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A Public-Private Sector Initiative

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AGENDA ITEM 3

PAPER 3-B

Financial Sector Reform: Towards a Menu of Policy Options for APEC Economies

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FINANCIAL SECTOR REFORM:

TOWARDS A MENU OF POLICY OPTIONS FOR APEC ECONOMIES

A paper presented to the APEC workshop

"Maintaining Financial Stability through Financial Safety Nets"

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Introduction and issues for discussion

1 This paper seeks views and guidance on a possible non-binding menu of policy choices for policy makers with responsibility for financial reform in APEC economies. The objective of the menu would be to identify practical options available to policy makers in the key areas of strengthening of financial infrastructure and financial institutions, within a framework which may assist policy makers' consideration of implementation and sequencing issues.

2 Four principles should explicitly guide the development of such a menu, viz:

- The general preconditions for successful reform and development of an efficient, stable financial sector are, to a large degree, common across a wide range of economic, social, and cultural conditions, but
- The most suitable method of achieving those preconditions is likely to be country specific, and is the legitimate responsibility of policy makers in each country.
- Establishment of suitable preconditions makes feasible a range of alternative policy strategies aimed at financial sector development, amongst which policy makers can choose those most suitable.
- Financial sectors continually evolve, such that the task for policy makers is to implement reforms which generate, on balance, desirable evolutionary responses, and for which the risks of potential undesirable outcomes are understood and manageable.

3 Consequently, this document provides, for discussion and subsequent refinement, a suggested framework within which policy options can be articulated, and some examples of how the framework can be developed by greater elaboration of those options. A key component of the approach lies in identifying a range of examples of how APEC economies have, implicitly, chosen from such a menu in undertaking reforms to develop and strengthen their financial systems.

4 The following questions/issues may help guide the ensuing discussion on this paper:

- Do participants consider that the proposed framework could be helpful in assisting decision makers in the APEC economies in identifying and considering practical policy options, and in communicating the rationale for these to key stakeholders and political constituents? What modifications would participants suggest to enhance the practical efficacy of the proposed framework?
- Do participants consider that the objectives set out in [paragraph 22] appropriately reflect the requirements of an effective and efficient financial system in APEC economies? If not, what modifications may be appropriate?
- Do participants consider the distinction made in the proposed framework between 'infrastructure' and 'institutional' elements of reform to be appropriate and helpful, especially with regard to considering practical sequencing choices?
- Do participants find the linkages between intermediate objectives and institutional policy initiatives set out in Table 1 a useful way of thinking about the issues?
- Are the illustrations offered [in attachments 1 to 4] of how the proposed menu could be used to drill down to practical policy choices available to advisers and decisions makers pitched at the right level of detail to be helpful? In particular, which of the "specific issue" approach adopted in attachment 2 or the "country case study" approach adopted in attachments 3 and 4 are preferable?
- Do participants agree that, to maximize its value to policy makers, the policy options identified in the menu should reflect actual APEC economy experience? If so, would economies be prepared to provide input to the development of the

menu, in the form of case studies drawing out implementation challenges and issues? and

- Would the proposed menu of policy options be most accessible and continually relevant to APEC financial sector policy makers if it were constructed as a web based resource available for updating and contributions from members, as a completed printed document, or in some other form?

Background

5 Financial Sector Reform is a complex task requiring the identification of an appropriate set and sequencing of value adding reform measures which are suitable for the current economic, social and political conditions of the economy in question. It requires political commitment in the face of likely opposition from influential vested interests, and relies on developing support from diverse stakeholders (including government officials, financial sector entities, and users of financial services). It is also necessary to manage the change process in a world of ongoing economic shocks whose effects may strengthen resistance to reform, but which may, equally, provide unique opportunities for progressing the reform agenda.

6 The ultimate goals of a reform process are common to all economies. They involve development of a financial sector which promotes: macroeconomic and financial stability; an efficient flow of funds (between savings and investment, and across an appropriate spectrum from safe to risky activities) for growth and economic development; and which contributes to objectives of fairness and distributional justice.

7 Critical in the reform process is the recognition that financial systems are continuously evolving organisms. They are subject to ongoing change as decision-makers in financial markets and institutions react to regulatory changes, technological developments, changing economic needs, and as competitive forces spur financial innovation and development. Consequently, effective financial reform is possibly more about policy initiatives which set in motion a desirable (and manageable) process of private sector reactions, than about making changes focused on achieving some idealized financial sector structure.

8 Consequently, for each economy, the optimal financial sector reform process will have unique features reflecting its social, economic, legal, cultural and political characteristics. It should not be expected that there is a "one size fits all" template for financial sector reform available to guide policy makers across all economies.

9 But all financial systems perform a common set of economic functions (outlined in more detail in Appendix 1). The role of institutions and markets in enabling the performance of these core economic functions, provide motivation for many identifiable components of reform and capacity building activities in the APEC region. Examples include development of bond markets, establishment of ratings agencies, micro-finance initiatives, development of long-term savings institutions etc. But for the contribution of these "institutional" initiatives to be maximized in terms of the performance of those core economic functions, core financial "infrastructure" must also exist. That infrastructure, heavily dependent on legal and regulatory systems, but also involving generally accepted business and social behavior, promotes the informed decision-making, and integrity and smooth operations of contractual relationships and markets necessary for economic growth, efficiency and fairness. Box 1 elaborates.

BOX 1

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options for developing financial infrastructure and institutions to assist policy makers in choosing practical options most suitable for their economy's current circumstances.

