Further, rural banks are still prohibited from selling microinsurance from within their premises. The Philippines continues to benefit from collaboration with the Japan Fund for Poverty Reduction and the ADB in improving the regulatory framework, strengthening capacities of regulators and service providers and promoting financial literacy in regard to microinsurance. Complementary technical assistance is soon to be provided by GTZ. In terms of national microfinance strategy, the expectation is that if microfinance assists the poor with their present financial needs, then microinsurance will offer a shield for their unexpected and future financial needs.

In discussion the following points were raised: The issue of discrimination affecting certain classes of people for insurance (of any sort); policies of companies may block access. This suggests the need to guarantee access. It may be useful to assemble data on observable exclusion from access to insurance

coverage and to conduct pilot programs trialling products and institutions to overcome this problem. There may also be a role for policyholder protection legislation. Mr Beltran reported having some data concerning access to services for the Philippines and noted that microinsurance there arises from a culture of community 'friendly societies'. Another person commented that 'microinsurance' may be altogether too diverse a range of products; it might be better to differentiate products by risk and to start with those products most easily provided.

Thursday, 2 April 2009

SESSION FIVE

RETHINKING GOVERNANCE AND MANAGEMENT OF PUBLIC BANKS TO PROMOTE FINANCIAL INCLUSION

Questions and issues explored during this session:

- Mitigating political influences that hinder sustainable operations and competition.
- Incentivizing and professionalizing management and governance of state banks.
- Managing the evolution of public banks: transitioning from first tier (retail) to second tier (wholesale) activities, market development strategies to attract private players, decisions on reforming v. closure.
- Phasing out subsidies, leaving fair and transparent market-based disclosure and pricing regimes in their place.
- Effective models of public-private partnerships to foster service expansion to the poor.

Session Chair:

Mr. Yo Takeuchi, *Chief Financial Officer and Member of the Board, Development Bank of Japan, Inc.*

Introduction by the Session Chair

Mr Takeuchi referred to his own institution, which played a role from 1951 in the postwar reconstruction of Japan and, having recently become a joint-stock company, is now tracking towards full privatization. It is undergoing a transformation, with a new corporate philosophy and a new business model. During this process he has come to appreciate more fully the need for good governance and commercial orientation, characteristics crucial for the success of any policy-based financial institution. Public banks assume an even more important role under current economic conditions since institutions with a long-term developmental perspective can step in to assure the continued growth of microfinance and have great potential for promoting financial inclusion.

Governance and Management of Public Banks and Financial Inclusion: Case Study from India

Mr. M.V. Nair, *Chairman and Managing Director, Union Bank of India*

India, with more than a billion people and some 630,000 villages, still suffers considerable financial exclusion despite recent rapid economic growth. Thus, among farmers, 86% are excluded from formal credit sources and more than 50% are excluded from any formal financial services. The total unbanked population is some 400 million people, despite several government initiatives aimed at providing access to services. The Government nationalised banks in 1969 and then in 1980 to assure provision of services to poor and rural population. During the 90s the pendulum swung back, with a phase of banking liberalisation. New private sector banks seized the opportunity to grow and innovate, making substantial inroads into the market share of State owned banks. Also during the 90s, State owned banks commenced new approaches to rural financial inclusion, which were increasingly influenced by microfinance principles (eg, self-help groups). Since 2007 there are signs of State-owned banks reversing the loss of

market share. State-owned banks have reformed Corporate governance and incentive structures, and gained greater operational autonomy, as well as embracing new technologies. Union Bank of India was the first large public bank to network all of its branches (some 2,600 of them). In parallel with these reforms, recent regulatory and government initiatives are changing the banking landscape, especially in rural areas. Branchless banking has been facilitated by allowing the appointment of banking agents, giving extra reach and faster delivery. Banks have yielded to Government by opening millions of 'no-frills' bank accounts for the poor (although results of this innovation appear mixed so far). A target of establishing 100,000 'common service centres' (already one-third fulfilled) has been set to provide rural transactions services. A 'National Payment Corporation' set up as a public/private partnership in 2008 will provide a robust retail payment infrastructure nationally. A National Identity card, expected to facilitate financial inclusion, is being rolled out for all citizens.

Union Bank of India, the State owned- bank, of which Mr Nair is Chairman and Managing director, has contributed to recent innovations in financial inclusion. It regards its own fortunes as being closely linked to the success of the financial inclusion enterprise. It has issued biometric financial identity cards to milk collection agents with an ultimate aim to reach more than 12 million retail 'milk pourers'. This is an agency financial services model, with the agents handling payment and credit products. The bank has provided cards to 150,000 hawkers [migrant labourers] (among about 10 million active in India) to allow them to access savings, credit, remittance and micro-insurance products offered by Union Bank of India. More than a million cards have been issued to recipients of benefits under the National Rural Employment Guarantee Program (NREGP). The bank has established 200 'village knowledge centres' providing financial literacy training, counseling and facilitating self-help groups. It has partnered a government agency to set up 250 'training-cum-incubation centres' benefiting rural youth.

In terms of further policy and regulatory breakthroughs, Mr Nair believes that Government should have land records put onto a technology platform to simplify searches and create a collateral asset for landholders. It should press on to create a unique and trackable identifier for every citizen, enabling cost savings in the delivery of financial products and, in addition, administer all grants and social programs via chip-enabled cards. From the regulatory perspective, all interest rate caps on small loans should finally and comprehensively be lifted. Eligibility for 'Business Correspondent' status should be reviewed to permit a wider field of recruitment, while restrictions on banks' collaborating with other industries should be eased, to lower distribution costs. All players in the industry should be encouraged to spend more on promoting financial literacy. In conclusion, Mr Nair is convinced that Indian public banks continue to gain strength and confidence and are ready to meet new challenges. The unique Indian public banking model is worthy of wider emulation. 'Don't get rid of your public banks. You may need them one day!'

Governance and Management of Public Banks and Financial Inclusion: Case Study from Mongolia

Mr. Peter Morrow, *Chief Executive Officer, Khan Bank*

Mr Morrow noted the contrasts, in scale and other characteristics, between the Mongolian case and that of India. Khan bank operates in a country of small and sparse population spread across large distances. Population is 2.5 million with 42 million head of livestock. Khan had been a failing state bank whose turnaround was (eventually) executed by a successful privatization and the injection of outside management. Separated from the state monobank in 1991, the bank was notionally privatised and renamed as the Agricultural Bank of Mongolia. This first phase ended in 1996 with the failure of the bank and its recapitalisation by donors. But operations continued as before and by 1999 it was placed in receivership. So dire were its circumstances that its closure was considered. But it was the only bank operating in rural

Mongolia, with 70% of the country's bank offices, was essential for pension and budget payments, had 400,000 customers and was politically impossible to shut down. So a compromise 'remediation' program was devised jointly by the GoM and the central bank with the World Bank and USAID. Government reacquired 100% control and agreed to hire external management, to appoint an independent board, to refrain from operational interference and to eventual privatisation. A management contract was awarded to US firm DAI. This provided for two expatriate managers (CEO, COO) with full control, four local executives and 400 days of consulting support. The brief called for the institution to be made financially sound, for rural financial services to be restored and for the bank to be prepared for privatisation. Total cost for 27 months was \$2.7m.

The critical challenge for reform lay in the branches, around 270 of them, mostly rural. After study, management determined they had huge 'franchise value' as the only bank in rural areas and the only branch network in the country. Most branches were remote, located in towns of 200 to 500 residents and often 50 to 150 km from the next town. The population was very poor, without telephone or internet, or even roads, and 180 branches had no electricity. Most were losing money (but not much) but operating costs were very low and no lending income was coming in. There appeared to be little sense, and much risk, in closing branches while the upside risk of expansion seemed small and the possibilities were promising. In terms of lending performance the Ag Bank had a bad record. The central bank counselled against resuming lending, but remediation of the bank's condition required lending to recommence. So a single, simple, pilot product, trader credit, was launched. It presented an attractive alternative to pawnshop lending at 10% per month, on which traders had been forced to rely. All policies and procedures were overhauled, intensive training was done and the product was introduced systematically to the system, accompanied by intensive monitoring. This careful start has since broadened out to a successful portfolio. In the event it turned out that there was a huge pent-up demand for financial services and that repayment performance is good if loans are properly structured.

Bank staff, 75% of them graduates, were long-tenured and very loyal. While tactically excellent they were strategically weak and accustomed to following orders. Saying 'no' was difficult for them. The approach taken was to teach staff new tasks and enforce new policies (eg, transparency), to harness the culture rather than change it, to require quantitative goals to be met and to offer an incentive salary structure, all in the context of intensive training. The idea that an entrenched 'state sector culture' would hold the bank back proved incorrect. The staff turned out to be a source of strength. Marketing also played its part: Ag Bank was rebranded as 'Khan Bank' with new logo, colours and style. The new brand was promoted vigorously and foreign management was presented, successfully, as an asset for the corporate image. Having overcome initial obstacles, attention then turned to the privatisation. As embodied in the project agreement, there was commitment to a transparent process, open to foreign and domestic bidders. There were to be no restrictions on future operations other than required by prudential regulation. A Japanese entity was the highest bidder and in the final outcome a consortium of that bidder together with IFC and local shareholders was formed. DAI was retained as manager with 4% equity. Today Khan is Mongolia's largest and most profitable bank, used by 80% of households, banker to the government, used by most corporates and international agencies and with a credit rating higher than Mongolia's own sovereign rating. It has entered urban and SME markets, has ATMs and POS services, cards and phone banking. Since 2007 it has been involved in investment banking and international capital markets. Key lessons are that to restructure a state bank for high performance requires independent management with power to say no, a strong measure of international support ('conditionality'), the attitude of running 'a bank, not a project', starting with a clean balance sheet and being adequately funded up to the point of profitability.

Brief Commentaries:

Ms Wajeetip Pongpech, *Financial Institutions Policy Group, Bank of Thailand*

Ms Wajeetip addressed the topic from the perspective of a Thai central banker. She claimed that almost 84% of Thai households use formal sector financial services (including the many rural people who are affiliated with government-funded 'village funds' linked to state banking institutions). Most households use about three or four products. Around 10% of the population, low income people in rural areas who are labourers or economically inactive, do not access institutional financial services. This success is due to requirements imposed on commercial banks and the active role of state institutions. However 4% of households still lack access to deposit accounts due to isolation, high minimum deposit requirements or financial illiteracy, while 15% lack access to formal credit services due to inadequate financial status or collateral or inadequate information and financial understanding. A particular feature of the Thai banking landscape is the set of 'specialised financial institutions' (SFIs). These are state-owned, each with a mandate to serve a particular market segment that might otherwise be underbanked. Two institutions, the Government Savings Bank and the Bank for Agriculture and Agricultural Cooperatives are especially significant in promoting financial inclusion. The promotion of national savings and community stability are particular concerns. They are not regulated by the central bank and regulatory and supervisory authority is spread among a number of agencies.

