



THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

Document: AGFSCB 30-035

Draft: **SECOND**

Source: AGFSCB Chair

Date: 19 August 2010

Meeting: Bangkok, Thailand

Third Meeting 2010

26 August 2010

Ballroom 1, InterContinental Hotel, Bangkok

Bangkok, Thailand

Meeting Paper 8-A

Draft 2010 Report on Capacity-Building Measures to Strengthen and Develop Financial Systems

[Second Draft]

Office of the Advisory Group Chair



THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

2010 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS

Second Draft as of 12 Aug 2010

This report has been prepared under the authority of the Chair of the Advisory Group on APEC Financial System Capacity-Building, Mr. Mark Johnson. For further information, please contact the Advisory Group Coordinator, Dr. Julius Caesar Parreñas (tel 81-3-3240-5279; fax 81-3-3240-3879; email jc_parrenas@mufg.jp).

**THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM
CAPACITY-BUILDING**

**2010 REPORT ON CAPACITY-BUILDING
MEASURES TO STRENGTHEN AND
DEVELOP FINANCIAL SYSTEMS**

Table of Contents

<i>SUMMARY OF RECOMMENDATIONS</i>	i
INTRODUCTION	1
I. PROMOTING INCLUSIVE GROWTH THROUGH AN APEC FINANCIAL INCLUSION INITIATIVE	2
II. IMPROVING SMALL AND MEDIUM ENTERPRISES' ACCESS TO FINANCE	4
III. EXPANDING PRIVATE INVESTMENT IN INFRASTRUCTURE THROUGH AN ASIA-PACIFIC INFRASTRUCTURE PARTNERSHIP	7
IV. TAKING ASIA-PACIFIC CAPITAL MARKET DEVELOPMENT TO THE NEXT STAGE: A PROPOSED PACKAGE OF MEASURES	8
V. BUILDING CAPACITIES FOR REGULATORY REFORM IN ASIA- PACIFIC EMERGING MARKETS	10
<i>ATTACHMENT A – CONFERENCE REPORT OF THE APEC PUBLIC- PRIVATE SECTOR FORUM ON THE DEVELOPMENT OF BOND MARKETS AND FINANCIAL INCLUSION, 31 MAY, SAPPORO, JAPAN</i>	
<i>ATTACHMENT B – CONFERENCE REPORT OF THE PUBLIC-PRIVATE PARTNERSHIPS FORUM, 9 FEBRUARY 2010, MELBOURNE, AUSTRALIA</i>	

THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

2010 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS

Summary of Recommendations

This year, the Advisory Group on APEC Financial System Capacity-Building focused on enabling the financial sector to play its crucial role in the successful pursuit of APEC's new growth strategy. 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 undertook discussions with various key institutions and organizations this year. The results of these discussions are reflected in the following conclusions and recommendations.

Promoting inclusive growth through an APEC Financial Inclusion Initiative.

Microfinance has emerged as a potent tool to promote financial inclusion, 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. There is very significant potential in regional cooperation to assist economies in providing a favorable environment for promoting financial inclusion through microfinance. In last year's Report, the Advisory Group recommended that APEC Finance Ministers undertake a financial inclusion initiative as part of the broader APEC agenda to promote inclusive growth. This year, several economies have expressed their desire to sponsor a financial inclusion initiative under the APEC Finance Ministers' Process.

- *The Advisory Group welcomes the launch of an APEC financial inclusion initiative under the APEC Finance Ministers' Process and calls on APEC member economies, multilateral institutions and the private sector to collaborate in the successful implementation of this initiative.*

Improving small and medium enterprises' access to finance. Small and medium enterprises (SMEs) form a key component of any effort to promote inclusive growth. Lack of access to finance is a major obstacle to the growth of SMEs, and inadequate information and legal environments are the most serious problems in this regard. Regional collaboration focused on improving the information and legal environments in APEC member economies, with active participation of the private sector and international financial and development institutions, would greatly contribute to expanding SMEs' access to finance throughout the region.

- *The Advisory Group urges APEC to undertake an SME Finance Initiative that focuses on developing properly structured credit sharing information systems and improving legal infrastructure to promote SME finance.*

Expanding private investment in infrastructure through an Asia-Pacific Infrastructure Partnership. There is a huge potential for public-private partnership (PPP) to contribute to the development of infrastructure in a way that will benefit governments, the private sector

and the public at large. APEC could play an important role in providing a model for regional cooperation through an initiative to be undertaken by interested member economies and later evaluated and considered for adoption on a wider scale. Activities under such a pathfinder initiative could include initial discussions among interested member economies focused on strategic and policy issues. These would need to involve a high-level panel of private sector advisors and multilateral institution participation, and followed at a later date by discussions focused on practical issues.

- *The Advisory Group recommends that APEC undertake a pathfinder initiative in cooperation with ABAC and the Advisory Group and involving interested member economies, to promote an Asia-Pacific Infrastructure Partnership (APIP), bringing together public and private sectors and multilateral institutions.*

Taking Asia-Pacific capital market development to the next stage. Bond market development in the region has reached a significant stage, owing to various regional cooperation efforts. Key weaknesses still need to be addressed, including supply constraints arising from inadequate market depth and liquidity, market infrastructure and architecture and legal and regulatory frameworks. There is wide scope for the introduction of new initiatives, building on current achievements, to bring capital market development and integration in the region to the next higher level. In addition to continued efforts to address key issues in the development of government and corporate bond markets, innovative solutions can be pursued on a regional basis under the APEC framework.