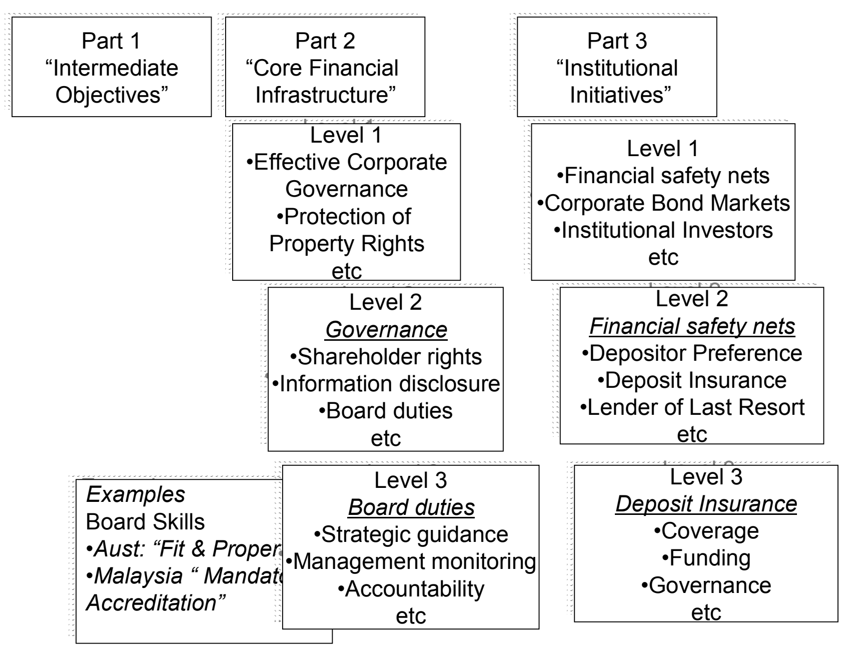
11 The objective of this paper is to identify an approach to developing such a menu. It envisages that the proposed menu would be best aimed at providing information on alternatives available, and identifying conditions under which particular alternatives are likely to be effective in achieving improvements to the financial structure. It also proposes that this be done at a relatively broad level, recognizing that policy makers, more cognizant than outsiders of the key features of their economy, are best placed to choose policy options at a more detailed level.

12 In this regard, a major benefit of the proposed menu of policy options could be to assist policy makers in managing the challenge of effectively sequencing policy reforms within the constraints imposed by the specific political, social and institutional realities they confront. Such a menu could assist in providing policy makers with options to quickly take account of opportunities that may arise. This recognizes that it may not always be possible to sequence reforms in an ideal way. Indeed, while this paper does attempt to provide a broad framework for an ideal way to sequence reforms, the various examples included highlight that much reform is taken at opportune times. For this reason, it is not intended for the menu to be prescriptive in its approach. The need for countries to take into account what other countries are doing to ensure regulatory regimes are complementary and conducive to integration over the longer-term is also an important consideration.

A framework for the proposed menu

13 One approach, consistent with the preceding discussion, would be to identify broad objectives of financial sector reform, common to all economies, and then to distinguish between two broad interrelated areas of focus for reform – the development of the essential market infrastructure, and the development of appropriate institutions. Identifying and articulating the objectives of policy (reflected in a set of "intermediate objectives") is a necessary first step in policy formulation. This is supported by identification of the core "financial infrastructure" requirements needed for specific institutional initiatives to be successful in achieving the intermediate objectives. The articulation and implementation of policy options focused on developing particular financial market institutional structures, is the third element in this process. On one level, this highlights the desirable 'first best' approach to sequencing; ideally, infrastructure needs are addressed first. In practice, the two interrelated dimensions for successful economic reform are more likely to be addressed contemporaneously. (The 'art' of successful real world reform is to ensure that progress, on both the infrastructure and institutional agendas, is mutually reinforcing, and that the costs of imperfect sequencing are minimized.)

14 For each of the components of the core infrastructure needs and the institutional initiatives, menus outlining more detailed components and possible choices can be presented. Indeed, it would be possible to cascade the menu structure down several levels to finer levels of detail, as shown in the outline below.



15 To develop such a menu, therefore, it is necessary to start with delineating components of the set of "*intermediate objectives*" (referred to above) for an efficient, equitable, smoothly functioning financial system. These intermediate objectives arguably flow from recognizing that a financial system involves economic agents making decisions to undertake transactions with others, where those transactions involve: self interest; imperfect information; expectations about future outcomes; risks associated with those outcomes; and contracts which provide for an incomplete range of contingencies and require settlement/enforcement arrangements. The economic agents involved include: end users of financial services such as individuals and business; decision makers within financial institutions; operators of and in financial markets; suppliers of ancillary services for financial transactions; governments. In many cases, the decisions are being made as agents on behalf of principals, in an environment of imperfect information, where self interested actions create well known agency problems and generate arrangements for countering those effects

16 Adopting this perspective leads to the following possible set of *intermediate objectives* for an efficient financial system, which constitute generic goals to which policy changes can aspire and be judged against:

- *Informed End Users:* End users (households, firms) of financial services and holders/issuers of financial instruments who are well informed about
    - Properties (risk, costs, expected return) of financial contracts they may enter
    - Suitability of those financial contracts to their personal circumstances
    - The financial strategy (wealth accumulation, investment, risk taking) best suited to their own needs
- *Informed Financial Services Providers:* Providers of financial services who are able to obtain adequate information about risk characteristics of potential counterparties to underpin their decision-making.
- *Good Governance Structures:* Institutional and governance structures which promote informed and good decision making in financial institutions, and which generate institutional objectives (towards risk taking and achieving legitimate stakeholder objectives) consistent with the perceived role of that institution in the economy.