The SFIs are subject to performance evaluation by a government agency, the State Enterprise Policy Office, which sets performance criteria for these institutions in terms of support for government policy, financial and non-financial performance and governance. Ratings are published annually and the incentives and bonuses of directors and employees are linked to the outcomes. With regard to issues of political interference in the operations of SFIs, there is a need for transparency. This can be promoted by financial accounting which distinguishes clearly between the public sector activities and the normal business accounts of these banks. It is important that accountability should be clearly identified for any losses arising from government projects carried on the balance sheets of SFIs.

In future it is likely that the SFIs will evolve in the direction of wholesale dealings with community-based entities such as village funds, savings groups and cooperatives. These will need capacity-building to allow them to provide financial services to rural people. While the level of financial inclusion appears satisfactory, a third of Thai households save less than 5% of their earnings. Whether subsidies that currently support the operations of SFIs in rural areas can be phased out and commercial banks can be convinced to provide services in these areas is a major problem. The performance gap between state and private institutions is narrowing and there is an increasing overlap between their respective target markets. The government's 'Financial Sector Master Plan' aims to provide an enabling environment for a commercial banking presence in the countryside and to provide supporting infrastructure. Greater efforts to increase financial literacy will also be needed. A credit guarantee scheme for small business loans may prove to be a model for public-private partnership in rural areas.

Comments: Discussion turned to how financial institutions can help Thai agriculture. A banker commented that strong political will is necessary to improve financial inclusion. In the past, Thai governments offered 'sweeteners' to commercial banks to operate in rural areas and banks were permitted to cross-subsidise their rural operations. The crisis at the end of the '90s forced closures in rural areas although banks are still expected to provide some minimum coverage. They tend to 'horse-trade' among themselves to find ways of meeting these requirements. Ms Wajeetip commented that the expansion of SFIs after the crisis was intended to compensate for the decline in commercial bank presence in the regions but their role must change in future.

A Mexican participant noted that in his country the state bank is currently playing an anti-cyclical role. This has renewed debate on the proper role of such banks: should they be concerned with profit, sustainability or social goals? Do they deserve special treatment in terms of regulation? There is a multiplicity of state programs which can be said to support

financial inclusion but there are many overlaps, perverse incentives and instances of local capture. Mr Nair commented that ‘efficiency should be ownership-neutral’. He denied that any ‘special treatment’ occurs in India and. But neither is there a level playing field, since state ownership ‘dampens’ the decision-making process. However the state banks have an advantage in retaining trust, especially in difficult times.

SESSION SIX

INNOVATIONS IN BUILDING INCLUSIVE FINANCIAL IDENTITIES

Questions and issues explored during this session included:

- Using identification technology, including biometrics, to build inclusive financial identities in unconventional ways.
- Balancing innovation in identification techniques with data privacy protection and security.
- Education and awareness-raising so new identity tools, including customer data, are both trusted and protected.
- Risk-based adjustment of Know-Your-Customer rules to create affordable basic financial services.
- Proactive measures for reducing identity fraud and improve the quality of personal information in credit registers.
- Public-private partnerships to implement and scale-up systems of identification and sharing of customer transaction records.

Session Chair:

Dr. Twatchai Yongkittikul, Co-Chair, Advisory Group on APEC Financial System Capacity-Building; Co-Chair, ABAC Finance Working Group and Secretary-General, Thai Bankers’ Association

Building Inclusive Financial Identities

Dr. Nicola Jentzsch, Senior Research Fellow, Technical University Berlin

Participants were introduced to ‘Regina’, a person without financial identity. This is because although she is well known in the village in Bangladesh where she has lived all her life, she has no birth certificate (and nor has anyone else in her family). Her house has electricity, but the account is in her husband’s name. How can she secure financial ID in order to apply for credit for the small shop she runs?

An identity is established by a set of ‘identification parameters’ or features (name, address, phone number, etc ...) whose combination is uniquely attributable to just one individual. A financial identity is an identity associated with the financial transaction history of an individual (payment transactions, credit repayment, savings behaviour, etc ...). The technical documentation of identities is from official documents (passports, ID cards, driving license, etc) and non-official documents such as worker’s ID, utility records, letters of attestation, etc...). Financial identities are built up from public and private information sources, and involve data aggregation and dbase management, together with data analytics. The individual’s identity must be established for engagement in such financial matters as transaction accounts, credit facilities, asset management and insurance. Where civil registration is universal, as in most of the developed world, identity is built upon birth registration and the subsequent noting of life events. ID documents (ID card, passport, driver’s license) can be issued on the basis of civil registration. Where (as in much of the developing world) there are wide variations in registration rates, the establishment of identity is much more problematic. Financial systems, or individual institutions, may create databases for financial ID in response to central bank concerns (KYC and AML obligations, etc) but obviously this leaves much room for uncertainty. Globally, it is estimated that in 2007 some 350 million working people were unidentified.

In terms of financial identity, international standards have been promoted for ‘Know your customer’ procedures by the Financial Action Task Force (FATF). Inter alia, these include the requirement to verify clients’ identity based on ‘reliable independent source documents, data or information [that is] most

difficult to counterfeit'. Simplified KYC procedures are available for specific institutions and some transactions judged lower-risk. However grey areas remain in the implementation of these procedures. A pragmatic approach involves risk-adjusting ID requirements to particular bank products and circumstances, with data requirements increasing as a client passes over a series of 'thresholds'. At the lowest level, in the world of informal reputational systems and social networks (such as self-help groups) formal ID parameters are not required to permit customers to deal with institutions. A threshold must be crossed, requiring some minimal ID parameters, to permit low risk customers to open a basic bank account. Further thresholds, with successively more rigorous parameters, must be crossed to permit (firstly) 'normal' customers to engage in standard commercial bank transactions and (next) 'high risk' customers to access services. Simplified KYC requirements introduced by the Reserve Bank of India in 2008 allow customers to be 'identified' for small savings and credit accounts, and allow already 'identified' clients to introduce other clients. Photos are required and client addresses are verified informally. In the Philippines, authorities now accept a variety of credentials, including school, voter and municipal IDs. In South Africa a national ID card is required for a basic account but informal address verification is acceptable and a standard 'risk matrix' is applied to identify low risk customers and transactions. Biometric cards are being issued in Uganda and Malawi, the first a private sector initiative and the second a World Bank field experiment. The costs involved may be too expensive for some countries. Data protection issues also arise in these and other circumstances. Privacy protection is necessary and failure to maintain it can threaten confidence in the banking sector.

The creation of financial identity will increase financial inclusion. It will do so more quickly with further innovations in identification and the more widespread use of biometrics or other reliable techniques. The creation of affordable basic accounts suitable for micro-transactions and reduced ID obligations, mobile banking for such transactions and a greater number and variety of service points at which identity may be established, will all contribute to greater inclusion, increasing the financial status of individuals. However personal data must be protected throughout the ID lifecycle and consumers need to be educated about privacy issues. Open policy issues include the need for innovative ways to ID persons using local infrastructures, how to create the incentives (ie. useful and sustainable entry-level products) for people to seek ID and how to design optimal private privacy protocols.

Innovations in Building Inclusive Financial Identities: Case study from Indonesia

Mr. Pungky Purnomo Wibowo, *Senior Researcher, Directorate of Banking Research and Regulation, Bank Indonesia*

Title: Increasing financial access for the unbanked by developing financial identities: a concept note.

Mr Wibowo introduced participants to a pilot project to be conducted by Bank Indonesia in conjunction with AFI. With almost 60% of Indonesians unbanked, the project focus is on the lack of 'financial identity' as a factor in their inability to access formal services. There is insufficient information available in most cases to permit identities to be constructed. While another project has been working on a credit rating scheme for SMEs this is not yet available. Obstacles exist to the compilation of necessary data. Community awareness of the value of collecting and using relevant data is limited. Data relating to communities that has been compiled by provincial and local authorities is not online nor is it easily compiled in a central database. Further, there is a lack of coordination between agencies with access to various necessary data elements. The objective of the project is to overcome these difficulties and to create a financial identity database capable of supporting an increase in the level of financial inclusion from the present 42% to 65%. Individuals will be given a 'financial identity number' (FIN) by which they can be identified and their data accessed by authorised financial institutions. An early objective will be to prepare a 'blueprint' for the project in discussion with relevant agencies whose collaboration is essential to the success of the project. Considerable effort will be put into assuring the commitment of all stakeholders. Preliminary surveys will be conducted for pilot projects, each dealing with a particular segment of the unbanked. Examples are people involved in 'arisan' (traditional Indonesian informal savings and loan groups whose membership runs into many millions) and the school savings program, also a mass movement. This is to be done in preparation for the construction of databases for these people, satisfying minimum KYC requirements. At the same time, Bank Indonesia will work with commercial banks to persuade them to design and offer a free basic bank account suitable for these people when they acquire FIN identities. The project will aim to add a million identities to its database annually

over a five year pilot project timeframe and to see those people graduate to entry-level bank accounts, while steadily increasing the number of banks that offer such accounts. While work proceeds on creating FIN identities for the unbanked, Bank Indonesia has work underway to create other financial identifiers for people already accessing the financial system. These will include a 'customer ID number' (CIN) for those with bank accounts and a 'debtor ID number' (DIN) for borrowers. It is planned in due course to integrate these data bases with the project's FIN data to create a 'single ID number' (SIN). This will be the key to a unique financial identity for each person recorded in the system. With further growth in coverage this could become a potent instrument for financial inclusion in Indonesia.

Brief Commentaries:

Mr. Tony Lythgoe, Principal Financial Specialist, Global Credit Bureau Program, International Finance Corporation

The main problem is not necessarily a lack of ID, but rather inconsistencies in the use of IDs. A unique identifier is what is needed. For example, there are some 22 ID systems in Egypt, with no link, for example, between a person's passport number and an ID number. Without such cross-references it is not possible to have a unique identifier and people may be inclined to use different identifiers for dealing with different banks. Another quite common problem with ID systems occurs when they are kept 'tight', so that it is not possible to check with the issuing authority to validate the client's ID. Technology presents both opportunities and limitations, as seen with biometric IDs which are effective in providing unique identification but vulnerable to technological problems, such as may occur in storing and transmitting data. The condition and performance of telecoms infrastructure may be deficient in many developing country situations. Other problems may be socio-political; for example certain populations may be resistant to biometric or other ID registration (for example, Australia is a technologically-advanced country whose voters appear to share this aversion).

Mr. Khandakar Muzharul Haque, Executive Director, Bangladesh Bank

In Bangladesh biometrics have been used successfully by the Electoral Commission for a national ID card (used for the election in December 2008). However there are challenges in Bangladesh, in the form of overlaps between various databases, which raise the possibility of coordination failure. Authorities are also concerned about privacy issues associated with biometric ID and its use in the banking environment. The state of infrastructure is also a concern in Bangladesh. Investment in the platforms for transmission and storage of biometric data is necessary, especially given problems experienced with electricity supply.