- *The Advisory Group recommends that APEC Finance Ministers and Senior Finance Officials undertake discussions with a view to compiling a package of measures to bring the development of the region's capital markets to the next level. We recommend that these discussions focus on (a) development of wholesale securities markets exclusively for professional investors; (b) regional public-private sector collaboration mechanisms to reduce barriers to cross-border settlement; (c) use of foreign securities as eligible collateral throughout the region; (d) ways to accelerate the region-wide convergence of accounting standards, disclosure regimes and corporate governance practices; and (e) establishment of a pathfinder initiative to introduce a regional funds passport scheme.*

Building capacities for regulatory reform in Asia-Pacific emerging markets. The Advisory Group coordinated the program and preparations of the 6th SEACEN-ABAC-ABA-PECC Public-Private Dialogue for the Asia-Pacific Region, which was held on 15-16 June 2010 in Manila, Philippines. This year's dialogue dealt with the theme *The Role of the Financial Sector in Sustaining Economic Growth and Stability*, and discussed current global financial regulatory reform processes in the context of ongoing regional efforts to strengthen and develop the region's financial markets. The conclusions of the dialogue helped shape the Advisory Group's views on the situation of financial systems in the region and its recommendations on how they may be strengthened.

- *The Advisory Group recommends that APEC Finance Ministers support capacity-building measures to help emerging markets in the region improve financial supervisory capacity, calibrate local conditions to global standards, promote the adoption of proven tools such as scorecards to strengthen corporate governance, and strengthen financial sector safety nets (including frameworks for liquidity support, sound crisis management policies and procedures and deposit insurance firms' governance and strategies).*

- *The Advisory Group proposes that APEC Finance Ministers support the development of a robust regional financial architecture, including a regional forum of financial regulatory authorities and the financial industry to address regulatory issues in light of the region's needs, review the relevance and impact of global reforms on the region, and ensure that development of global standards take into account market practices and market infrastructure in the region.*

THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

2010 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS

Since the completion of the Advisory Group's previous Report in 2009, the global economy has recovered from the deepest financial and economic crisis of the postwar period, on the back of unprecedented and globally coordinated fiscal stimulus measures and monetary policy accommodation. Robust growth in emerging markets, particularly China, provided additional support to the global economy, softening the impact of diminished private consumption and investment in developed markets.

At the time of this current Report's completion, however, the sustainability of the recovery remains uncertain. In advanced economies directly impacted by the crisis, unemployment remains high, soundness of banking systems have yet to be restored, and sovereign risks have emerged as the new focus of financial market turbulence, severely limiting the scope for future public stimulus measures. Clear signs are yet to emerge of a sustained recovery of private demand, in the absence of which these economies will enter another difficult period, once the effects of current stimulus packages have run their course.

A major issue for the region is how to revive demand to preserve huge productive capacities that have been built up prior to the crisis and prevent the economic and financial dislocations that would arise with the scaling down of such capacities. Unprecedented global economic growth prior to the crisis, driven to a large extent by US consumption and Asian exports, was made possible by huge internal and external imbalances, with the accumulation of current account deficits and household and financial sector debt in developed markets. These were mirrored by corresponding accruals of surpluses and savings in export-oriented and resource-rich economies, large parts of which were reinvested in developed markets, perpetuating conditions for the continued build-up of imbalances until the very onset of the present crisis.

Given that a return to such unsustainable pre-crisis patterns of production and trade now appears unlikely, mitigating painful adjustments will require efforts to further expand the world economy's growth potential, particularly through increased consumption in emerging markets. Accordingly, policymakers have announced intentions to promote a transition to a more balanced pattern of global growth that should at the same time be stronger and more sustainable, inclusive, innovative and secure. A major part of this transition would have to occur in developing APEC member economies, through the promotion of conditions to accelerate the movement of labor from low-productivity to high-productivity sectors and to spur the rapid growth of domestic private demand, paving the way for the emergence of a new engine for global economic growth.

Last year's Report cited the considerable potential for domestic demand-led growth in developing economies, particularly in emerging Asia, with its large population, rapidly growing middle class, considerable pool of savings, and relatively healthy financial systems. The Report also made a reference to factors that constrain growth of domestic consumption and investment. These include, among others, the lack of access to finance of small

enterprises and of the large number of people at the bottom of the economic pyramid, policy environments that hinder expanded private investment in infrastructure, and underdeveloped financial markets, especially those for long-term local currency financing. Underpinning these are financial regulatory systems and policies that need to be improved and updated through capacity-building.

This year, the Advisory Group on APEC Financial System Capacity-Building focused on financial sector solutions to these issues. In undertaking this work, the Advisory Group continues to build on previous efforts since its 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. Working closely with the APEC Business Advisory Council (ABAC), the Advisory Group has developed various ideas during discussions with key internationally active institutions and organizations. These ideas are reflected in the proposals contained in this Report.

This report is divided into five major sections. These deal with (a) promoting inclusive growth through an APEC Financial Inclusion Initiative; (b) improving small and medium enterprises' access to finance through an initiative focused on credit information and legal infrastructure; (c) expanding private investment in infrastructure through an Asia-Pacific Infrastructure Partnership; (d) taking Asia-Pacific capital market development to the next stage through a proposed package of measures; and (e) building capacities for regulatory reform in Asia-Pacific emerging markets.