- *Contract Credibility:* Legal and institutional arrangements which enable contracts to be efficiently written and enforced, and which protect property rights.
- *Failure Risk Mitigation and Management:* Mechanisms to minimize and/or deal with market outcomes which are viewed as failures having adverse and unacceptable social consequences
  - Ex ante – prudential regulation, supervision, development of markets for risk transfer and hedging
  - Ex post – financial safety nets
- *Minimizing Market Distortions and Imperfections:* Minimization of distortions or imperfections which prevent mutually (and socially) beneficial transactions between economic agents and which impede economic development, innovation, and financial inclusion of groups of potential end-users of financial services.
- *Cost Efficiency:* Incentives for (risk adjusted) minimum cost – efficient production of valuable financial services

17 Such a set of intermediate objectives can be achieved in a variety of ways, involving a variety of possible institutional and market structures, different legal systems, and differing regulatory arrangements. Particular policy initiatives towards capacity building and market development will each affect more than one of these objectives, and there are a range of policy options available for consideration. Critically, however, the effectiveness of policy initiatives will depend on the environment in which they are carried out. Their effectiveness will depend upon whether a sound financial infrastructure (architecture) is in place to underpin change and prevent possibly adverse consequences. If this is not the case, consideration will need to be given not only to developing the necessary architecture, but also to the selection of institutional options which strengthen the incentives, including the political support, in favor of desirable supportive infrastructure development. Hence an awareness of sequencing considerations, including management of the political economy dimensions, is important.

18 Table 1 aims to summarize and highlight the interrelationship between intermediate objectives, broad policy areas of financial market development ("institutional initiatives") and core components of the financial infrastructure. Shaded cells indicate that the policy items are of particular relevance to achieving that intermediate target, although generally policy initiatives will have implications for all intermediate objectives. The core components of the financial infrastructure necessary for success are shown as being relevant for achieving all intermediate objectives.

19 There are, undoubtedly, other broad policy areas which could be included, and potential for debate about the relative significance of the impact of particular institutional initiatives on various intermediate objectives. Implicit in the structure of the Table is the view that the ultimate effects of institutional initiatives on intermediate objectives will depend on the achievement of core infrastructure requirements and the extent to which some other institutional initiatives have been achieved. There is a high degree of interdependency amongst components of a financial reform process.

20 One benefit of specifying a set of "institutional initiatives" lies in the fact that this is how policy reforms are often articulated, in order to provide a focus for a range of activities. Another is that an approximate chronological ordering between some components can be developed, illustrating the desirable sequencing of reforms and establishment of preconditions needed for success of individual reform components. For example, development of adequate disclosure requirements and accounting standards would ideally be "early stage" reforms because of their pervasive effect on development of informed end-users, informed financial institutions, and deep and liquid markets (which are important in contributing to other intermediate objectives. Similarly, development of appropriate insolvency laws, clarification of rights and duties of financial agents, and implementation of good corporate governance requirements, should also ideally be "early stage". Finally, development of effective regulatory agencies and appropriate standards of conduct and disclosure by official agencies is also "early stage".

21 Within both core infrastructure requirements and institutional initiatives there are a range of possible alternatives from which policy makers may choose the specific case most suited to their current needs. For example, in designing effective regulatory agencies, there are choices between having a single financial regulator (responsible for prudential supervision of institutions as well as securities market and exchanges), or separate prudential and securities markets regulators, as well as choices to be made regarding the relationship of such entities to the Central Bank and/or Ministry of Finance. In addition, the funding of such bodies may be derived from government budgets or from industry levies, or a mix of both. While there is no strong evidence that a single "best" structure exists, the important requirement is that such agencies have appropriate degrees of independence, accountability, and transparency.

TABLE 1: Intermediate Objectives, Core Financial Infrastructure and Institutional Initiatives

Intermediate Objectives	***Informed End Users***	***Informed Financial Institutions***	***Good Governance Structures***	***Contract Credibility***	***Failure /Risk Management& Mitigation***	***Minimizing Market Distortions & Imperfections***	***Cost Efficient Financial Services***
Core Financial Infrastructure Requirements	Strong Corporate Governance Standards and Practices Effective Legal Protection and Enforcement of Property Rights Enforcement of Reliable Accounting and Auditing Standards Appropriate Information Disclosure Requirements and Practices Strong and Effective Supervisory Agencies and Practices Efficient and Reliable Settlement and Payments systems						
Institutional Initiatives							
Strengthening Financial Institutions							
Achieving a sound Prudential Regulation Framework							
Designing a suitable Financial Safety Net							
Creating Deep & Liquid Capital Markets							
Developing an Institutional Investor Base							
Developing Long Term Savings Institutions							
Promoting Ratings Agencies							
Promoting self-Regulatory Organizations							
Development of Credit Bureaus							
Improving Risk Management Options							
Financial Education & Literacy Programs							
Microfinance Initiatives							
Clarifying Rights and Duties of Financial Agents							
Ensuring adequate competition in financial product markets							
Improving Securities Market Regulation							
Rationalizing Ownership Restrictions							
Improving Economic Policy transparency							
Reducing Distorting Financial Taxes							
International Harmonization of Regulation							

A Proposed Menu Structure

22 A possible "policy menu" structure therefore consists of three major parts. The first is the agreement on a set of *"intermediate objectives"*, such as outlined earlier, to which all policy makers can subscribe. For each economy, particular objectives may receive more emphasis at certain times than others, depending upon current conditions, needs, and events. Through self assessment activities, or processes such as FSAP's involving external parties, countries can ascertain the extent to which their current financial system meets such objectives.

POLICY MENU – Part 1

Intermediate Objectives
(a) Informed End Users (b) Informed Financial Institutions (c) Good Governance Structures (d) Contract Credibility (e) Effective Failure and Risk Management / Mitigation Arrangements (f) Minimizing Market Distortions and Imperfections (g) Promotion of Cost Efficient Supply of Financial Services

23 The second dimension of the policy menu involves the choices to be made in developing the core financial infrastructure, which in an ideal world is a necessary precondition for effective policy choices among institutional initiatives. For these desirably "early stage" elements of the policy choice, there are a range of options for each menu component, and some guidance can be obtained from the range of core principles and standards produced by institutions such as the Basel Committee, IOSCO, etc. Within each area, a range of practical approaches is available and components (examples) of this menu outlined in subsequent sections.