Discussion: Dr Jentzsch said it is difficult for credit bureaus to operate without a functioning ID system and certainly more expensive for banks to conduct their inquiries. The number of documents required is multiplied. If banks are given an efficient system of financial identity and are able to price loans for risk more effectively, then 'risk-based pricing is rent-switching', meaning that cross-subsidies tend to be eliminated. Also, in her presentation she had mentioned the possibility of negative externalities occurring if information is collected for one purpose and then used for others, without consent of the persons concerned. There are pressures to allow 'legitimate' private sector users access to data (banks, telcos, marketers) and a 'bandwagon' effect can occur. There are legislated protections against this now in Europe. She likened the absence of financial identity to a form of exclusion, for example the 'identity exclusion' of pavement dwellers. Socio-political obstacles may exist in a variety of circumstances; Indonesians, for example, appear quite averse to fingerprinting. In order to convince recalcitrant populations, policy must aim to place the balance of advantage quite obviously on the side of accepting the technology. Biometrics are not the only way, or necessarily the cheapest. Indian experience with smart cards may point in an alternative direction.

Raul Hernandez-Coss mentioned that Mexico has IDs but not a national ID system, and that such systems are often associated with dictatorship in the popular mind. But identification is a global problem with many facets; for example, about 10% of Mexican manual labourers don't have a recordable fingerprint. Eduardo Jimenez referred to private credit bureaus which do not communicate with one another and to the real problem of identity exclusion among the poor. Dr Thorat referred to the merging of databases and the need to have privacy protocols to avoid injustice to individuals about whom adverse conclusions might otherwise be drawn. Mr Lythgoe asked 'whose data is it anyway?' if permissions have been given by

respondents (although the issue of informed consent may be relevant here). The DVD/Betamax comparison is apt; we need to avoid each agency adopting its own protocol and being unable to talk with the others. He warned that a functioning financial ID system won't necessarily give lenders a greater appetite for risk. Another referred to issues of governance; sloppy supervision of contractors may lead to inefficient implementation. The capacity of bureaucracies to handle the issues is a real problem.

SESSION SEVEN

CONSUMER PROTECTION INNOVATIONS AT THE BOTTOM OF THE PYRAMID

Questions and issues explored during this session included:

- Balancing protection with access through simple, basic rules and principles that keep costs manageable and legal uncertainty to a minimum.
- Translating consumer protection codes into concrete changes in microfinance providers' policies, procedures, and customer interaction
- Fair, accessible recourse and redress, especially when judicial options are limited. What is the most suitable and effective enforcement model?
- Technology solutions to improve consumer protection and informed choice.
- Using credit information and other data sources to monitor indebtedness trends and abuse in credit markets.
- Policies that are effective in preventing excessive lending to poor customers resulting in over-indebtedness.
- Financial education programs to initiate inexperienced customers to new ways of saving and managing risks.
- Detection and prevention of common financial fraud schemes and consumer education on warning signs for fraud (e.g. financial pyramids)

Session Chair:

Dr. Yashwant Thorat, *Regional Associate, Alliance for Financial Inclusion*

Introduction by the Session Chair

Dr Thorat introduced the topic by listing an 'overarching set of principles' for consumer protection at the bottom of the pyramid. First: the need for education and publicity. Poor and marginalised consumers need to understand the products presented to them, and especially so in the case of financial products. For this reason organisations catering to the financial needs of the poor normally have induction or education programs prior to offering services, and especially loan services. The Reserve Bank of India has launched a mass financial literacy program with picture books in major communal languages to explain financial services. Mass media (TV, radio) and public events are employed for consumer education. Second: the principle of transparency (a small word with multiple dimensions). In the financial sector this encompasses easy-to-understand contracts with the most important provisions brought specifically to the attention of the customer. To enhance transparency, can we think of a 'code of commitment' that banks could accept, adherence to which would be monitored and enforced, either by self-regulation or by an enforcement agency? Third, the principle of reasonableness or fairness: Contracts must be fair and not loaded against the consumer; charges should not be excessive or usurious and should bear a reasonable relationship to the matrix of cost and normal profit; an approved and transparent policy for interest rates should treat equally all customers who are placed equally. From a normative perspective, those at the bottom of the pyramid deserve some degree of concessionality. Perhaps the state should make subventions to reduce the transaction cost and risk premiums applying to services for the poor, while designing such subventions to avoid their being misused. Fourth, regarding responsibility for the actions of agents and outsourced services: Banks should accept responsibility to compensate, fairly and transparently, customers who suffer due to the mistakes or misdeeds of agents or outsourced services, or

the failures of IT systems. Added risks arise in the case of branchless banking and these must be addressed by the banks. Fifth, there are issues arising from the need for fair recovery practices: Separating the functions of selling and recovery can create biases in favour of irresponsible marketing and harsh recovery. Regulators need to review the incentives offered to agents by banks and MFIs. Here also there is a case for a 'code of commitment' eschewing any resort to violence in words or action or other forms of harassment. Finally, there are issues related to redress for complaints or grievances: machinery for the redress of client concerns may be internal or external. In some countries a Banking Ombudsman exists for redress of grievances not dealt with internally by banks. However, considering the numbers of clients involved, their often low levels of education and access to formal procedures, more innovative approaches may be called for. Perhaps local 'awareness camps' can be convened, to be attended by bank staff responsible for handling grievances and staff of the Ombudsman, together with customers wishing to air grievances. In-camera sittings might be arranged where reconciliation can be managed and rulings given in simpler matters. The Ombudsman could have Q&A sessions, via newspaper columns or talkback radio and TV. These could be valuable in tracking trends in bank practices and management of customer grievances as well as in informing the public.

Consumer Protection Innovations: Case Study from Peru

Dr. Fernando Arrunategui Martinez, *Head of the Department of Products and Services to the Consumer Superintendency of Banks, Insurance and Private Pension Funds, Peru*

The confidence of consumers is a key element in financial inclusion and transparency is more powerful than regulation in securing that confidence (though both are necessary to consumer protection). The Superintendency does not solve consumer complaints but regulates the policies and procedures followed by financial institutions themselves in order to receive, manage and resolve complaints presented by consumers. Other recourse mechanisms are available to consumers unsatisfied by the responses of financial institutions. Apart from the courts, these are the Financial Ombudsman of the banking association and a consumer protection agency. The better managed complaints are, within the offending institutions, the fewer will be referred on to these third party agencies. Close to 400,000 complaints were directed to financial institutions in 2008 of which only a tiny proportion proceeded on to the Ombudsman or consumer agency because they were unresolved. The role of the superintendency (SBS) is to take preventive, or ex ante, measures to assure resolution of difficulties. It aims to provide adequate regulation and constant supervision efforts, together with promoting increased financial literacy to reduce complaints. It focuses on what it does best, regulating and supervising institutions so as to decrease the potential reputational risk they might suffer through consumer malpractice, as with any other possible source of risk. To this end, SBS drafts and approves appropriate regulation, carries out supervision, conducts information campaigns and financial literacy projects and engages in consumer orientation and inquiry-solving processes. For greater information transparency and consumer protection, it has consolidated all relevant regulations in a single document. This includes the obligations of institutions to provide all relevant information and to install an in-house 'user services system' to assure consumer protection and information transparency. Institutions must calculate and publish 'comparison' rates for credit and deposit products that show costs and yields after all relevant charges are taken into account. In regard to branchless banking, regulations now prescribe the public disclosure required of agents when dealing with the public. As E-banking products and services have grown in importance, internet services must be backed by institutional websites with full disclosure of necessary information. As phone and mobile banking are more recent, no special regulations exist yet for these procedures, although for the time being operational risks and informational disclosures of these services are covered by general regulatory provisions. Where new regulation is thought necessary SBS is required to 'pre-publish' new or amended regulations to permit comment.

Supervision is conducted off-site, on-site and unannounced. For the first of these, SBS constantly checks information published by institutions (websites, mass media, price lists, complaint reports) to assure disclosure of relevant information. A 'consumer risk model' is used to identify financial institutions requiring guidance. The model is a rating device that employs statistical scoring and combines quantitative and qualitative information about compliance with the consolidated regulatory document. SBS conducts information campaigns, publishing market average interest rates which are carried by mainstream media, also comparative information on other costs on a comparative basis. More recently

this information has been presented, with real-time updates, on the SBS website. Advertising campaigns refer consumers to the information on the website and issues are picked up in the media, increasing visibility and awareness. Financial literacy is encouraged by the insertion of elements into high school curricula and teacher training programs, and by targeting various social groups. These efforts are spreading in scope and numbers of people contacted. Much attention is given to producing attractive and informative materials. A 'virtual classroom' CD is distributed to teachers for lesson preparation and is to be made available online. A 'financial literacy plan' is being developed for the period 2009-11. This will commence with baseline measures of financial literacy in six target audiences, then conduct widespread 'propagation' action to reach these audiences, followed by a closing measure of literacy levels. SBS has opened three 'Offices for User Services' to provide information and take part in campaigns and consumer protection fairs. All this activity has produced some lessons. Ex-ante action is a more cost-effective way of protecting consumers than attempting to resolve their problems directly. Regulation and oversight are key tools for consumer protection just as for other areas of supervisory concern. When financial services are extended through non-traditional channels, this requires review of consumer protection rules as well as operational procedures. Transparency in information is not a natural process and requires regulatory attention. Financial literacy is an efficient way of empowering consumers, a tool of economic policy against financial crisis and a means to increase awareness of new service channels. Finally, partnership with educational authorities and mass media is essential.

Consumer Protection Innovations: Case Study from Malaysia

Ms. Koid Swee Lian, *Director, Consumer and Market Conduct Department, Bank Negara Malaysia*

To have well-informed and empowered consumers of financial services and to assure their fair and equitable treatment is to support the broader stability of the financial system. Achieving these ends in a changing financial system requires correcting information asymmetry and improving transparency levels. These tasks are complicated by the introduction of innovative and complex financial products, by changing delivery channels and the trend towards growing consumer debt and lower household saving levels, as well as by attitudinal changes especially among the young. Low levels of financial literacy and the prevalence of scams create problems while extended life expectancies and higher expectations impact on financial needs and behaviour. Regulators operate in an arena of competing expectations and pressures from various stakeholders and a balance has to be struck between protecting consumers and allowing innovation. Regulation must be both appropriate and avoid imposing excessive costs, while key stakeholders have to be brought along with the process at all times. Market conduct regulation is a tool for balancing bargaining power between consumer and service provider by reducing information asymmetry between them, requiring plain language in contracts and other documentation and exerting market discipline on providers. Surveillance of conduct and enforcement of breach remedies are part of the regulation package. Ensuring fair treatment of consumers and market integrity requires specific regulation as well as intelligence gathering by means of attention to customer complaints and 'mystery shopping', 'name and shame' publicity and reprimands and penalties where appropriate. Close attention is paid to assuring effective product disclosure, providing consumers with the information to make informed decisions and facilitating comparison of alternatives. In regard to fees and charges, an effort is made to take a balanced approach with due regard to market forces, but applying guiding principles and requiring a basic framework of services. Institutions are required to provide access to a minimum level of financial products and services at reasonable cost, obligations which are spelt out in detail.