I. PROMOTING INCLUSIVE GROWTH THROUGH AN APEC FINANCIAL INCLUSION INITIATIVE

As noted in the Advisory Group's 2008 Report, a majority of the adult population in many developing economies 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.

In last year's Report, the Advisory Group recommended that APEC Finance Ministers undertake a financial inclusion initiative as part of the broader APEC agenda to promote inclusive growth. We suggested that such an initiative 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.

This year, the Advisory Group collaborated with ABAC and Japan's Ministry of Finance together with APEC Senior Finance Officials to convene the APEC Public-Private Sector Forum on the Development of Bond Markets and Financial Inclusion. The Forum was held in Sapporo, Japan on 31 May 2010 back-to-back with this year's Senior Officials' Meeting – Senior Finance Officials' Meeting (SOM-SFOM) Dialogue. Discussions in this Forum provided deeper insights into financial inclusion and how an APEC financial inclusion initiative can add value to current activities being undertaken in the G20 and elsewhere. Following are key points arising from these discussions:

- With the growing commercial viability of microfinance, there is increasing interest among investors and great potential for channeling commercial investment into the sector. Public-private partnership with IFIs and bilateral institutions playing key roles could facilitate the expansion of such commercial investments. Nevertheless, while promoting and facilitating private sector investment is important, the major issue is not the lack of funds or investors, but rather the still limited number of top-tier MFIs.
- To broaden investment opportunities, it is important to accelerate the process of upgrading existing MFIs, as well as to promote wider participation of financial institutions. The most difficult challenge, however, is how to broaden the base of the financial inclusion pyramid, by expanding the coverage and penetration of microfinance. This reinforces the recommendation put forward by ABAC in 2009 that policy makers and regulators consider undertaking measures in six areas identified in a recent ground-breaking study where policies can have the most impact. These are mobile phone banking, agent banking, channel and product diversification, public bank reform, financial identity and consumer protection.
- An area where APEC can play a constructive role in promoting financial inclusion is the development of properly structured credit sharing information systems. This could involve the promotion of reforms to enable full-file and comprehensive credit reporting in member economies to private credit bureaus, which should be accompanied by measures to develop appropriate legal and regulatory frameworks defining key procedures, including types of information that can be collected, rights of data subjects, acceptable uses of information, data security requirements and obligations of credit bureaus, data furnishers and data users.
- There are already many existing best practices in providing an enabling environment for the introduction and use of new technologies and innovations. Many of these can be easily made available through various institutions. There is also a need to recognize the potential of the public sector, especially government banks, in promoting financial inclusion, especially given the magnitude of the challenges to expand coverage of microfinance. Capacity-building measures to assist developing economies in effectively harnessing public sector resources and in promoting public-private sector partnerships are needed.
- There is a lot of commonality between the G20's approach and the approaches currently being discussed in APEC and there is great potential for APEC to undertake an initiative that complements the work of the G20. Finally, there are ample resources, including expertise, funding and networks that private, international and bilateral institutions are willing to share in support of an APEC financial inclusion initiative.

In response to the growing interest in financial inclusion that has been generated by the work of various institutions including ABAC and its various collaborators in the Advisory Group in previous years, several economies have expressed their desire to sponsor a financial inclusion initiative under the APEC Finance Ministers' Process. The launch of such an initiative this year at the forthcoming APEC Finance Ministers' Meeting in Kyoto will be an important milestone for regional cooperation that will significantly contribute to achieving more inclusive growth.

The Advisory Group welcomes the launch of an APEC financial inclusion initiative under the APEC Finance Ministers' Process and calls on APEC member economies, multilateral institutions and the private sector to collaborate in the successful implementation of this initiative.

II. IMPROVING SMALL AND MEDIUM ENTERPRISES' ACCESS TO FINANCE

Small and medium enterprises (SMEs) form a key component of any effort to promote inclusive growth, as they play important roles in the economy, and particularly in providing employment opportunities. The following examples illustrate this reality:

- In Japan, SMEs contribute around 51% to sales and 70% to employment, and represent 99.7% of all companies.
- In Thailand, SMEs account for 38% of GDP, 76% of employment and 99.6% of all enterprises.
- In China, SMEs are responsible for 56% of GDP, 62% of exports, 75% of employment in urban areas, 43% of tax revenues and 99% of companies.

The Advisory Group discussed a framework developed by World Bank staff for analyzing factors that affect the availability of credit to SMEs,¹ which explains how policies affect the availability of credit, through their impact on lending infrastructure and the structure of the financial industry, and how these two factors determine the feasibility and profitability with which different lending technologies are deployed.

The lending infrastructure, which refers to the rules and conditions affecting the ability of these institutions to lend, include (a) the information environment; (b) legal, judicial and bankruptcy environment; (c) social environment; and (d) tax and regulatory environment, including capital regulation and bank supervision. Along with the financial industry structure, the lending infrastructure has a profound impact on lending technologies.² Discussions undertaken by Advisory Group participants have identified the *information and legal environments* as the key areas where reforms could help expand SMEs' access to finance within the region.