POLICY MENU – Part 2

Core Financial Infrastructure requirements

Areas	**Sources of Guidance**
Strong Corporate Governance Standards and Practices	OECD "Principles of Corporate Governance" 2004
Effective Legal Protection and Enforcement of Property Rights	
Insolvency Systems	"Creditor Rights and Insolvency Standard" Draft, 2005, based on World Bank "Draft Principles for Effective Insolvency and Creditor Rights Systems" 2005 and UNCITRAL "Legislative Guide on Insolvency Law" 2004 http://uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf
Appropriate Information Disclosure Requirements and Practices	
Banking	Basel Committee "Enhancing Bank Transparency" 1998
Insurance	IAIS "Guidance Paper on Public Disclosure" 2002
Enforcement of Reliable Accounting and Auditing Standards	
Accounting	IASB "International Accounting Standards " 2002
Auditing	IFAC "International Standards on Auditing" 2002
Strong and Effective Supervisory Agencies and Practices	
Strong Agencies	
Effective Supervision	
Banking Supervision	Basel Committee "Core Principles for Effective Banking Supervision"
Insurance Supervision	IAIS "Insurance Core Principles"
Securities Regulation	IOSCO "Objectives and Principles of Securities Regulation"
Efficient and Reliable Payments and Settlements Systems	CPSS "Core Principles for Systemically Important Payment Systems" IOSCO "Recommendations for Securities Settlement Systems"

24 Attachment 1 outlines how the menu of policy options could be expanded to different levels, using the cases of corporate governance and protection of property rights as examples. Attachment 2 illustrates how examples of alternative approaches taken by various countries in addressing particular elements of that framework can be presented.

25 The third dimension of the policy menu involves the institutional components of the policy choice, set out in Table 1. These are policy areas common to all countries such as: financial sector safety nets, money, bond and equity market development, institutional investor development, strengthening of financial institutions, improving risk management options through derivatives markets and insurance firms, development of long term savings institutions. The Table below illustrates this third part of the policy menu. Again, there are many variants of institutional initiatives, and subsequent development would focus upon elaborating on choices from within the menu items. In Attachments 3 and 4 illustrations are given of how this might be done for the case of corporate bond market development and for financial safety nets. The approach taken there is to provide "vignettes" of country case studies, rather than focusing upon illustrating specific level two components of the menu as was done in Attachment 2, and the relative merits of these (or other) alternative approaches warrants discussion.

26 The process of policy reform in itself, also offers a range of options, any of which may be effective, depending on the political, social and economic factors shaping the policy environment. Should reform needs be identified by a Government commissioned public inquiry with subsequent discretionary implementation (or non-implementation) by government? Should FSAPs provide the main source of guidance? Should governments develop reform options "in-house" through advice from bureaucrats? Should a long term (5- 10 year) reform agenda be specified, as was the case in Malaysia's 2001-2010 plan, which identified key phases in the reform process. Different approaches may have particular merits, at certain times and in particular cultural and political settings, in building political consensus and public support for the reform process.

27 Illustrations of how the "menu" can be expanded to numerous levels of greater detail and examples/case studies of approaches followed for particular topics follow in the attachments. For construction of the final output, it may be that a web based format involving linkages to successively greater levels of detail and example would be a useful approach to follow, and which could allow for updating using contributions of examples and experiences submitted by APEC members.

POLICY MENU – Part 3

Broad Policy Institutional Initiatives	
Strengthening Financial Institutions	Strengthening (Recapitalizing) Bank Capital Restructuring Bank Ownership Enhancing Financial and Risk Management Skills
Achieving a Sound Prudential Regulation Framework	Developing Risk Based Supervision Transition to Basel 2 Preventing regulatory forbearance
Design of Financial safety nets	Lender of Last Resort arrangements Depositor Preference arrangements Deposit Insurance Bank Insolvency arrangements Strengthening regulatory agencies
Creating Deep and Liquid Capital Markets	Money Markets Bond Markets Equity Markets
Developing an Institutional Investor base	Mutual Funds Insurance Firms Pension Funds
Developing Long Term Savings Institutions	
Development of Ratings Agencies	Bond Ratings Agencies Corporate Governance Ratings Agencies
Development of Self-Regulatory Organizations	Stock Exchange responsibilities Industry Association responsibilities Professional Bodies responsibilities
Development of Credit Bureaus	Public registries Private credit bureaus
Improving Risk Management Options	Development of OTC Derivative Markets Development of Derivatives Exchanges Insurance Firms
Financial Education & Literacy Programs	
Micro-Finance Initiatives	
Clarifying Rights and Duties of Financial Agents	
Ensuring adequate competition in financial product markets	
Improving Securities Market Regulation	
Rationalizing Ownership Restrictions	
Improving Economic Policy transparency	
Reducing Distorting Financial Taxes	
International Harmonization of Regulation	Mutual Recognition Agreements

ATTACHMENT 1
Core Infrastructure Requirements: Expanding the Menu

The following tables illustrates how the menu of policy choices can be expanded from a broad general level, such as the core requirements of effective corporate governance and protecting property rights, to more detailed elements of that requirement.