The Consumer and Market Conduct department's mandate includes also accepting responsibility for enhancing consumers' financial capability by developing and disseminating financial information via print and electronic media and in schools and community groups. Apart from the general community there are also outreach activities for the visually-impaired, both adults and children. Action has been taken to create and publicise avenues for consumers to seek help and redress. Financial institutions must have a complaints unit and there are specific services such as the Credit Counselling and Debt Management Agency which targets youth, the Financial Mediation Bureau Centre which has financial industry involvement and a Small Debt Resolution Scheme. The central bank has its own focal point, an 'Integrated Contact Centre', for complaints management and advice. Other institutional infrastructure has relevance for consumer protection, including deposit insurance to which all banks subscribe and a credit information database (the Central Credit Information System) designed to facilitate credit risk

management and promote a more efficient credit process as well as to avoid consumer over-indebtedness. Identities of individuals are assured by collaboration with national registration authorities, company details are provided by the Companies Commission of Malaysia and 64 participating financial institutions report data to the system, which also draws upon the information base of a private credit reporting provider.

Consumer Protection Innovations: Case Study from South Africa

Ms. Nomsa Motshegare, *Chief Operations Officer, National Credit Regulator, South Africa*

This presentation describes the evolution of a regulatory framework for microfinance lending in South Africa from the late 1990s to 2006. The impetus for regulation came after a period in which micro-lending activity had proliferated. In 1999, a 'Usury Act exemption Notice' was issued, with the effect of regulating both commercial and NGO lenders while exempting them from the interest rate cap applicable under the Usury Act. The Microfinance Regulatory Council (MFRC) was appointed to the regulatory task. The MFRC's mandate covered the regulation of the micro-lending industry, facilitation of increased access to finance and consumer protection. The Exemption Notice made it a condition of all micro-lender operations (those who extended credit up to a new maximum of R10,000 at rates above the statutory cap) to register with the MFRC. In 2002 it became compulsory for all suppliers of microfinance to register with the National Loans Register (NLR). The NLR is a database that records all loans disbursed by lenders registered with the MFRC. Under the Exemption Notice lenders were obliged to comply with certain conditions. These included protections for borrowers: that loan agreements must be in writing, rules of disclosure under loan agreements, that lenders must not use client's bank card or pin to collect money, that lenders must have complaints procedures, and that agents used by lenders are managed in accordance with MFRC stipulations, in terms of training, registration and contracts with agents. There were also provisions designed to prevent 'reckless lending'. Lenders must have policies to prevent this; they must consider the ability of borrowers to repay and they must make enquiries on the National Loans Register before final approval.

Subsequently the National Credit Act of 2005 was enacted to provide comprehensive legislation for micro-lending. The National Credit Act aims to regulate the granting of consumer credit by all credit providers, including microlenders, banks and retailers. This new legislative framework created formal bodies, the National Credit Regulator and the National Consumer Tribunal, to play a vital role in ensuring enforcement, promotion of access to redress and to deal with breaches of the Act. Credit providers, credit bureaux and debt counselling services are obliged to register under the Act. However the Act applies generally, irrespective of registration status. Credit providers under a (quite low) threshold are exempt, but such providers are unable to advertise and their agreements are unenforceable. The Act does not apply to borrowers classed as 'juristic persons' with assets or turnover above \$100,000. There is an informal complaints resolution process, telephone-based in the first instance. The approach to enforcement is to require letters of undertaking, or compliance notices may be issued or matters may be referred to the National Consumer Council. The NCR has an active program of stakeholder outreach and uses the media actively to propagate its messages. It has a research capacity, with particular interests in access to finance issues, socio-economic impact and over-indebtedness. It takes active measures to combat reckless lending, by requiring lenders to make 'affordability assessments' of clients. If lenders are judged to have infringed reckless lending provisions the courts may suspend enforcement and may refer consumers to debt counsellors. The NCR makes efforts to achieve fairness in credit marketing, by prohibiting automatic increases in credit limits, by requiring a standard 1 page pre-agreement quote on all agreement. It has prohibited 'single premium' credit life insurance, required crucial disclosures and created a register of credit agreements while regulating credit bureaux. In conclusion, the NCR operates to monitor the conduct of all registered entities to ensure compliance with the Act. While consumers must accept responsibility for their actions, the credit industry has been too willing to push the limits. South Africa has to develop a market where consumers can benefit from access to credit without being damaged by it. The Regulator's priority is to engage constructively with banks to achieve constructive working relationships and to balance consumer rights with the requirements of the industry to the benefit of all players.

Financial Education for Consumer Protection

Ms. Monique Cohen, *President, Microfinance Opportunities*

Financial education communicates the knowledge, skills and attitudes that people need to adopt good money management practices for earning, spending, saving, borrowing and investing. A core curriculum for financial education would include budgeting, savings, debt management, bank services and financial negotiation. It could be supplemented by specialised modules for topics such as risk management and insurance, remittances, consumer protection and perhaps current concerns such as mobile banking. Some emphasis on youth and money management would also be useful. But it's important not to forget that MFIs and their clients have different perspectives and that MFIs also need education and attitudinal change. MFIs may feel satisfied with their focus on concerns such as quality of service, good treatment of clients, avoidance of over-indebtedness, fair pricing, transparency and appropriate debt collection practices. From a client perspective, while there is a degree of correspondence in terms of these issues, there are often significant differences in emphasis. Issues of respect and truthful information, and mechanisms for redress of grievances, also feature among their concerns.

'Transparency' may have a different meaning for the clients who have difficulty understanding what is written on the whiteboard. They see 'transparency' in terms of what they can understand and they may fear to ask questions for fear of being denied a loan. When repayment terms are explained they will likely focus simply on the monthly cash obligation. They may be embarrassed to show their ignorance of interest rates. However difficult the task, it is necessary to present the material to them in a fashion they can grasp and their passivity should not be interpreted as inability to understand. While privacy is often overrated as an issue of concern for borrowers, they may be unsure of what constitutes inappropriate collection behaviour. Complaint mechanisms are often a difficult area ; the channels are not always obvious and few ever attempt actually to use them. Fear of blacklisting is again a factor here. Underlying all these attitudes is a lack of confidence and the belief that lenders tend to hold the cards.

Financial education can be seen as making customers aware of their rights and responsibilities as users of financial services. They have the right to be treated with respect, to decide for themselves, to receive information, and the right to be heard. They have the responsibility to treat others with respect, to evaluate offers made to them conscientiously, to comply with terms and conditions and to provide true and timely information. They are entitled to consumer protection, but also to understand that this is a matter of balancing rights and responsibilities. They need some technical understanding : judging which financial product suits their needs, understanding flat and declining interest rates, having a sense of the debt level they can afford, whether debt collection practices are appropriate or not, where and how to complain.

While everyone agrees that financial education is important, some parties feel threatened by it, for reasons discussed above. It can be argued that the function should be performed by central banks or regulatory agencies, or by MFI associations, or within individual MFIs. Perhaps it is a task for community or consumer organisations or media or training organisations. While all these candidates have claims they are also likely to have biases, conscious or not. In any case it is not desirable to give an exclusive franchise to any entity. There are choices to be made concerning modes for training delivery, whether face to face or via the mass media, whether direct to consumers or via 'training of trainers'. Other presentations have shown a range of approaches to these issues adopted in various countries. Whatever choices are made, financial education is a process, while financial literacy is the desired outcome. On the last topic, of responsibility for financial education, an Indian participant commented that while India has a National Alliance for Financial Literacy representing a range of stakeholders, the task is too large to be done by a single entity. The central bank is also taking a constructive interest.

Friday, 3 April 2009

SESSION EIGHT

THE ROLE OF REGIONAL CAPACITY-BUILDING AND PUBLIC-PRIVATE PARTNERSHIP IN PROMOTING FINANCIAL INCLUSION

Questions and issues explored during this session included:

- The role of regional cooperation in capacity-building and the involvement of the private sector in promoting financial inclusion in Asia and in Latin America.

- Effective strategies for extending the reach of microfinance to population segments that remain financially excluded and for strengthening microfinance institutions.
- Policies and regulations that facilitate the banking sector's participation in microfinance.
- Strategies to promote private sector investment in microfinance and financing through capital markets.
- The role of technology in the development of microfinance and its implications on policies to promote financial inclusion.

Session Chair:

Dr. Matthew Gamsler, *Principal, Advisory Services, East Asia and the Pacific, International Finance Corporation*

Introduction by the Session Chair

Regional Capacity-Building and Public-Private Partnership to Promote Financial Inclusion: An Asian Perspective

Mr. Craig Wilson, *Executive Director, Foundation for Development Cooperation*

The Foundation for Development Cooperation (FDC) is active in regional capacity-building in the Asia-Pacific. Its expertise lies in the fields of economic development and assessment, policy analysis and strategic research. It operates through partnerships and leverage, grassroots-based community initiatives, advocacy, consulting and advisory services. It has created, or is associated with, a number of partnerships or networks that span the region and include significant public and private sector entities working together to build capacity for development activities in microfinance and financial inclusion. From offices in Brisbane (Australia), Singapore and Suva (Fiji) it manages the Asian regional 'Banking with the Poor' Network and the Pacific islands network 'Microfinance Pasifika', as well as a consortium of national-level microfinance networks drawn from APEC developing economies.

FDC sees the need for a similar organisational approach to be taken to the APEC initiative for financial inclusion, with an operational committee capable of convening private sector interests in banking and technology at the highest level, to establish the business case for involvement. Central banks and international financial institutions should also be drawn into activities mandated by the APEC finance ministers. Under the leadership of Singapore in 2009 APEC should initiate a set of activities in support of greater financial inclusion in APEC developing economies. In Asia, given that human resources are the biggest constraint, capacity-building and technical assistance will be crucial to the success of efforts to expand the frontiers of financial inclusion. This will require the participation of both public and private sectors and the dissemination of best practices in microfinance partnership-building. Notwithstanding present difficulties, support can be tapped from a variety of private sector sources, especially in banking and information technology, with motives including commercial gain, corporate social responsibility and philanthropy. Public sector initiatives will deal with financial education, with regulatory environments (eg, for microfinance and IT), financial inclusion targets and the role of public sector banks. They should draw upon the outcomes of the UN High Level Commission on the legal empowerment of the poor. Such an APEC initiative will benefit from broadly-based ownership, good management, a clear mandate and brand. It will require measurable targets for its outputs and need to identify appropriate technical solutions, together with the capacity to engender policy responses and achieve external recognition.

Regional Capacity-Building and Public-Private Partnership to Promote Financial Inclusion: A Latin American Perspective

Dr. Carlos Moya, *President, Banca de las Oportunidades (Colombia)*

Despite its name, the *Banca* is not a bank, but a program, designed to bring excluded population segments within the net of financial services. It involves a public/private alliance

with government offering an appropriate regulatory framework and incentives to service providers, while private operators react by increasing their institutional outreach and range of services. Regulatory reforms have included the promotion of agent banking, the development of electronic accounts for small balance savings, a product geared for low-income clients with lower entry barriers and costs, and simplified procedures, and interest rate reforms. The project supports financial education activities, provides support to NGOs that have business development programs and has arranged a public guarantee program for credits to the vulnerable population. It has been active in supporting the development of new financial products, including mobile banking and microinsurance. It has given particular support to M-banking with external support from the IDB-Korea fund. In the first phase, this required an enabling environment to be created for M-banking, in terms of legal, regulatory and institutional framework. An action plan detailed necessary legal and regulatory reform and actions required to assure the participation of key players and to overcome identified bottlenecks. This involved international information exchanges. A second phase saw pilot projects in which incentives for financial institution participation were trialled. Target markets were poor families in marginal city areas and the poor in rural areas. After evaluation, lessons learned were applied on a larger scale. Another activity has been concerned with developing micro-savings facilities, especially for poor families receiving cash transfers under a government program. This is being trialled with the objective of extending the service to 3 million families in due course. Similarly, attention is being given to micro-insurance for families receiving cash transfers.