A survey of business sector organizations in APEC economies conducted by the Japan Chamber of Commerce and Industry on SMEs³ also reached similar conclusions. A key finding of the survey is that overall inadequacies in the information and legal environments (particularly related to collateral) are the most serious problems affecting SME finance, with the former cited by many respondents in developing economies and the latter by respondents in the more advanced economies. In addition, regulatory and tax issues are also seen as significant issues in more advanced economies, while the lack of government schemes to support SME finance are considered as another important issue in developing economies.

These findings suggest that regional collaboration focused on improving the information and legal environments in APEC member economies, with active participation of the private sector and international financial and development institutions, would greatly contribute to expanding SMEs' access to finance throughout the region. Transparency and reliability of lien registration and perfection systems is one area where improvement and harmonization have a potential to incentivize additional financing for worthy borrowers, particularly among SME's who use asset-based financing to a high degree. Accordingly, an APEC SME Finance Initiative could be undertaken under the APEC Finance Ministers' Process with two essential

¹ Allen Berger and Gregory Udell, *A More Complete Conceptual Framework for Financing of Small and Medium Enterprises*, World Bank Policy Research Working Paper 3795, December 2005.

² Lending technologies refer to the combination of primary information source, screening and underwriting policies and procedures, loan contract structure and monitoring mechanisms. They play a key role, in that they are the conduit through which government policies and financial structures affect the availability of credit to SMEs. Lending technologies can be divided into transactions lending technologies, which are based on hard data, and relationship lending, which is based on soft data. A third category, trade credit, involves both hard data and soft information. Berger and Udell (2005).

³ A Survey on Actual SME Business Conditions in the APEC Region, Japan Chamber of Commerce and Industry 2010.

components: (a) developing properly structured credit sharing information systems and (b) improving legal infrastructure to promote SME finance.

Developing properly structured credit sharing information systems. Credit information sharing systems are key elements of modern financial sector infrastructure. Credit bureaus have assumed a core role within such systems by helping lenders acquire a more precise knowledge of a borrower's likelihood of repaying. However, the extent to which this result is achieved depends on the structure of credit reporting, bureau ownership and the type of information reported. In this context, distinctions between the following need to be made:

- Negative-only reporting versus full-file reporting. Negative-only reporting is the reporting of only negative data. Full-file reporting is the reporting of both negative and positive data (which may include information on the timeliness of payments, account type, lender, date opened, inquiries, credit utilization rates, credit limits and account balances).
- Segmented versus comprehensive reporting. Segmented reporting is a system in which only data from one sector or a limited number of sectors, e.g., retail or banking, are contained in reports. Comprehensive reporting is a system in which payment and account information contains information from multiple sectors, e.g., utilities payments.
- Public versus private credit bureaus. Public bureaus have been set up largely for supervisory purposes, to monitor the safety and soundness of the financial sector and determine whether reserves are sufficient. Private bureaus, by contrast, are set up to ease lending, and collect data primarily to reduce information asymmetries and improve risk assessment in lending. By this account, private bureaus are complements rather than substitutes to public bureaus.

A number of studies summarized in surveys undertaken by the Political and Economic Research Council (PERC)⁴ and in the Advisory Group's report of the APEC Public-Private Sector Forum on the Development of Bond Markets and Financial Inclusion (*see Annex A*) underscore the benefits of credit reporting regimes with full-file and comprehensive reporting to private credit bureaus. Under such regimes, broader-based lending and wider access to capital improve economic growth, growth in the capital stock and productivity, while contributing to lower income inequality.

The development of full-file and comprehensive credit reporting systems requires robust legal and regulatory frameworks governing important procedures, 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. The Organization for Economic Co-operation and Development (OECD) Fair Information Practice Principles provide a useful reference point in developing legal and regulatory framework.

Properly structured credit sharing information systems can be developed by observing key principles: (a) Positive and negative payment data should be reported to private credit bureaus. (b) Bank, non-bank and non-financial payment data should be reported and data should not be segmented by sector. (c) Consumer rights and protections are paramount, as spelled out in the OECD Fair Information Principles. (d) Private credit bureaus and public credit registries are complementary, with private bureaus focused on making lending efficient. (e) Reporting of

⁴ Michael Turner, Robin Varghese and Patrick Walker, *Financial Inclusion through Credit Reporting: Hurdles and Solutions* (A PERC Briefing Paper for The Asia-Pacific Credit Coalition), April 2010. See also Michael Turner, Robin Varghese and Patrick Walker, *The Structure of Information Sharing and Credit Access: Lessons for APEC Policy* (A PERC Briefing Paper for The Asia-Pacific Credit Coalition), July 2008.

payment data should be voluntary. (f) Data use should be limited to well-defined permissible purposes.

APEC member economies can also benefit from the sharing of actual experiences in developing credit information systems. The Advisory Group considered the Japanese SME credit information database as an example of an existing system that can provide useful lessons for other economies. Under this system, over 200 participating institutions (including financial institutions, credit guarantee corporations and rating agencies) provide financial and non-financial data as well as default information to the Credit Risk Database (CRD) Data Center, which stores the data in anonymous form and consolidates them for use by members in credit risk scoring, data sampling and statistical information.

Japan's experience highlights a number of issues that can be discussed under an APEC initiative to help member economies design robust credit information systems. These include incentives for SMEs to disclose accurate information; confidentiality and trustworthiness of data; types of data to be collected; financial sustainability; and enhancing the value of the system for participating institutions.