Core Financial Infrastructure: Effective Corporate Governance	
Level 1	*Level 2*
Ensuring the Basis for an Effective Corporate Governance Framework	Promotion of transparent and efficient markets Consistency with the rule of law Clear articulation of the division of responsibilities among different supervisory, regulatory and enforcement authorities. Supervisory, regulatory and enforcement authorities should have appropriate authority, integrity and resources.
The Rights of Shareholders and Key Ownership Functions	Protection of basic shareholder ownership rights Ensuring shareholder access to information Provision for effective shareholder participation Disclosure of disproportionate controlling interests Ensuring effective corporate control markets Exercise of shareholder rights facilitated Intra-shareholder communication facilitated
The Equitable Treatment of Shareholders	Equal treatment of all shareholders in a class Insider trading and self dealing prohibited Disclosure of insider material interests
The Role of Stakeholders in Corporate Governance	Stakeholder rights respected Opportunity for redress if legal rights violated Performance enhancing mechanisms for employee participation allowed to develop Provision of information to stakeholders Stakeholders should be free to communicate concerns to the board, without risk Corporate governance needs to be supported by an effective insolvency regime and creditor protections
Disclosure and Transparency	Accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company. Preparation and disclosure of information in accordance with appropriate accounting standards Annual audit External auditor accountability Timely and fair distribution of information Mechanisms for enhancing information usage
The responsibilities of the Board	Core duties – good faith, due diligence and care, in the best interests of the company Treat all shareholders fairly Apply high ethical standards Fulfill key functions including strategic guidance of the company and effective monitoring of management Exercise objective, independent judgment on corporate affairs Must have access to accurate, relevant and timely information

Source: OECD Principles of Corporate Governance

ATTACHMENT 1 (continued)
Core Infrastructure Requirements: Expanding the Menu

Core Financial Infrastructure: Protection of Property Rights	
Level 1	*Level 2*
Creditor Rights	Security Arrangements Registry Arrangements Enforcement Arrangements
Risk Management & Corporate Workout	Creditor Information Systems Director and Officer Accountability Enabling Legislative Framework Informal Workout Procedures Regulation of workout and risk management practices
Commercial Insolvency	Commencement – Due Process, Eligibility, Applicability and Assessment Provisional Measures & Effects of Commencement Management Creditors and the Creditors' Committee Collection, Preservation, Administration and Disposition of Assets Stabilizing and Sustaining Business Operations Treatment of Contractual Obligations Administration: Avoidable transactions Treatment of Shareholders rights and priorities Claims and Claims resolution Reorganization Proceedings
Institutional, Legal, Regulatory Framework	Role of Courts Judicial Selection etc Court Organization Transparency and Accountability Judicial Decision Making and enforcement of orders Integrity of the System Role of Regulatory and Supervisory Bodies Competence and Integrity of Insolvency Administrators

Source: World Bank "Creditor Rights And Insolvency Standard" Draft, 2005

ATTACHMENT 2:
Core Financial Infrastructure –Options and Examples

Strengthening Corporate Governance. Strong corporate governance is a key component of the financial infrastructure. It assists in achieving good economic performance directly as a result of better corporate decision making, and indirectly through creation of an environment in which corporate stakeholders have greater confidence. While there are a number of general principles which can guide corporate governance arrangements, there is a variety of approaches to achieving good corporate governance standards and outcomes. Moreover, "best" corporate governance practice is evolutionary, and may be as much a matter of culture as of structural arrangements, since it ultimately relies on the attitudes and approaches of corporate decision makers. In this respect, business culture and education play a key role, as also does the legal framework in specifying appropriate behavior and practices and in their enforcement. National approaches to improving corporate governance also need to take into account differences in underlying business and financial sector structures, including the relative importance of non-listed companies and family owned firms, and the extent to which markets for corporate control and long-term institutional investors or bank monitoring of borrowers provide effective mechanisms for enforcing good corporate governance practices.

The following discussion provides some examples of choices and approaches used in developing core financial infrastructure requirements in Corporate Governance as outlined in Attachment 1.

Level 2 Core Requirement: **Clear articulation of the division of responsibility among different supervisory, regulatory and enforcement agencies.**

Existing regulatory structures in APEC economies are the result of historical processes and have led to situations in which corporate governance related responsibilities may be spread across official bodies such as Securities Commissions, Stock Exchanges, Central Banks, and Companies Commissions, as well as self-regulatory organizations. Gaps and overlaps in responsibilities may exist, leading to the need for a reassessment of organizational arrangements, including the appropriate division of particular levels of decision-making responsibilities between legislative and regulatory bodies (and the degree of independence accorded to the latter).

APEC and East Asian economies have addressed this issue in a number of alternative ways. One approach is for the existing set of multiple regulators to *vest powers* related to corporate governance to one of their members. The approach being considered by Bangladesh under a Technical Assistance program with the ADB looks to be of this type.
Multi-regulator committees focusing on specific issues may be established comprising representatives of relevant regulators to coordinate approaches, or with particular delegated responsibilities. In Malaysia, the High Level Committee on Corporate Governance Enforcement was established in May 2004. *New Regulatory Entities* may be established to better deal with particular aspects of corporate governance regulation. In Thailand, the Department of Special Investigations was established in 2004 to improve criminal prosecution. Hong Kong, a Bill was introduced in 2005 to establish a Financial Reporting Council with responsibility for dealing with auditing, legal and accounting issues. In Chinese Taipei, the Financial Supervisory Commission was established, incorporating a number of previously separate supervisory agencies, made independent of Government, and with responsibility to look after all corporate governance related regulatory issues.

ATTACHMENT 2: (cont)

Level 2 Core Requirement: **Accurate Disclosure (regarding governance)**

Information about governance arrangements and performance is important for stakeholders to assess likely performance of the company. Shareholders, analysts, and also regulatory agencies have particular interests in this information. Such information is also of value for Boards in meeting their responsibilities, by enabling them to benchmark their performance against other entities.

A range of alternative approaches are possible for improving disclosure and use of information about corporate governance practices and performance. These may involve *mandating* the provision of certain information in some format or encouraging *voluntary disclosure*. Independent third parties may provide *ratings* of corporate governance performance, regulatory agencies may *benchmark* performance of companies against some specified criteria, or companies themselves may undertake *self-assessment* based on particular criteria or use of a "score-card".