When the provision of enabling frameworks appears not enough incentive to persuade institutions to expand into marginal areas and populations, government has offered monetary subsidies for the purpose. 'Dutch auctions' are conducted, to determine levels of subsidy acceptable to institutions as incentive to initiate, for example, non-bank agencies, micro-credit NGOs, financial cooperatives or commercial finance companies in particular areas. Technical assistance has been given to the voluntary sector to initiate self-help group banking models in low-income population. Similarly, technical assistance is given to commercial banks for the implementation of microcredit technologies (with USAID), to financial cooperatives (WOCCU) and to microcredit NGOs for institutional strengthening. In the case of non-bank agents, results have been encouraging. Some 5000 agencies were established, offering deposits, withdrawals, collections and transfers, in an 18 month period. Banks had only succeeded in opening some 4300 branches in the previous 130 years! Agencies are located in a wide variety of commercial establishments and the effect on the 'bancarization' of the population has been obvious. Over a two year period the proportion of adults with banking relationships rose from 47% to 55%. Substantial increases have been recorded in the numbers of micro-entrepreneurs accessing credit, in the volume of credit advanced and in the value of other microfinance transactions.

Enhancing the Private Sector's Potential to Promote Financial Inclusion: The Experience of the World Savings Bank Institute

Ms Anne-Francoise Lefevre, *Head, Institutional Relations, World Savings Banks Institute*

The WSBI, headquartered in Brussels, regards itself as the global voice of savings and retail banking. It includes 109 individual banks and banking associations from 92 countries, both developing economies and mature markets. It makes use of that wide reach to conduct comparative studies of various aspects of financial inclusion, from the perspectives of both developed and developing countries. Among its findings are, that of 1.4 billion institutional accounts in developing economies, some 1.1 billion are held in savings banks. Indeed, savings banks have greater outreach among the poorest households than most other pro-poor institutions. WSBI members in general have the mission to bank the unbanked; they are typically 'double bottom-line' institutions, concerned with social as well as commercial objectives. They have commitment to local communities, including to the expansion of services to the unserved. For this reason, they use the term 'proximity banking' to describe

their outlook and rationale. They regard their accessibility, proximity and capacity to adapt products to local needs as key success factors. Often they possess extensive distribution networks, with low requirements for potential customers to access services and facilities to accommodate low-income clients. They offer basic products, including passbook savings accounts and over-the-counter settlement of bills. They are responsive to market conditions, building on their strengths to diversify products and on their banking relationships to offer multi-channel distribution. They add competitive pressure to many market situations.

Certain key barriers to financial inclusion remain, institutional, governmental and market-based. The drive for institutional improvements in product design, delivery channels, operational procedures and staff capacities must be continuous. Policy and regulatory barriers such as restrictions on investment, stringent prudential requirements and AML measures must be removed. Market obstacles, including the lack of information and trust for banks, misconceptions regarding the role of financial institutions and outdated views of the capacities of 'proximity banks' must be overcome. Better data on the extent of exclusion and unmet demand for services would assist in making the business case for a pluralistic banking system. An enabling environment with proportionate and adapted rules is necessary for further progress by this element in the banking industry. It is helpful to document the business case for institutions taking the 'long view'. Strategic alliances with public and voluntary agencies hold promise. WSBI contributes to these processes by providing a platform for information exchange, training and publication of learnings, as well as for dialogue with policymakers and stakeholders. Research done in collaboration with regional and international organisations provides opportunities to contribute to the policy and regulatory debate. WSBI has the vision of doubling the number of savings accounts in selected member institutions within five years, on a sustainable commercial basis (with Gates Foundation support) and to spread lessons from this experience more widely in years to come. The focus on savings is justified because they are the key asset to finance productive activities, a safety net available in emergency, and a resource for financial intermediation and long-term growth. WSBI members will be challenged to join this enterprise from October 2009.

Discussion: Mexico, like Colombia, offers incentives to financial institutions to move into underserved territories. But these have proved vulnerable to politicisation; politicians like to preside over the opening of branches, whether or not they subsequently prove viable. How can such schemes be protected? Dr Moya gave more details of the Colombian process and explained the Dutch auction procedure. Successful bidders accept an obligation to operate for at least two years and sites are chosen for potential to break even in three years. Some agencies have been transformed into branches because of the potential unveiled by the process.

Key Issues: Expanding Access

Dr. John Conroy, *Consultant, Rural- and Micro-finance*

We need to remember that a majority of people in developing economies are still financially 'excluded'. ABAC has decided to press the APEC Finance Ministers for recognition of 'financial inclusion' as an essential element in financial development. It has nominated microfinance as the appropriate policy tool for achieving inclusion. Access to financial services is important because it supports economic efficiency, distributional equity, and even financial stability to some degree. Important also in these troubled times is the fact that financial inclusion supports social cohesion. Some financial exclusion exists in all economies, though (significantly) many countries are unable to produce the data. Among APEC economies the range is from 98% inclusion in Singapore to only 8% in Papua New Guinea. In developing economies, poor households suffer particularly from exclusion, but even many non-poor people in the SME sector are excluded in some countries. Poor households need access to deposit services, remittances and payments and (lastly) credit. The 'excluded non-poor' in the SME sector may have personal access to some financial services, but are often excluded from formal credit for working and investment capital. Significant differences in the financial service needs of household enterprises and SMEs, together with major differences in

their cultures and modes of operation, suggest that the two should be analysed and dealt with separately. The paper considers the argument that the poor will benefit more if the credit needs of SMEs (as employers) are given priority. It rejects this as 'credit-centric' thinking which fails to appreciate the needs of the poor for a wide range of financial services other than credit, and undervalues the significance of savings mobilisation among poor households.

The paper considers how access to financial services for the poor can be expanded. It discusses six 'policy solutions' for microfinance nominated by ABAC for consideration by the APEC Finance Ministers. These are agent and mobile banking, the diversification of service providers, reform of public banks, financial identification and consumer protection. These measures are categorised as being primarily supply side initiatives, although at least one, the establishment of financial identity, has implications for both the supply and demand sides of the industry. The initiatives are considered in terms of their characteristics: whether they are largely regulatory in nature or require either technological or managerial 'fixes'. While some element of each of these is found in every solution, regulatory considerations are clearly of primary importance overall. Technological and managerial considerations appear of about equal weighting. In only one case, reform of state banking, are management considerations of primary importance. Finally the six measures are examined in terms of whether they appear to offer 'economy-wide' benefits (or positive externalities). These are found to exist in a number of cases. All, for example, are judged to support financial deepening. One helps create a regulatory public good, another, an informational public good, while at least three support increased competitiveness overall. One initiative, the introduction of 'mobile' banking, is judged to have the potential for broad macroeconomic stimulus. The menu of policy reforms offers insight into dynamism and creativity emerging in the microfinance industry due to the combination of regulatory innovation, technological change and managerial advances. A striking feature of the industry is its internationalisation, especially in terms of the rapid diffusion of ideas and technology. More problematic is its internationalisation in terms of capital flows. This is so to the extent that cross-border flows may tend to diminish the incentive to mobilise domestic resources and discourage savings mobilisation, which is the financial service of greatest value to the poor.

Key Issues: Facilitating Banking Sector Participation

Mr. Chandula Abeywickrema, *Chairman, Banking with the Poor Network and Deputy General Manager, Hatton National Bank*

Microfinance has matured greatly after almost four decades of initiative and innovation. There is greater awareness of the potential for the marginalised to become 'banked'. Growing financial literacy among the people at the bottom of the pyramid has made them more responsive to opportunities to promote their own economic wellbeing through access to microfinance services. Commercial bankers are realising that, as traditional markets become more crowded, growth opportunities are now found outside their comfort zones. The entrepreneurial poor must be regarded as a bankable community and ways must be found of achieving this. Technological changes now make it possible to deliver services to more people in more places and at lower transaction costs. Banks will increase profitability by setting out to 'graduate' microfinance customers to the next level of activity, while the growing importance of migrant labour and the swelling volume of remittances offer new business opportunities. Many models now exist to guide commercial banks in down-scaling operations: in retail banking by reaching down to the level of the micro-entrepreneur, in wholesale banking by partnering with MFIs, and through franchise or agent banking by employing technology and managerial innovation. Commercial banks need to facilitate four main microfinance products. These are micro-savings, micro-credit, remittance/microfinance linkages and micro-insurance. Mobile phones have revolutionised communications in emerging economies, they must now do the same for financial services by facilitating partnerships between banks and telecommunications operators. This will be facilitated by new regulatory and supervisory tools to enable traditional restrictions to be overcome.

A commercial bank may have the opportunity to facilitate 'owner-managed micro-banking units' by allowing them to operate under its banner in a franchise banking model. Such a model may enable regulatory hurdles to be overcome since commercial banks already have permission to operate in areas where franchising arrangements could be extended. Allowing a franchisee to be treated as a bank branch, with the commercial license-holder accepting responsibility for operations conducted under its franchise, could become a widely accepted model for low-cost expansion of commercial bank outreach. Low-cost deposit mobilisation in virgin territory is not the least of the attractions of such a model for a commercial bank. The franchise model is more effective than agent models in mobilising savings since deposits are backed by the name of the bank and depositors regard it as 'safe'. Estimates of remittance flows suggest annual volumes around \$300million, perhaps half of which moves through informal channels. If banks are able to lower costs and increase the accessibility of their remittance services for migrants they will capture a larger proportion of these flows and migrants are likely to be better served. Moreover, despite the large funds at their disposal, in aggregate, migrants have limited access to other formal financial services, either at home or in the countries where they work. International banking partnerships and cross-border collaboration on removing regulatory obstacles will help to improve this situation. In fact, there are numerous elements in current regulatory arrangements, including Basel II risk weightings and AML requirements, which impede an efficient and profitable response to the opportunities represented by microfinance and financial inclusion. Since much of this is unintended there are grounds for optimism that solutions can be found. Access delayed is access denied; the hopes and dreams of the poor ride on finding just and equitable solutions.

Key Issues: Promoting the Use of Technology in Microfinance

Mr. Alberto J. Jimenez, *Global Business Advisor, FSS, IBM Global Services*

Mr Jimenez briefed participants on IBM's microfinance 'processing hub' capacity and its potential to support financial inclusion. IBM sees potential for the profitable provision of appropriate 'back-end' technology to the microfinance industry. Observing the growth of the microfinance industry, the scale of the potential market, and current inefficiencies in the business models of banks and MFIs, the company feels that access to processing hubs can assist microfinance service providers to overcome cost hurdles holding back the advance of financial inclusion. In the case of traditional banking channels, costs of distributing services to remote locations in low volumes are high. Provision of credit in the micro-market is fraught with uncertainty because of the lack of formal credit histories. Low literacy rates in the target market make conventional documents less useful and place greater burdens on staff to educate consumers verbally, while the physical security of cash may be problematic in remote locations. Thus the conventional retail banking model is inappropriate for microfinance operations. Partnerships with MFIs might offer some solutions to these problems, but limited transparency of MFI operations discourages banks from committing resources to them. On the other hand, current operating models of most MFIs are deficient in terms of capacity to supply the growing demand for micro-financial services. The vast majority do not have access to appropriate back-end technology. Microfinance leaders acknowledge that cost control, management of technology, and product development are the principal challenges for the industry.