An APEC initiative could also discuss the regional dimension of credit information systems to support cross-border business activities involving SMEs. Such discussions could include subjects such as collection of SME data across the region and developing an accurate data base to facilitate securitization of SME loans and strengthen SMEs' ability to raise funds from capital markets.

Improving legal infrastructure to promote SME finance. In general, security enforcement regimes in most APEC jurisdictions are intended to encourage provision of credit to commercial borrowers by recognizing and protecting the expectations of senior-secured lenders and providing legal certainty in the event of borrower insolvency. However, a number of important gaps remain. The absence of clear legal frameworks to enforce rights of secured lenders is an impediment to credit availability, disproportionately affecting SMEs and other businesses that have historically had difficulty accessing bank credit. Systems for creating and perfecting valid security interests in the first instance are often not exclusive, universal and accessible to prospective lenders. Legal rules often do not clearly contemplate various forms of structured finance that are useful to providing SME with operating liquidity.

Key issues related to the legal infrastructure for secured lending that need to be addressed in various member economies are the following:

- Absence of exclusive security interest registry, giving rise to the "hidden lien" problem
- Voidable conversion/preference
- Unclear perfection rules for certain types of collateral, such as movables, receivables and goodwill
- Absence of blocked account security precedence
- Untested debtor-in-possession process
- Treatment of floating charges or absence of such concepts
- Lack of broad licensing authority for commercial lending.

An APEC initiative to improve and harmonize standards for perfection and enforcement of security interests in collateral, as part of a system for developing a robust commercial finance market, would promote innovative financial products, enhance overall liquidity for the SME sector, and advance the goal of financial sector inclusion and sustainable growth. In addition to facilitating financing for SMEs, a harmonized approach would promote regional investment and trade in financial services in the APEC region. Such an initiative could focus on the following activities:

- A survey of key enablers of financing availability
- Developing model elements of an APEC or region-wide code of security interest creation, perfection and enforcement, which could include clear perfection rules, broad coverage of collateral types, exclusivity to eliminate the “hidden lien” problem, and provisions for debtor-in-possession financing.
- A model treatment of floating charges/accounts receivable financing
- Establishment of a public-private dialogue to validate improvements
- An APEC checklist for statutory/regulatory implementation
- Promoting broad licensing authority for commercial finance, such as non-bank financial company charters.

The Advisory Group urges APEC to undertake an SME Finance Initiative that focuses on developing properly structured credit sharing information systems and improving legal infrastructure to promote SME finance.

III. EXPANDING PRIVATE INVESTMENT IN INFRASTRUCTURE THROUGH AN ASIA-PACIFIC INFRASTRUCTURE PARTNERSHIP

Financing infrastructure, a key ingredient of economic growth, is a major challenge for the region’s developing economies. A recent study⁵ has concluded that on average, Asia would need to invest about US\$750 billion annually to meet domestic and regional infrastructure needs over the period 2010-2020. In its 2009 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. A number of underlying issues remain to be addressed.

- The first is the information asymmetry between the public and private sectors. Given the private sector’s considerable information advantage, the public sector has been reluctant to engage more broadly in infrastructure partnerships. An environment for constructive and confidential dialogue, where industry can provide input and perspective without risk of loss of financial benefit or intellectual property, would be helpful in addressing this issue.
- The second is the need to develop broader and deeper capital markets for infrastructure projects, which are generally long-life assets earning revenues in local currencies. 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 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. The

⁵ Asian Development Bank and ADB Institute, *Infrastructure for a Seamless Asia*, 2009.

Advisory Group recommended that APEC launch a regional infrastructure partnership for this purpose.

The Advisory Group convened a Public-Private Partnerships Forum in Melbourne on 9 February 2010 to discuss these issues and consider the idea of an Asia-Pacific Infrastructure Partnership (APIP) that would bring together public and private sector interests, multilateral agencies, academic institutions and professional groups. The Partnership would assemble knowledge and information, address issues of information asymmetry and support and promote capacity-building. (*See Annex B for the complete Forum Report.*)

Forum participants, who included representatives of business, public sector institutions, the ADB, academia and professional groups involved in PPP design, administration, finance and management, supported the idea of establishing the private sector component of APIP. Participants also welcomed the offer of RMIT University to provide financial support for its Australian APEC Study Centre in playing a coordinating role during the initial period of efforts to bring about the formation of APIP. The Advisory Group endorsed suggestions on the structure, governance and operation of a secretariat for APIP developed by the Australian APEC Study Centre, which provided for transitional arrangements to support the development of APIP, leaving open the prospect of an appropriate institution taking on the role if the concept gains broad support over the next few years.

The Advisory Group sees the role of APIP as twofold.

- At a strategic level, it would provide unbiased and objective advice to governments in the region on identifying and evaluating critical PPP development objectives and priorities, by helping ministers and senior officials develop a strategic approach to PPPs, consider PPPs in a holistic way and help in making appropriate policy choices.
- At a practical level, it would help officials deal with specific issues related to design, contracts, implementation and management of PPPs, making use of private sector expertise and experience in these areas, including related legal and financial issues and risk management.

The Advisory Group believes that the value of APIP can be demonstrated through an APEC pathfinder initiative involving a number of interested developing member economies and multilateral development institutions. Activities under this pathfinder initiative could include initial discussions with a small set of interested developing economies focused on strategic and policy issues with a high-level panel of private sector advisors and multilateral institution participation, to be followed at a later date by discussions focused on practical issues.