Mandatory requirement for inclusion of a "Corporate Governance Statement" in annual reports for listed companies has been introduced in Hong Kong. In Australia, ASX listing rules have been tightened in recent years to specify expected contents of the required statement, but on a "comply or explain why not" approach. (In addition, to ensure that stakeholders are well informed, there is mandatory, detailed, reporting of Executive and Director Remuneration in listed companies.)

Many countries in the APEC region have introduced codes of practice or best practice for corporate governance which companies are mandated to, or expected to, follow. In Australia, the ASX Corporate Governance Principles provide a "principles based" approach for listed (and other) companies to follow in achieving good corporate governance. An "If not, why not" approach, involving requirement for companies to explain why they choose not to comply with articulated principles has been adopted, reflecting the fact that company circumstances may suggest some preferred alternative. Singapore introduced a similar approach in 2003. In Thailand, the Stock Exchange awards Certificates to companies adhering to its recommended principles and offers fee remissions for assessed good performance against those principles.

PECC (2004) proposed that corporate governance scorecards, which provide opportunities for Boards to assess comparative performance against benchmarks and progress over time, should be developed. A number of APEC economies have introduced such approaches. In the Philippines, the SEC (since 2003) requires listed companies to submit a self-assessment report. Various private bodies (such as Institutes of Company Directors) in the region are cooperating to develop scorecard approaches for use in self assessment by companies and for use by analysts.

Level 2 Core Requirement: Board fulfils key functions

Ensuring that company directors have adequate skills and understanding of good board practices is a vital ingredient for good corporate governance. In Malaysia, a Mandatory Accreditation Program was introduced in 2001 by KLSE for directors of listed companies, following a study of director educational needs, together with the introduction of a Continuing Education Program. Since 2005, Boards have been required to determine director training needs. Thailand has also introduced mandatory training requirements.

In many countries, responsibility for director education, training, and professional development, lies with private sector associations such as Institutes of Company Directors. In Thailand, the Government provides subsidies for directors to attend corporate governance workshops run by such entities.

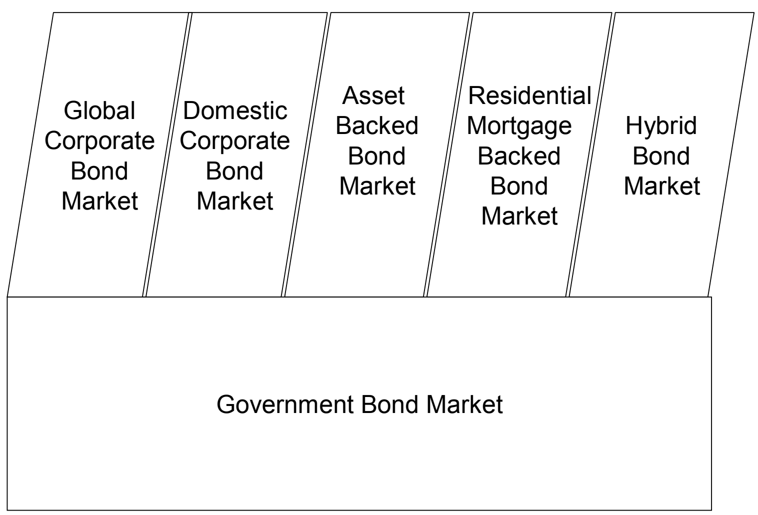
In the case of financial institutions it is commonly accepted that higher levels of governance and accountability are required. In Australia, APRA has implemented "Fit and Proper Requirements" for Directors of Financial Institutions.

ATTACHMENT 3:
Expanding the Menu – Institutional Policy Initiatives
Corporate Bond Market Development

The benefits of developing bond markets as a complement to bank intermediation are well known. They provide expanded choices for investors, expanded funding options for issuers, mechanisms for price discovery, and can facilitate the adjustment of financial markets to shocks.

The variety of issuer and instrument types often leads commentators to compartmentalize bond markets into government, corporate, international, asset backed, mortgage backed, hybrid sectors etc. But substitutability in investor portfolios (given appropriate pricing of different risks) creates substantial interlinkages. Consequently policy initiatives to develop bond markets may, reflecting economy specific factors, appropriately emphasize development of particular segments of the market at particular times. Development of any segment assists subsequent development of other segments.

Developing Corporate Bond Markets



But, regardless of emphasis, there are a range of pre-requisites for successful bond market development. Investor demand will depend upon legal certainty of claims, efficient trading mechanisms, information availability and reliability, and trust in issuer integrity and honesty. In this regard, weaknesses in the *Core Financial Infrastructure* will inhibit development of bond markets. In addition, successful market development requires the existence of features such as corporate pricing benchmarks, and market liquidity and depth. Issuers require assistance from experienced advisers with issuance arrangements and need legislative arrangements which facilitate the appropriate structuring of securities suitable to investor needs.

ATTACHMENT 3: (cont)

Corporate Bond Market Development: Expanding the Menu

The following table illustrates how the menu of policy choices can be expanded from a broad general level, such as the institutional policy initiative of corporate bond market development, to more detailed elements of that requirement. The subsequent discussion provides some examples of alternative paths taken for development of bond markets in different countries.