In summary, while today's banks often have difficulty reaching the poor, today's MFIs have innovative ways to reach them but are challenged in scaling up to the task. MFIs are burdened by inflexible back offices, with 45% of them using paper or spreadsheets. Larger MFIs use traditional application, but these are expensive and lack full support for microfinance functionality. The banks and MFIs represent a 'financial ecosystem' which can be integrated using the IBM processing hub. The hub provides modern, economical and appropriate 'back office' services to MFIs, with the potential to overcome the high volume, low value drawback to processing MFI transactions. It provides an interface between the banking system and the MFI sector and gives banks access to the networking and distribution possibilities of MFIs. The Hub could also assist in linking MFIs with other key economic actors, including

regulators, international payment networks, credit bureaus, Telcos, and NGOs and the donor community. Based on experience in India and Latin America, IBM is currently establishing MF processing hubs in five regions to meet the IT needs of financial institutions serving the low-income markets. These promise to lower the processing costs of MFIs dramatically, offering them scale advantages enjoyed by traditional banks by creating an 'end-to-end' technology solution for low-income retail banking institutions. Hubs will be accessed by various channels to permit 'many-to-many' interactions. All applications will employ VPN (virtual private network) communications to some degree. Some end users, for instance those using M-banking, will connect directly to the hub via VPN. Transactions of the clients of an MFI will be transmitted to the hub from the MFI office. Larger MFIs will link their branches in, also by VPN. Apart from the case of M-banking, there will be a physical connection with the customer at the last link in the chain. This generates the data to be transmitted to the hub for processing. Institutional users of hub services will buy access to the system from 'resellers'. These will stand in relation to IBM as retail Telcos relate to wholesale telecommunications service providers.

Key Issues: Mobilising private finance for inclusion

Mr. Matthew Gamser, *Principal, Advisory Services, East Asia-Pacific, International Finance Corporation*

The IFC: who we are, what we do. IFC is an arm of the World Bank group which invests, mobilises capital for investment, and advises private sector entities in developing economies. There has been an increasing emphasis on capital mobilisation over time due to the realisation that private capital resources will always dwarf whatever IFC has at its own disposal. IFC also has a structured finance department which devises risk-sharing instruments to attract private capital resources into projects considered marginal in conventional terms, including agricultural supply chains. IFC is owned by its 181 member countries. It has offices in 100 countries and is increasingly focussed on 'frontier' markets and IDA countries. It aims to build long-term relationships with emerging market players, promoting private sector growth and developing local financial markets.

IFC's investment services include loans and intermediary services, equity and quasi-equity, syndications, structured and securitised products, risk-management products, trade finance, subnational finance and treasury operations. It has five main lines of action, concerned with the business enabling environment, access to finance, corporate advice, environmental and social sustainability and infrastructure needs. In fiscal 2008 it made 372 new investments in projects in 85 countries, while providing advisory services for some 300 projects in 75 countries. It raised \$16.2bn in financing, including \$4.8bn in external resources, with IDA countries accounting for 45% of investments. IFC's risk-sharing facility is intended to improve access to financing and improve financing conditions for more marginal investments. By offering to share risks on loan portfolios IFC can persuade banks to support the growth of the Corporation's lending to IFC priority sectors, while improving the banks' origination and monitoring capabilities. For other clients, risk-sharing helps to support the growth of their business and to transfer the responsibility for managing loans. IFC risk-sharing arrangements have, or will, assist in financing schools in Ghana and Kenya, student loans in Indonesia and Chile, loans to SMEs and to health facilities, to agricultural supply chains (in PNG) and for cellphone distributors (East Africa, Pacific). A variety of arrangements involving acceptance of 'first loss' risk by various parties can be agreed.

Discussion: Mr Gamser was asked about the impact of the current crisis on the availability of capital for IFC investments. He agreed that the phenomenon of 'financial protectionism' is impacting the availability of capital negatively at present. IFC is deploying a recapitalisation fund to assist selected banks and is active in supporting trade finance in certain countries whose exports are threatened by lack of access to facilities. Mr Jimenez stated that IBM could develop hub capacity to serve 400 institutions within five years. He was asked whether his diagrams embodied the assumption that the hub would facilitate a 'top-down' financial relationship with external funds being channelled to the micro-financial system on the

periphery and with no obvious place for savings mobilisation among the poor. Mr Jimenez replied that the diagrams reflected the value chain of technology that would be created, rather than a flow of funds diagram. It was suggested that in their present form the diagrams appeared not to reflect the role of savings in the 'financial ecosystem'.

CLOSING SESSION

Session Chair:

Dr. Masahiro Kawai, *Dean, Asian Development Bank Institute*

Closing Remarks

Mr. Yoshihiro Watanabe, *Chair, ABAC Finance and Economics Working Group and Managing Director, Institute for International Monetary Affairs*

Mr Watanabe congratulated the sponsors and organisers on the importance and timeliness of the workshop, because he believes the people at the bottom of the pyramid will suffer most under present world circumstances. He welcomed the recent G20 declaration, which included a number of important measures, including the allocation of \$50bn for social protection measures and commitments to prevent damaging trade measures being adopted by leading economies. The world needs continuing efforts to secure financial inclusion, especially in view of the reduction in international capital flows to support this. ABAC will continue to press the issue. He intends to brief ABAC colleagues at their meeting in Brunei in May on the outcomes of this meeting, with a view to taking the case to the APEC Finance Ministers when they meet in Singapore later in the year. He hopes the Finance Ministers will respond by endorsing an APEC financial inclusion initiative.

Dr. Twatchai Yongkittikul, *Co-Chair, Advisory Group on APEC Financial System Capacity-Building; Co-Chair, ABAC Finance Working Group and Secretary-General, Thai Bankers' Association*

Speaking for the Advisory Group, Mr Twatchai offered a brief summary of lessons from this workshop and what ABAC will carry away from it: Concerning agent banking, innovative policy and regulation can bring many into the financial sector using a variety of channels and with fruitful public/private collaboration. Concerning mobile banking: its explosive growth has facilitated a range of transactions, but also presents challenges as it crosses regulatory domains and raises issues of data privacy and consumer protection. Diversifying providers is a solution that requires initiatives to lower regulatory barriers to innovative start-ups. The costs and benefits of such measures have to be evaluated carefully to assure a net benefit to the economy. Concerning public banks, it has been shown that they can play an important and productive role, but policy must give most careful attention to issues of governance and management. In the matter of financial identity, it is clear that this reform increases access, but regulatory frameworks must have the necessary flexibility and maintain protection of privacy. Consumer protection raises the important issues of fair treatment of microfinance clients, the protection of their information and the importance of campaigns for financial literacy. Finally, today's program has underlined the importance of public/private collaboration. All of these matters are of considerable interest and value to the ABAC Advisory Group on APEC Financial Sector Capacity Building and will influence its future deliberations.

Dr. Alfred Hannig, *Executive Director, Alliance for Financial Inclusion*

Dr Hannig said that, in his view, this has been a great event, and a worthy preliminary to the AFI Global Policy forum to be held in Nairobi in September. In the interim, AFI would be introduced to the international community at a G24 event to be held on the sidelines of the IMF/World Bank Spring meetings on April 24.

Dr Hannig said he believes ABAC should accept certain priorities: first to define financial inclusion for its purposes, then to consider how the challenge of inadequate data might be

addressed and how standards for data collection might be agreed. With respect to regulation, ABAC should examine regulation of services with particular attention to risk profiles. It should accommodate the desire of regulators to communicate more closely with the industries that are drawn together into the web of microfinance, especially telecommunications companies. In conclusion, we at AFI 'feel encouraged to start the work with you'.

Closing Remarks by the Session Chair

Dean Kawai congratulated organizers, sponsors and participants on the success of the workshop and expressed pleasure that the Asian Development Bank Institute had been able to facilitate the event.

ATTACHMENT B

REPORT OF THE 3RD APEC PUBLIC-PRIVATE SECTOR FORUM ON BOND MARKET DEVELOPMENT

**16 July 2009
Singapore**

Executive Summary

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.

RECOMMENDATIONS

- **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.**

REPORT OF THE 3RD APEC PUBLIC-PRIVATE SECTOR FORUM ON BOND MARKET DEVELOPMENT

16 July 2009

Singapore

Recent years have seen various initiatives and public-private sector dialogues on the development of local currency bond markets in the region. Many of these have produced important insights and recommendations. Such dialogues have proven very useful to both sectors by providing advice on measures to encourage private sector activity to increase the depth and liquidity of bond markets, and an understanding of how markets are likely to develop in response to measures being undertaken by the public sector.

At their meeting in Hanoi on 7 September 2006, APEC Finance Ministers welcomed ABAC's proposal to facilitate in-depth discussions with individual economies on how the public and private sectors can collaborate to develop their respective bond markets, with special attention to corporate bond markets. These are to take the form of public-private sector forums, each of which will focus on a few selected developing economies.

ABAC requested the Advisory Group on APEC Financial System Capacity-Building to coordinate preparations for the forums. The first forum was held in Melbourne, Australia on 8 May 2007, focusing on the bond markets of Indonesia, the Philippines and Vietnam. The second was held in Cusco, Peru on 9 July 2008, with Chile, Mexico and Peru as focus economies. Both were held in conjunction with meetings of APEC Senior Finance Officials.

Following up on the results of these previous two forums, the Advisory Group this year 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, in collaboration with the Singapore Ministry of Finance and the Monetary Authority of Singapore.

The forum was divided into four main sessions. The first session focused on international financial institutions' views on fallout from the crisis and its impact on the region's capital markets, including the ability to attract institutional investors. It also touched on the development of the Asian Bond Market Initiative (ABMI) and its contribution to the growth of local currency bond markets and financial integration in the region.

The second session dealt with the perspectives of officials and regulators on their economies' experiences in local currency bond market development. They discussed future plans, challenges and opportunities for collaboration with the private sector, with special attention focused on broadening the institutional investor base. Officials from Malaysia and Thailand presented their economies' progress in developing their bond markets.

The third session was a panel discussion, where private sector representatives commented on the region's bond markets, how institutional investors have been affected by the current financial and economic crisis, and what measures are needed to energize corporate bond markets in the region. The fourth session focused on capacity-building and public-private sector cooperation to broaden the region's institutional investor base.

I. INTERNATIONAL FINANCIAL INSTITUTIONS' VIEWS ON ASIA-PACIFIC CAPITAL MARKETS AND THE GLOBAL FINANCIAL CRISIS

The July 2009 *IMF Global Financial Stability Report Market Update* notes the improvements of financial conditions as a result of unprecedented intervention by governments, including conventional and unconventional measures by central banks and fiscal stimulus. These actions have reduced the risk of failure of systemically important banks and raised expectations of economic recovery. Risk appetite has returned and investors have begun shifting out of safe havens (such as US Treasuries) to more risky assets such as commodities and equities. Credit spreads have tightened. Portfolio flows into emerging markets have recovered, although these have been limited mainly to investment grade borrowers.