The Advisory Group recommends that APEC undertake a pathfinder initiative in cooperation with ABAC and the Advisory Group and involving interested member economies, to promote an Asia-Pacific Infrastructure Partnership (APIP), bringing together public and private sectors and multilateral institutions.

IV. TAKING ASIA-PACIFIC CAPITAL MARKET DEVELOPMENT TO THE NEXT STAGE: A PROPOSED PACKAGE OF MEASURES

Bond market development in the region has reached a significant stage, owing to various regional cooperation efforts, especially the Asian Bond Market Initiative (ABMI), which continues to undertake important initiatives. Nevertheless, discussions held during the past three years under the APEC Public-Private Sector Forum on Bond Market Development have revealed key weaknesses that still need to be addressed. In particular, supply constraints

arising from inadequate market depth and liquidity, market infrastructure and architecture and legal and regulatory frameworks represent the key obstacle to market development.

These discussions highlight the importance of continued and focused capacity-building efforts and collaboration among government and regulatory agencies, investors, issuers, credit rating agencies, private sector experts and international agencies. On 31 May 2010, the Advisory Group and ABAC, in cooperation with Japan's Ministry of Finance, convened the APEC Public-Private Sector on the Development of Bond Markets and Financial Inclusion in Sapporo, Japan. (*See Annex A for the full report.*)

The great diversity within the region has been highlighted by the discussions of the local currency bond markets in China, Korea and Japan, which are at different levels of development and facing different sets of challenges. The experiences of these three economies and the progress they have achieved over the past several years underscore the tremendous impact that reforms can have on market development. Going forward, each of these economies needs to focus on particular issues in order to sustain the momentum of market development.

- For China, the focus will be on optimizing the financing structure, improving the diversity of products and the issuer base, promoting globalization through increased foreign issuer participation and increased overseas issuance of domestic entities, more closely integrating the bond and banking markets, and the development of derivatives markets.
- For Korea, the key issue is ensuring that regulatory changes being undertaken as part of global regulatory trends in response to the recent crisis are in line with the objectives of market development, particularly with respect to their impact on liquidity and the demand for bonds and other safe assets.
- For Japan, the major issues revolve around improving the efficiency, transparency and liquidity of primary and secondary markets, the development of a robust market infrastructure and the diversification of the investor and issuer base, particularly through increased participation of foreign investors and issuers in the market.

There is wide scope for the introduction of new initiatives, building on current achievements, to bring capital market development and integration in the region to the next higher level. In addition to continued efforts to address key issues in the development of government and corporate bond markets, innovative solutions that can be pursued on a regional basis under the APEC framework include the following:

- Development of wholesale securities markets open only to professional investors (exempt from strict disclosure rules designed to protect retail investors), to encourage the expansion of the issuer base, including foreign issuers, and to promote more issuance by current issuers. Individual economies could establish such arrangements and eventually collaborate to develop regional arrangements for securities settlement, removing barriers to entry and undertaking further steps to create an integrated regional professional securities market.
- Collaboration between government and regulatory officials and market players to reduce barriers to cross-border settlement. The public sector should take the lead in addressing barriers related to tax, foreign exchange controls, cash controls, investor registration, omnibus accounts and quotas. The private sector should lead efforts to address barriers related to messaging formats and pre-matching. Both public and private sectors should

collaborate in addressing barriers related to physical certificates, securities numbering and settlement cycle.

- Promoting the use of foreign securities as eligible collateral throughout the region to enable major domestic and foreign financial institutions and investors to participate in cross-border collateral markets. In these markets, bonds can be actively used as collateral in money market transactions or traded in repurchase agreements, contributing toward more liquid bond markets. Existing arrangements can be considered as starting points in developing new bilateral arrangements, with a view toward a region-wide system.
- Continued collaborative efforts among governments, regulatory agencies, credit rating agencies and market players to promote region-wide convergence of accounting standards, disclosure regimes and corporate governance practices toward robust global standards.
- Establishment of a pathfinder initiative to introduce a funds passport scheme. Such a scheme is intended to facilitate the distribution of collective investment funds complying with a widely agreed common set of fund investment guidelines across participating jurisdictions. It should be designed to provide superior standards of retail investor protection and regulation compared to non-qualifying funds. Development of the common set of guidelines under which funds can apply for distribution across participating economies will need to be accompanied by efforts to address related regulatory and tax barriers as well as currency issues.

The Advisory Group recommends that APEC Finance Ministers and Senior Finance Officials undertake discussions with a view to compiling a package of measures to bring the development of the region's capital markets to the next level. We recommend that these discussions focus on (a) development of wholesale securities markets exclusively for professional investors; (b) regional public-private sector collaboration mechanisms to reduce barriers to cross-border settlement; (c) use of foreign securities as eligible collateral throughout the region; (d) ways to accelerate the region-wide convergence of accounting standards, disclosure regimes and corporate governance practices; and (e) establishment of a pathfinder initiative to introduce a regional funds passport scheme.