Institutional Policy Initiatives: Corporate Bond Market Development	
Level 1	Level 2
Efficient risk-based pricing	Existence of a Pricing Benchmark (Government securities market and yield curve) Sufficient Market Depth to provide liquidity Complementary infrastructure such as repo and securities lending, markets Timely and accurate issuer information disclosures
Attractive Funding Source for Issuers	Appropriate regulation of issuance requirements (merit based v disclosure based) Facilitation of Asset Backed Securities
Liquid Secondary Market	Absence of transaction-inhibiting taxes
Investor Demand	Development of Ratings Agencies Development of institutional investors Reliable Information dissemination

Alternative Paths to Bond Market Development

The development of **South Korea's Asset Backed Securities** market (Dalla, 2006) provides one illustration of policy initiatives facilitating bond market development. The *civil law* framework meant that specific laws, enacted in 1998, were necessary to provide the legal foundation for establishing, and transferring assets into, Special Purpose Vehicles. Central Bank guidelines on securitization and capital adequacy treatment clarified arrangements for bank involvement in the market. Following the 1997 Asian Crisis, the Government took the opportunity to repackage non-performing loans as asset-backed securities which helped develop the market. The involvement of international investors was facilitated by the existence of a currency swap market. Earlier, in 1993, an amendment to the Securities and Exchange Act had provided the basis for the Korean Securities Depository. Transactions taxes which would inhibit the required asset transfers were removed or waived. These initiatives capitalized on the existence of a strong institutional investor base, and the existence of domestic ratings agencies. More recently (2003) the Government has established the Korean Housing Finance Corporation to promote the growth of the residential mortgage backed securities market.

McCauley and Park (2006) describe the evolution of the **Canadian Corporate Bond** market as one involving a gradual shift to greater reliance on issuance of bonds denominated largely in $US in international markets. Underpinning that shift was access to a wider investor base interested in $US denominated assets, together with the existence of a deep cross-currency interest rate swap market, which enables the issuers to hedge foreign currency exposure and effectively create a synthetic Canadian dollar liability. To achieve such an outcome, local firms need a regulatory framework which permits issuance into international markets, together with coverage by ratings agencies. The existence of a local government bond market, an effective foreign exchange market and freedom of capital flows to enable development of a cross-currency interest rate swap market are also implied. Australian corporate bond issuers have also utilized this method heavily, as have issuers from Hong Kong and Singapore.

The **Australian** domestic corporate bond market provides a good example of how market development may occur through initial involvement of financial institutions rather than non-financial corporate issuers, and be facilitated by government policy initiatives. Financial liberalization in the 1980s freed interest rates and enhanced foreign participation in Australian capital markets. Futures markets in government debt were permitted, and bond indices established by private sector participants. Various inhibiting regulations including stamp duties on transfers were removed, while regulatory capital requirements on banks gave incentives to the securitization process. Mortgage originators were able to compete for housing borrowers. Sound legal arrangements regarding enforcement of titles etc enabled special purpose vehicles to obtain credit enhancement over asset backed securities issued. The emergence of a strong institutional investor demand through the growth of the superannuation industry provided a ready market. More recently, commitment has been given to maintaining a deep government debt market in the face of budget surpluses in order to provide benchmark pricing.

Mustamir Bin Mohamad (2005) outlines the approach followed by **Malaysia** to development of its bond market involving the 1999 establishment of a national Bond Market Committee and subsequent development of a Capital Market Master Plan involving capacity building measures, subsequent liberalization and planned internationalization. As well as implementing measures to rationalize issuance procedures, develop a benchmark yield curve, widen the investor base, improve liquidity, and facilitate risk management instruments, the specific opportunity was taken to focus upon the development of Islamic Private Debt Securities. A chronological listing of development efforts is available at http://www.sc.com.my/eng/html/bondmkt/bondev_chrono9899.html .

More information on paths to bond market development in Asia and elsewhere can be found at: http://www.bis.org/publ/bppdf/bispap26.htm and http://www.bis.org/publ/bppdf/bispap30.htm

ATTACHMENT 4:
Expanding the Menu – Institutional Policy Initiatives
Financial Sector Safety Nets

Financial Safety Nets are the nexus of arrangements put in place by governments which recognize that banking (and other financial intermediation activities) which generate significant benefits to society, can also be subject to crisis events and failures. The objective of these arrangements is to limit the extent of adverse consequences arising from such events and involve such arrangements as providing some degree of protection of bank deposits, efficiently resolving bank failures, providing facilities to banks to prevent unnecessary failures, limiting, and allocating across society, losses arising from bank failure. These arrangements include: deposit insurance schemes, lender of last resort facilities, bank failure resolution arrangements, and bank supervision and regulation arrangements.

Crucial to the design of a good financial safety net is the need to prevent "moral hazard" arising from the removal of incentives for prevention of excessive risk. Depositors who are protected from loss may pay less attention to, and exert less discipline over, risk taking by banks, whose managers and owners may have incentives to expand risk taking. Thus, as well as designing a safety net which retains incentives for depositors (or other agents) to monitor and discipline banks, it is crucial to have in place *core financial infrastructure* such as sound governance arrangements in banks, strong and effective supervisory agencies, and clear legal arrangements which enable rapid resolution of problems when they emerge. For supervisors and bank stakeholders to adequately assess bank risk taking, the core financial infrastructure components of adequate information disclosure and accurate accounting information and auditing are also needed.

The following Table illustrates how the menu of policy choices related to the financial safety net can be expanded to successively greater levels of detail.