Nevertheless, vulnerabilities remain. The deleveraging of banks' balance sheets continues and securitization remains impaired, except where there is support from government programs. The increasing supply of government bonds and further public issuance plans are generating growing concerns in the markets. Deleveraging has also negatively affected cross-border bank flows.

While recent developments have been encouraging, very significant risks remain. The financial sector continues to be dependent on significant public support, resulting in an unparalleled transfer of risk from the private to the public sector. More work is needed to clean up the bad assets in banks and to further strengthen financial markets. With further deleveraging expected, there is a resurgence of tail risks resulting from remaining bank problems that have not yet been addressed, as well as the risk of financial setbacks if markets get too far ahead of economic recovery. Other risks consist of instability in sovereign debt markets in the case of failure to manage or re-absorb growing public sector burdens, as well as instability in emerging markets as a result of failure to deal with capital outflows.

Regarding exit strategies, the IMF recommends that even if it may still be too early to implement such measures, economies should start to lay down their exit strategies in order to reduce market uncertainty, particularly in connection with growing public debt and market concerns about the stability of sovereign debt markets. Main objectives of exit strategies should include sustained price stability, safe financial system governed by market principles, sustainable public finances and balanced and sustained global growth. In addition, there is a need for consistent and coordinated exits within and across economies.

The Asian Development Bank (ADB) submitted a presentation on the Asian Bond Market Initiative (ABMI) as a model for regional collaboration in the development of local currency bond markets. The ABMI was launched to help develop efficient and liquid bond markets in the region and to foster a high degree of financial independence in Asia. It was endorsed by the ASEAN Plus Three Finance Ministers during their meeting in Manila in August 2003. Participation of economies in the ABMI is on a voluntary basis.

The ABMI has contributed to promoting a more favorable policy environment. Measures included new rules to allow the issuance of local currency bonds onshore, adoption of new policies to cut after-tax interest costs and to simplify registration, training of domestic credit rating agencies on international best practice and harmonization of rating practices. Agreement has been reached on the option for the establishment of a credit guarantee mechanism for local currency bonds, and the possibility of establishing a regional settlement intermediary is being studied.

Two main areas being addressed by ABMI are facilitating access to markets through a wider variety of bond issuers and investors in the region, and enhancing the market infrastructure for bond markets, which includes a guarantee mechanism, new products, credit rating systems,

information dissemination, clearing and settlement, policy dialogue among participants, and legal and regulatory frameworks.

The ABMI framework consists of work being undertaken at various levels. At the highest level, Finance Ministers hold annual meetings, which are supported by semi-annual meetings of deputy finance ministers and by an ABMI Steering Group that monitors progress and coordinates future plans. Various activities are being undertaken by a number of task forces, with each one dedicated to a particular topic, including promoting local bond issuance, facilitating demand for local currency bonds, improving the regulatory framework, and improving related infrastructure for the bond market. There is also a technical assistance coordination team.

Going forward, the challenges to the development of bond markets in the region include the need to strengthen financial market infrastructure, improve liquidity, improve legal and regulatory frameworks to ensure certainty and transparency, remove constraints to market entry and investment, encourage greater investor diversity, develop hedging instruments (particularly derivative, swap and repo markets) and strengthen regional cooperation to better understand the link between changes in the real economy and in those in financial markets.

The ABMI has achieved significant progress with strong support from the ADB in the form of technical support for activities to improve market infrastructure and issuance of local currency bonds. ADB intends to provide further support in the future, especially with respect to the establishment of a regional credit guarantee and investment mechanism, infrastructure bond financing, securitization of remittances, information dissemination through roadshows and the Asian Bonds Online website, among others.

During the discussion, participants noted the impact of the crisis on the capacity of developed economies to continue intensive engagement in capacity-building to help develop financial markets in the region. Consequently, there is a need to generate efforts among less affected economies, especially in Asia, to fill this gap and for APEC to keep this issue on its agenda. It was pointed out that private sector involvement in such initiatives could be enhanced, for example, through the mechanism of the Group of Experts established in April 2008 to provide advice to ASEAN Plus Three on various issues related to bond market development. Participants also noted that capacity-building strategies may need to be modified to reflect the current difficult situation of financial markets.

II. GOVERNMENTS' PERSPECTIVES ON THE DEVELOPMENT OF BOND MARKETS AND THE INSTITUTIONAL INVESTOR BASE IN THE ASIA-PACIFIC REGION

Officials discussed the development of bond markets and the institutional investor base in Malaysia and Thailand.

In the case of Malaysia, the Asian Financial Crisis provided the impetus to begin developing its local currency bond markets, inasmuch as it highlighted vulnerabilities arising from overdependence on the banking system for corporate finance and the increased volatility of capital. The government identified the key building blocks and focused on their development. These included the establishment of a reliable and efficient benchmark yield curve, introduction of an efficient and facilitative issuance process for corporate bonds, widening of the issuer and investor base, improvement of secondary bond market liquidity, and facilitating the introduction of risk management instruments. These elements formed the core of the Capital Market Master Plan for 2001 to 2010.

Since the initiation of the Master Plan, progress has been achieved in all of these areas:

- Benchmark yield curve: Introduction of an auction calendar for government securities; introduction of Malaysian Government Securities (MGS) in stages with tenors of 3, 5, 10, 15 and 20 years; and review of principal dealers' system.
- Issuance process: Disclosure-based framework and deemed approval process for issuance of corporate bonds, guidelines for private debt, Islamic and asset-backed securities.
- Issuers and investors: Framework for ringgit and foreign currency bonds, development of sukuk markets, access to bond information for investors, supervision and surveillance of intermediaries and secondary markets, withholding tax and tax incentives, introduction of a credit guarantee institution, encouragement of the growth of mutual funds and investor education.
- Liquidity: Non-financial institutions allowed to conduct repo transactions, guidelines on securities borrowing and lending program, introduction of online Institutional Securities Custodian Program (ISCAP) and enhancement of existing market infrastructure.
- Hedging instruments: Introduction of 3-, 5- and 10-year MGS futures.

These have contributed to the rapid growth of the Malaysian bond market, which is today the fourth largest in Asia (and third largest relative to GDP, after Japan and Korea). As of 30 June 2009, outstanding bonds amounted to RM260 billion. Corporate bonds accounted for 46% of the total. Islamic bonds (sukuk) accounted for 38% of total outstanding bonds and 59% of total corporate bonds.

Malaysia has also become a center for innovation for the Islamic capital market, being the leader in sukuk issuance. It accounts for 60% of global outstanding sukuk, having issued the world's first global sukuk in 2001 (to the equivalent amount of US\$150 million for Guthrie Berhad), the world's first sovereign sukuk in 2002 (worth the equivalent of US\$600 million), the first exchangeable sukuk in 2006 (to the equivalent amount of US\$750 million Khazahah Nasional Berhad) and the world's largest sukuk in 2007 (equivalent to US\$4.7 billion for Binariang GSM Sdn Berhad). Being shariah-compliant, sukuk has enjoyed strong investor demand.

The Malaysian government also strengthened its collaboration with the private sector. In 2006, the Malaysian International Islamic Finance Centre was established as a collaborative effort by financial market regulators and the financial industry to provide an international hub for Islamic finance. Other public-private sector initiatives are Bursa Malaysia (an electronic trading platform for trade reporting and matching of orders in the secondary market) and the first bond pricing agency set up in 2005 to provide daily fair value prices of local currency bonds (a collaborative effort of Malaysian and Korean private sector entities with support from regulators). Regulators have also sought private sector views prior to implementation of every single regulatory and development initiative.

To broaden the institutional investor base, the Malaysian government addressed a number of key issues. These included (a) providing a facilitative and transparent regulatory framework to encourage diverse investor participation; (b) ensuring attractive tax regimes for domestic and foreign investors; (c) issuance of bonds in sufficient sizes and numbers to attract investors with diverse risk appetites; (d) adoption of comprehensive measures for investor protection; and (e) adoption of internationally accepted standards on documentation and practices for the bond market.

In the case of Thailand, the government also played an active role in developing the bond market, which grew rapidly after the Asian financial crisis. At present, the state remains the major issuer, accounting for 80% (including state-owned enterprises) of total bonds

outstanding as of end-May 2009, with corporate bonds making up 19% and foreign issuers 1% of the market. This also reflects the sharp rise in government funding requirements in 2009 in the wake of the current global financial crisis.

Currently, the government is undertaking various measures to promote the broadening of the investor base. First, to promote product diversification, it is focusing on maintaining the level of regular benchmark bonds with tenors of 5, 10, 15 and 20 years, encouraging more investments by reducing liquidity mismatches for investors, the issuance of 30-year bonds and inflation-linked bonds to attract life insurance firms and pension funds, increasing the supply of treasury bills through regular issuance to target commercial banks, and the issuance of savings bonds whose interest payments increase over time for retail investors.

Second, it is undertaking a number of strategic measures, including investor training, regular market dialogues, issuance of pre-announced quarterly bond schedules, doubling the income tax deductible allowance for retirement mutual fund investors, introducing tax exemptions for interest, discount and capital gains on bonds issued by government agencies, and holding of road shows to promote investment in the bond market.

III. PRIVATE SECTOR VIEWS ON EMERGING BOND MARKETS AND CHALLENGES IN BROADENING THE INSTITUTIONAL INVESTOR BASE

Private sector market players contributed their views on how to address the challenges faced by developing economies in the region in promoting bond market development and broadening the institutional investor base. The key issues from the discussions were as follows:

- 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.

IV. CAPACITY-BUILDING AND PUBLIC-PRIVATE SECTOR COOPERATION TO BROADEN THE REGION'S INSTITUTIONAL INVESTOR BASE

Participants reviewed the results of the first (Melbourne) and second (Cusco) forums. A major conclusion of discussions was that supply constraints present the key obstacles. These supply constraints fall broadly into three major categories, namely depth and liquidity of bond markets; market infrastructure and architecture; and the legal, policy and regulatory framework.

Liquidity and depth are critical for bond market development, providing the flexibility that is important to promoting choice. Promoting liquidity of corporate bond markets would require diversification of financial instruments and maturities and the development of secondary markets. Key obstacles to the development of secondary markets include 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. Diversity of issuers in most economies is limited, and bond issuance in general is highly concentrated in the public sector. Key obstacles include under-developed market infrastructure; inadequate corporate governance, disclosure and availability of relevant financial information; high costs of issuance through charges and taxation; and uncoordinated regulatory and supervisory frameworks.

In most bond markets, the investor base is concentrated, with majority of bonds in Asia being held by banks and hedge funds, which have similar risk profiles. This concentration greatly limits the resilience of a market. There are a number of obstacles. First, there is a lack of

insurance companies and pension funds, which are natural holders of long-term fixed income instruments. In emerging markets, existing institutional investors tend to be conservative in their asset structure, compared to developed economies, where pension funds and insurance companies tend to be large-scale buyers of government bonds. Second, restrictions on capital flows and a lack of openness in a number of markets limit foreign investor participation. Third, underlying monetary policy objectives of some economies need greater clarity. And finally, there is a need to address regulatory disparities resulting in different rules for different market participants.