V. BUILDING CAPACITIES FOR REGULATORY REFORM IN ASIA-PACIFIC EMERGING MARKETS

Continuing its ongoing collaboration 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 6th SEACEN-ABAC-ABA-PECC Public-Private Dialogue for the Asia-Pacific Region, which was held on 15-16 June 2010 in Manila, Philippines. This year's dialogue dealt with the theme *The Role of the Financial Sector in Sustaining Economic Growth and Stability*, and discussed current global financial regulatory reform processes in the context of ongoing regional efforts to strengthen and develop the region's financial markets.

As in previous years, the dialogue helped shape the Advisory Group's views on the situation of financial systems in the region and how they may be strengthened. Key messages from the discussions were as follows:

- *Risks to financial markets are growing again.* Risks to global financial markets are increasing with banks in developed economies coming under stress due to rising sovereign risks and continued weakness of capital buffers for smaller banks in developed markets. Funding market strains are reappearing and banks are not lending to each other, increasing the need for renewed liquidity support from central banks. In developed

economies, downside risks are rising due to growing fiscal vulnerabilities. Asian emerging markets will be impacted with respect to both funding and capital flows and asset prices.

- *Asian banks and regulators face increased economic, financial and regulatory challenges.* Asian banks are negatively affected by uncertain global recovery prospects, regulatory overreaction to the crisis and the tightening of capital requirements. Asian central bankers are confronted by challenges related to large capital inflows, currency appreciation, heightened exchange rate volatility, distortion of asset prices as a result of capital inflows, the low interest rate environment, implications of new financial stability mandates and international policy coordination and resolution mechanisms.
- *Growing fiscal imbalances present serious new risks and must be addressed.* The growing risk arises from the low interest rate environment that can encourage fiscal imbalances. Events in Europe indicate that markets are not very tolerant of high public debt levels that are seen as unsustainable.
- *Regulatory reforms must be handled with care.* While there is support for regulatory reforms within the region, three key principles need to be kept in mind. (a) Regulators should guard against financial fragmentation and protectionism. (b) The aggregate impact of global reform measures should be adequately assessed. (c) Reforms should be undertaken with regulatory transparency through extensive consultation with industry, full impact analysis, allowing a transition period for implementation, appropriate grandfathering terms and consistent compliance and enforcement.
- *Conditions in the region are not adequately reflected in current reform initiatives.* There is significant concern within the financial industry about the value to the region of certain reform initiatives currently being considered. Negative impact of certain reforms in Asia would include significant reduction of liquidity in markets; putting Asian banks at a competitive disadvantage due to the lack of deep long-term capital markets to tap in beefing up capital; slowing the recapitalization of the banking sector; and extraterritorial impact of North Atlantic legislation.
- *Divergence between G20 and regional financial market development goals must be avoided.* There is concern that strong domestic political pressures in some economies striving to shape the G20's agenda poses significant potential for divergence between the G20's direction and the direction of Asian regional efforts to promote liquid and efficient financial markets, which may also end up damaging regional cohesion and solidarity. G20 member economies from within the region have a serious responsibility to ensure that the outcomes of this process are consistent with regional financial market development goals, and need to play an active role in shaping the G20's agenda.
- *Synergy between G20 and East Asian regional processes can be achieved.* The G20 is focusing on macro-economic policies and structural reforms to promote recovery and long-term growth, as well as on international financial regulatory reform. East Asian regional cooperation has focused on the development of a multilateral swap arrangement and local-currency bond markets. Synergies between these parallel global and regional processes could be achieved if members from the region ensure their voice is reflected in the development of policies at the global level and regional institutions work closely with their global counterparts.
- *Basel reform proposals still need substantial improvement.* Responses to the package of proposals contained in the 2009 BCBS consultative document indicate that there is need for substantial improvement. Following are key issues regulators and policy makers

should keep in mind: (a) Implementation of reforms should be coordinated globally and be internationally consistent, while taking into account economic conditions, business models and tax and accounting systems particular to each economy. (b) The impact of new regulations on the cost of doing business and on capital markets should be reviewed and evaluated. (c) There should be close consultations and dialogue with the private sector to determine what constitutes an appropriate level of capital and liquidity in financial systems.

- *Basel reform could increase costs but will provide long-term benefits.* It is expected that implementation of the new standards will result in a more stable banking system, lower risk premia and more efficient allocation of resources. However, it is also expected to increase the costs of funding, e.g., as a result of excessive capital-raising affecting banks' profitability and the costs being eventually passed on to the consumer. Basel reforms can lead to a more robust global banking system, but only if it is implemented at the right pace and time.
- *Need to minimize the use of top-down one-size-fits-all approaches.* In the context of Asian banking systems, it is still unclear whether Basel reform proposals would enhance financial stability. The new leverage ratio could penalize banks for taking excess deposits over loans. The net stable funding ratio would encourage banks to seek long-term funding from the market rather than through demand deposits. In Japan, a balanced reform package helped prevent major banking failures despite relatively low capital levels with lower quality capital components. These considerations indicate that some issues may be better dealt with through Pillar 2 (e.g., leverage ratio and net stable funding ratio) or through a balanced package of measures rather than through Pillar 1 and regulation of equity capital. It must also be kept in mind that more regulations will raise compliance costs and discriminate against regulated institutions vis-à-vis unregulated institutions, and encourage more regulatory arbitrage.
- *Focus on supervisory capacity is badly needed.* It is important that regulatory reforms are coordinated (to ensure level playing fields and avoid regulatory arbitrage). However, finding a proper balance between individual jurisdictions' discretion (amply needed) and consistency in implementation is a very difficult challenge. Implementation of agreed rules will also be meaningless unless complemented by strong supervision. There is therefore a real need to ensure that supervisors have adequate resources and authority as well as appropriate organizational frameworks and constructive relations with other agencies.
- *The Asia-Pacific region needs a regional architecture to effectively deal with regulatory reforms.* The crisis has led to major efforts at regulatory reform at the global level and in North America and Europe. Regulators in the region need to carefully assess the value of various proposals, including higher taxes for the financial industry, and determine costs and benefits of adoption. It is important for Asia-Pacific economies to review the relevance and potential impact of such reforms on the region, and to develop an architecture for this purpose.
- *Further develop the Chiang Mai Initiative Multilateralization facility.* To strengthen the region's emerging markets against volatile short-term capital flows that can lead to capital account crises, policymakers should begin studies on converting the standby CMIM facility into a well-endowed and effectively managed international financial institution, such as an Asian Monetary Fund when the time is ripe. An AMF that complements the existing global financial architecture could add value through its deeper