ATTACHMENT 4: (cont)

Institutional Policy Initiatives: Financial Safety Net	
Level 1	*Level 2*
Deposit Insurance	Institutional Coverage-Banks, other Depository Institutions Maximum coverage and co-insurance arrangements Pre or Post Funding Risk Based Pricing Insurance Agency Governance Arrangements Insurer Supervisory Powers
Depositor Preference Arrangements	Eligible securities Treatment of Non-resident Deposits
Lender of Last Resort	Discount window arrangements Eligible securities Minimum Liquidity requirements Last resort lender priority in insolvency
Bank Failure Resolution Arrangements	Creation of specific bank insolvency laws Purchase and assumption powers Reorganization powers Forced merger powers Liability transfer powers "Bridge bank" arrangements Recapitalization arrangements
Bank Supervision and Regulation Arrangements	Minimum Capital Requirements CAMEL (or other) ratings systems Prompt Corrective Action Requirements Multiple regulator coordination and responsibilities Home-host regulator coordination

ATTACHMENT 4: (cont)

Financial Sector Safety Nets: Alternative Approaches to Deposit Insurance

Explicit deposit insurance is one possible component of a financial safety net, but needs to be designed and introduced carefully to ensure that moral hazard is not created. In the absence of a financial crisis, when blanket government guarantees may need to be introduced to stabilize the banking system, a set of institutional preconditions are required for success. These include: effective bank supervision arrangements; effective failure resolution powers; adequately capitalized banks. In designing a scheme it is important that market discipline is maintained by some depositors (such as sophisticated, wholesale, informed depositors) are "at risk", and that there is credibility of protection arrangements. In practice, a number of APEC economies felt obliged to introduce blanket guarantees during the Asian crisis, and other countries without explicit schemes often have "de facto" implicit guarantees. Introduction of an explicit scheme offering limited protection for some depositors, if it is to occur, needs careful management.

A range of alternative approaches to deposit insurance can be observed.

At one extreme, there is the approach of explicit denial of depositor protection (caveat emptor) by the Government, as adopted by **New Zealand**. This approach relies upon the view that the institutional infrastructure, comprising effective supervision, legal arrangements to ensure good governance, adequate disclosure which interacts with depositor risk bearing to enable market discipline, are sufficient to minimize the possibility of failure. With adequate failure management powers available to the regulator to enable rapid action, the risk of systemic crisis arising from individual bank failure is believed to be negligible. But as part of these arrangements, the New Zealand government has been concerned to ensure that the foreign banks which dominate its banking sector, structure operations as subsidiaries, such that an explicit capital base is available to absorb losses otherwise faced by New Zealand depositors, including through any failure of an overseas parent.

Another approach which eschews explicit insurance arrangements is that currently operating (although under review) in **Australia**. This approach is partly premised on the view that *depositor preference* arrangements, combined with substantial non-deposit funding by major banks, are adequate to protect Australian retail depositors from loss, should a major bank fail.

In **Japan**, a blanket guarantee of bank deposits was implemented in 1996 to cope with the banking crisis, to operate until 2001. Subsequently, the Deposit Insurance Corporation of Japan was given new powers for supervision, prosecution and resolution. Surviving banks underwent a recapitalization process, and non-performing loans were removed from bank balance sheets. A gradual transition to partial coverage was put in place, with a maximum coverage amount to apply to "non-liquid" deposits from April 2002, with removal of full coverage of liquid deposits scheduled for 2003 (but later changed to 2005).

Vietnam introduced limited deposit insurance in 2000 and has been gradually developing the supervisory capacity and legal underpinnings required for successful operation of the system in a context where the role of market-mechanisms in the operation of the economy is being gradually increased. Core capital funding for DIV from Government is augmented with insurance premiums collected from participating deposit taking institutions. A relatively low level of protection for depositors currently exists. It has a strategic plan for 2006-2015 with objectives to further develop the legal framework, ensure transparency of operations, and develop institutional capacity. This includes transition to a risk based premium structure. Attention to the potentially distorting effects of exclusion of some types of deposit taking institutions from coverage is also to be addressed. Its objectives include protecting the Government budget from claims due to financial institution failures.

APPENDIX 1: Financial System Functions and Performance

Drawing on the "functional perspective" of Merton (1995) financial systems can be assessed against the extent to which they efficiently fulfill a set of core economic functions. Those functions and examples of institutions, markets, and mechanisms involved in their provision are:

- *a payments system for the exchange of goods and services* – involving Central Bank depository and settlement services, base money provision, bank provided payments and settlement arrangements, securities settlements services, credit card and EFT services, foreign exchange markets
- *a mechanism for the pooling of funds to undertake large-scale indivisible enterprise* – involving banks and depository institutions, institutional investors and mutual funds, stock exchanges, capital markets, investment banks, private equity firms .
- *a way to transfer economic resources through time and across geographic regions and industries* – involving savings, depository and other financial intermediaries, pension funds, foreign exchange markets, capital and money markets
- *a way to manage uncertainty and control risk* – involving insurance companies, financial intermediaries, forward markets, options and other derivatives markets.
- *price information which helps coordinate decentralized decision-making in various sectors of the economy* – involving money and capital markets, stock exchanges, foreign exchange markets.
- *a way to deal with the asymmetric information problems when one party to a financial transaction has information that the other party does not* – involving ratings agencies, credit bureaus, banking relationships, collateral, security, and guarantee arrangements, auditing, disclosure requirements.

In principle, there are two (complementary) approaches which can be used for assessing how well the financial system performs those core functions. One approach is to use direct measurements of performance. This could include such things as: examining how rapidly "news" is incorporated into financial prices; whether the price of particular financial services reflects an appropriate (risk adjusted) return for their suppliers; or how macro indicators of financial deepening have changed over time.

An alternative approach would involve focusing upon features of the financial system believed to be compatible with the desired outcomes, and using these as indirect indicators. Relevant indicators may include measures of such things as:

- Existence of effective competition in the financial sector
- Facilitation of beneficial financial innovation
- Absence of artificial regulatory distortion of financing channels or techniques (except where clear cases of market failure, and superiority of alternative arrangements, can be identified).
- Convergence of outcomes of private decision-making with social goals
- Informed decision-making by participants
- Good governance and decision-making in financial institutions
- Optimal involvement and engagement with the international economy

Reference

Merton, Robert C (1995) "A functional perspective of financial intermediation" *Financial Management*, 24, 2, Summer 23-42