With respect to corporate bond market infrastructure, constraints on market making and price discovery are the two primary impediments. Developing government bond markets is a fundamental first step to developing corporate bond markets, as they provide the market infrastructure and facilitate pricing and benchmarking. The key challenges relate to information and pricing, particularly with respect to (a) building benchmark treasury yield curves across a broad range of maturities; (b) the need for information and transparency for better price discovery, requiring strong disclosure laws, listing requirements, and accounting standards; (c) transparency, which is fundamental in maintaining and attracting larger pools of investors; (d) the need for post-trading information structures so that transactions could be reported to a central reporting arbitrator, facilitating the dissemination of timely information to markets; and (e) providing a clearance and settlement infrastructure that is free, transparent and involves minimal administration costs.

The role of credit rating agencies (CRAs) is vital as is the need to develop the credit rating industry to support the growth of the region's bond markets. Credit ratings provide an effective and objective tool in evaluating risk, benchmarking, effective valuation and pricing. Investors and issuers need independent and transparent valuations. Effective comparison of ratings across economies requires consistency in application of methodologies.

A number of associated derivatives markets remain underdeveloped in some economies. In the absence of those markets, investors' ability to reduce risk is diminished. Further, market participants are limited in their capacity to both warehouse and distribute risk, and as a consequence this limits the development of bond markets. In summary: (a) Without a functioning repo market, it is impossible to short bonds or to easily access liquidity, thereby limiting both trading and risk management. (b) Increasing the availability of hedging products such as interest rate swaps and foreign exchange swaps allow for the separation of credit and interest rate risk and better risk management. (c) The development of bond futures markets would be a useful market risk instrument.

A desirable development would be for bond markets to move beyond private placement as an issuance mode, especially to make more information available to facilitate trading and the growth of secondary markets. Auctioning and over-the-counter markets for bond issuing, trading and active inventory management were noted by participants as useful in market deepening, as was the emphasis on primary issuance markets at this stage of development in the region.

Investors and issuers in the region are confronted with a number of key concerns over the regulatory, supervisory, legal, and taxation environment. These are also linked to previously discussed concerns about the lack of participation, market depth and concentration in both investors and issuers.

The first is creating a level playing field, where rules and obligations are set forth and clear and are applied in a non-discriminatory manner to different types of participants. In some economies, there are problems arising from competing regulatory bodies and taxation authorities. In others, issuers are inhibited from entering a market due to varying regulatory

requirements and taxes applying to private and public issues. Addressing these issues would require greater coordination and collaboration of regulatory agencies, clear, transparent and harmonized rules to avoid duplication and confusion, proper enforcement, and regulatory and supervisory approaches that encourage innovation in product design and marketing.

The second is the quality of legal protection and legal infrastructure to support issuance and investment, which is a key determinant of market participation. Inconsistency and arbitrariness in the interpretation of rules are detrimental to confidence and the willingness of firms to enter markets. Government bonds and corporate bonds need to be regulated and have similar legal security if corporate bond issuance is to develop more strongly in some of the region's emerging markets. Key legal infrastructure to support investor and issuer participation include enforcement of contracts; creditor rights protection and enforcement; effective and efficient settlement systems; insolvency and bankruptcy laws supported by informal work-out arrangements within and across jurisdictions; and custodian relationships.

The third is taxation, of which there is a great diversity of arrangements in the region. The need to eliminate the negative impact of withholding taxes on corporate sector issuance is an important matter in promoting the growth of corporate bond markets. Investors in some of the region's economies have been using credit derivatives provided offshore since these can avoid tax and access limitations. Eliminating relevant tax and other barriers would contribute to bringing liquidity into domestic markets. Taxes have a significant impact on cross-border investment and issuance. APEC could play a role in addressing the impact of taxes on bond markets. Initiatives that may be considered include a survey of individual member economies with the support of finance ministries, central banks and financial regulatory agencies; undertaking regular reviews of these taxes within a regional context; and holding regional discussions with the aim of promoting concrete steps by individual economies to address adverse impacts of taxes on bond market development and cross-border transactions, including through harmonization.

The fourth is the need for coordination and collaboration among domestic regulatory agencies to avoid confusion in market supervisory arrangements and the arbitrary application of rules, as well as to reduce excessive and burdensome compliance costs such as those arising from multiple reporting requirements. This is especially important where there is no single authority to provide supervisory leadership.

The fifth is further liberalization of capital markets and the development of derivatives markets. Restrictions on capital flows, inability to manage foreign exchange and interest rate risks, and barriers to entry to both issuance and investment are key impediments that limit the growth of the investor base. Institutional development and access is important, especially for private sector institutions, and having a wide range of participants and a largely free entry position would increase the investor base and market depth and liquidity. Where there are flexible capital and exchange rate regimes, market activity would ultimately lead to reduced adjustment costs and facilitate risk management.

The sixth is exchange rate policy, which has a significant impact on the development of bond markets. Fixed rates impede market diversity and limit the ability of taking foreign exchange positions onshore, usually resulting in investors having to hold underlying assets to protect against currency moves. As such, foreign investor participation tends to be limited. In an environment of exchange rate flexibility, investors see more investible opportunities on a regional basis. For domestic investors, their first foray out of their own currency is predominantly in the US market. Greater exchange rate flexibility would encourage such first steps to be made instead in regional markets.

The seventh is the development of derivatives and repo markets that enable investors to hedge, such as through interest rate and currency swaps. These are important developments yet to take place in some markets, but are necessary for investors to manage underlying risks in their portfolios.

Looking ahead, it is important to undertake continued capacity-building efforts to develop bond markets in the region. Regional cooperation and integration is an important element of these capacity-building efforts. Regional cooperation is helpful in managing the externality and spillover issues that usually arise in the course of an economy's growing market-driven financial integration with the outside world, and thus facilitates this integration. Regional integration and cooperation contribute to economic growth, inclusive development and poverty reduction by helping to expand opportunities that can unlock the region's economic potential.

Experiences in Asia and Latin America underscore the positive contributions of closer collaboration between the public and private sectors to the success of efforts to develop domestic financial markets. A healthy market economy is one where the private sector engages in robust innovation and competition, while the public sector provides sound legal and policy frameworks, regulation and supervision. There is much scope for both sectors to help enhance each other's effectiveness in playing their respective roles. APEC economies could benefit from exchanges of information on best practices and implementing mechanisms for cooperation with the private sector. Holding regular roundtables involving relevant officials and regulators, the local financial industry and private sector organizations, as well as financial sector experts should be seriously considered.

Within APEC, there is a need to deepen connectivity between various capacity-building initiatives and the actual implementation of reforms in member economies. In this process, there is a critical role for public-private sector collaboration in generating support for policy measures, particularly with respect to corporate bond markets. The APEC Finance Ministers could consider APEC policy reviews on connectivity, focused on how regional and international capacity-building activities can more effectively support reform efforts of interested economies. This review should involve the public and private sectors and relevant international institutions.

In conclusion, taking all the issues discussed during the forum into consideration, the following measures are recommended to APEC:

- **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.

3RD APEC PUBLIC-PRIVATE SECTOR FORUM ON BOND MARKET DEVELOPMENT
BROADENING THE INSTITUTIONAL INVESTOR BASE

16 July 2009
Shangri-La Hotel, Singapore

PROGRAM

- 14:00-
14:30 **REGISTRATION**
- 14:30-
14:45 **OPENING SESSION**
- 14:30 **Welcome and Opening Remarks**
Mr. Mark Johnson, Chair, Advisory Group on APEC Financial System Capacity-Building and APEC Business Advisory Council Member
- 14:35 **Opening Remarks**
Mr. Poon Hong Yuen, Chair, APEC Senior Finance Officials' Meeting
- 14:45 **End of Session**
- 14:45-
15:30 **SESSION ONE**
- 14:45 **INTERNATIONAL FINANCIAL INSTITUTIONS' VIEWS ON ASIA-PACIFIC CAPITAL MARKETS AND THE GLOBAL FINANCIAL CRISIS**
- 14:45 **The Global Financial Crisis: Current Outlook and Impact on Global Capital Markets**
Mr. Romuald Semblat, Senior Economist, International Monetary Fund
- 15:00 **The Region's Bond Markets: The Asian Bond Market Initiative (ABMI) as a Model for Regional Collaboration**
Mr. Masato Miyachi, Senior Advisor, Asian Development Bank
- 15:15 **Open Discussion and Q&A**
- 15:30 **End of Session**
- 15:30-
16:00 **SESSION TWO**
- 15:30 **GOVERNMENTS' PERSPECTIVES ON THE DEVELOPMENT OF BOND MARKETS AND THE INSTITUTIONAL INVESTOR BASE IN THE ASIA-PACIFIC REGION**
- 15:30 **Development of Bond Markets and the Institutional Investor Base: Perspectives from Malaysia**
Mr. Kamaruddin bin Hashim, General Manager and Head, Bond Market and Private Debt Securities Departments, Securities Commission Malaysia
- 15:45 **Development of Bond Markets and the Institutional Investor Base: Perspectives from Thailand**
Mr. Tada Phutthitada, Director of Bond Market Development Bureau, Public Debt Management Office, Ministry of Finance, Thailand
- 16:00 **End of Session**
- 16:00-
16:15 **TEA BREAK**

16:15-	SESSION THREE
17:20	PANEL DISCUSSION: PRIVATE SECTOR VIEWS ON EMERGING BOND MARKETS AND CHALLENGES IN BROADENING THE INSTITUTIONAL INVESTOR BASE
16:15	Brief Commentaries by Panelists
	Mr. Ng Kheng-Siang, Head of Fixed Income, State Street Global Advisors
	Mr. Paul Bide, Head, Debt Markets Division, Macquarie Bank Limited
	Khun Nattapol Chavalitcheevin, President, The Thai Bond Market Association
	Ms. Rachana Mehta, Head of Fixed Income, KE Capital Partners
	Mr. Francisco Garces, Board Member, Banco de Chile; and Alternate Member, APEC Business Advisory Council
	Mr. Chia Liang Lian, Senior Vice President and Emerging Markets Portfolio Manager, PIMCO
16:45	Open Discussion and Q&A
17:20	End of Session
17:20-	SESSION FOUR
17:55	CAPACITY-BUILDING AND PUBLIC-PRIVATE SECTOR COOPERATION TO BROADEN THE REGION'S INSTITUTIONAL INVESTOR BASE
17:20	The First and Second APEC Public-Private Sector Forum on Bond Market Development: Summary of Results
	Dr. Julius Caesar Parreñas, Coordinator, Advisory Group on APEC Financial System Capacity-Building; and Advisor on International Affairs, The Bank of Tokyo-Mitsubishi UFJ Ltd.
17:30	Wrap-Up Discussions led by the Forum Chair
17:55	End of Session
17:55-	CLOSING SESSION
18:00	Closing Remarks
17:55	Mr. Mark Johnson, Chair, Advisory Group on APEC Financial System Capacity-Building and APEC Business Advisory Council Member
18:00	End of Session