understanding of Asian economies and avoid repeating mistakes committed before and during the Asian financial crisis.

- *The Asia-Pacific region needs a regional financial forum of regulators and the financial industry.* Given the highly fragmented situation of the region's financial market infrastructure, compared for example to Europe, it is important to complement regional surveillance with parallel regional efforts to ensure that global standards are developed taking into account market practices and market infrastructure in the region. There is a need for a regional financial forum to address regulatory issues in the light of the region's needs, involving collaboration among regulators and the financial industry. Private sector input that can take into account both local and global perspectives should also be solicited in the process of designing regional structures.
- *There is a continuing need to develop financial sector safety nets in the region's emerging markets.* With the increasing complexity of financial products and growing inter-linkages among financial markets, maintaining domestic financial stability has become a shared responsibility among various institutions, thereby requiring a coordinated approach among regulators domestically and internationally and cooperation with the private sector. Efforts should focus on basic components, building robust frameworks for liquidity support, sound crisis management policies and procedures and good governance and sound strategies for deposit insurance.
- *Good corporate governance is crucial for stable growth.* In the face of globalization and an uncertain future of the global economy, the public sector has expanded its intervention and regulatory scope. However, the great diversity of economies precludes the success of a one-size-fits-all approach. Success in managing a return to prudent growth will require good corporate governance. Identifying milestones can help economies make steady progress in reforming corporate governance practices. Corporate governance scorecards, which have proven very effective, should be considered as a useful tool for checking on commitments.
- *The challenge to regulators: calibrating local conditions to global standards.* International standards should be recognized as the minimum threshold rather than the limits of regulation. There should be ample room above the threshold to allow for local conditions to be calibrated into the governance standards. As financial markets gain their strength in the diversity they offer, which provide options to the public, the key is in managing the duality of a minimum threshold and accounting for localized conditions. This can be achieved by allowing idiosyncratic differences in the governance of the markets while ensuring consistency with the broad intentions of the minimum standards.
- *Balanced regulatory response to crisis is needed.* In responding to the dislocations caused by the crisis, stakeholders must work toward responsible change, balancing key objectives and interests. For the real economy to thrive, it must ensure businesses' continued access to capital. For financial institutions, it should ensure sufficient leeway to create viable markets out of mobilized funds. For regulators, it must define regulatory boundaries that enable them to take immediate and decisive action without micro-managing financial institutions. For the public, it must restore faith in financial markets, protecting savings within responsible limits while enabling people to take risks when the capacity to do so is in place.

APEC can play an important role in promoting capacity-building to assist emerging market regulators in the region in dealing with many of these issues. An example of such an initiative is the training program "Implementing Financial System Regulatory Reforms in the Region

following the global financial crisis,” funded by the APEC Support Fund and the Melbourne APEC Finance Centre at RMIT University, undertaken jointly with the Asia-Pacific Finance and Development Centre and endorsed by the Advisory Group. Benefiting regulators from 11 APEC economies and 17 non-APEC economies and involving representatives from the region’s financial industry and regulatory agencies and international institutions, this program provided a constructive example of a public private partnership in financial institutional capacity building.

The Advisory Group recommends that APEC Finance Ministers support capacity-building measures involving public-private sector collaboration to help emerging markets in the region improve financial supervisory capacity, calibrate local conditions to global standards, promote the adoption of proven tools such as scorecards to strengthen corporate governance, and strengthen financial sector safety nets (including frameworks for liquidity support, sound crisis management policies and procedures and deposit insurance firms’ governance and strategies).

The Advisory Group proposes that APEC Finance Ministers support the development of a robust regional financial architecture, including a regional forum of financial regulatory authorities and the financial industry to address regulatory issues in light of the region’s needs, review the relevance and impact of global reforms on the region, and ensure that development of global standards take into account market practices and market infrastructure in the region.

ATTACHMENT A

**CONFERENCE REPORT OF THE APEC PUBLIC-PRIVATE SECTOR FORUM ON
THE DEVELOPMENT OF BOND MARKETS AND FINANCIAL INCLUSION, 31
MAY, SAPPORO, JAPAN**

(To be Attached)

ATTACHMENT B

**CONFERENCE REPORT OF THE PUBLIC-PRIVATE PARTNERSHIPS
FORUM, 9 FEBRUARY 2010, MELBOURNE, AUSTRALIA**

(To be attached)