



The Advisory Group on APEC Financial System Capacity-Building

A Public-Private Sector Initiative

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Draft 2007 Report on Capacity-Building Measures to Strengthen and Develop Financial Systems

Office of the Advisory Group Chair

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2007 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS

Summary of Recommendations

Since its establishment in 2003, the Advisory Group on APEC Financial System Capacity-Building, working closely with the APEC Business Advisory Council (ABAC) and the Pacific Economic Cooperation Council (PECC), has been conducting regular discussions with the participation of international public and private sector institutions and organizations, to address these challenges. After reviewing various ideas during these discussions, the Advisory Group recommends that APEC Finance Ministers:

- Endorse the holding of subsequent APEC Public-Private Sector Forums on Bond Market Development beginning in 2008, based on the format of the successful 2007 First Forum in Melbourne, in conjunction with the APEC Senior Finance Officials' Meeting, with discussions covering the bond markets of selected individual developing APEC member economies, and request that officials respond to recommendations arising from the dialogues.
- Endorse the General Principles for Effective Bond Market Development Cooperation in the Asia-Pacific Region developed by ABAC and PECC (*see Annex*) to guide officials, regulators and the private sector in promoting synergy and public-private partnership in the development of bond markets.
- Endorse the continuation of the Public-Private Dialogue for the Asia-Pacific Region on the Implementation of Basel II and Developments in Regional Banking and Supervision jointly organized by ABAC, ABA, PECC and SEACEN, and encourage wider participation of relevant officials from the appropriate regulatory agencies and ministries in their respective economies in subsequent dialogues, and request that officials respond to recommendations arising from the dialogues.
- Undertake and promote further capacity-building measures based on public-private partnership among government and regulatory agencies, the financial industry and multilateral bodies in the following areas: (a) progress toward implementing Basel II; (b) developing best practices for supervisory colleges among member economies' bank supervisory authorities in the cross-border implementation of Basel II; (c) improving coordination among supervisory authorities in dealing with cross-border issues; (d) development of a financial consumer protection framework and a platform for cooperation on financial consumer protection issues; and (e) monitoring the development and

implementation of policies and regulations to promote good governance in member economies' banking systems.

- Endorse the wider adoption by financial institutions operating in the region of the non-binding regional guidelines for informal workouts and accompanying model agreement developed by the ADB in cooperation with the ABA, as well as the adoption of the related reform and capacity-building proposals to facilitate the operation of a region-wide informal workout regime.
- Develop a code of conduct for statistical agencies in the region to increase market confidence.
- Endorse the IMF's Special Data Dissemination Standard (SDDS) as well as its balance sheet approach with special emphasis on improving data from the non-bank financial sectors of participating economies, as well as the holding of discussions by individual economies of Public Information Notices (PINs) after the conduct of IMF surveillance.
- Endorse and undertake capacity-building activities to assist interested member economies in providing investor relations services, and individual economies that remain concerned about hedge fund and derivatives trading activities in establishing industry surveillance units that can become sophisticated observers of the market using multiple data sources.
- Undertake capacity-building measures to assist developing member economies in (a) formulating and implementing policies governing access to formal finance that do not discriminate between large firms and SMEs; (b) promoting improvement of accounting standards among SMEs; (c) disseminating information about alternatives to bank loans as a source of financing; (d) promoting training for SMEs to better access venture capital, equity and over-the-counter markets; and (e) providing support to SMEs such as through guarantee schemes and special funds (after commercial possibilities have been explored) in a way that avoids moral hazard, adverse selection and other problems frequently associated with such government assistance.
- Endorse reform of laws governing collateral, in line with those already in place in developed economies, particularly the inclusion of movable properties.



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2007 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS

Capacity-building plays a crucial role in fostering stable and fully developed financial systems. Despite their considerable successes in raising living standards during the past several decades, many developing economies in the Asia-Pacific region do not yet have sufficiently diversified, efficient and robust financial markets. This challenge needs to be addressed if growth is to be sustained in the years ahead. Regional cooperation can significantly contribute to the realization of this objective, which stands to benefit the whole region and facilitate the attainment of the APEC vision.

There is no lack of financial sector-related capacity-building initiatives in the region. On the contrary, various regional organizations and international financial and development institutions have been undertaking a multiplicity of projects that are helping many emerging markets today to achieve progress in strengthening and deepening their financial markets. The key challenges are how to promote greater synergy among these undertakings and, importantly, how to effectively involve and integrate the private sector in these efforts.

Since its establishment in 2003, the Advisory Group on APEC Financial System Capacity-Building has been conducting regular discussions with the participation of international public and private sector institutions and organizations to address these challenges. Working closely with the APEC Business Advisory Council (ABAC) and the Pacific Economic Cooperation Council (PECC), the Advisory Group has reviewed various ideas during these discussions, which are now reflected in the proposals contained in this report.

This report is divided into four major sections. The first deals with the development of local currency bond markets in the Asia-Pacific region. The second focuses on measures to strengthen and develop banking systems. The third touches on regional cooperation to promote financial stability. The fourth section deals with measures to strengthen the capacity of small and medium-sized enterprises (SMEs) to access formal finance.

I. THE DEVELOPMENT OF LOCAL CURRENCY BOND MARKETS

Since 2003, much attention has been focused on the development of local-currency bond markets, particularly in East Asia and within the framework of the Asian Bond Market Initiative (ABMI). Various international institutions have also contributed

significantly to these efforts. Within the private sector and academia, ABAC and PECC have played leading roles.

Of particular significance are the 2004 Taipei bond market conference that ABAC and PECC jointly held with the Asian Bankers' Association and the Association of Credit Rating Agencies in Asia; the 2005 Tokyo bond market conference they co-organized with the Asian Development Bank Institute; the 2006 Washington PECC bond market symposium; and the 2007 APEC Public-Private Sector Forum on Bond Market Development that the Advisory Group and ABAC held in collaboration with the Australian Treasury and APEC senior finance officials.

The reports of the 2004 and 2005 conferences,¹ which have been previously submitted to the APEC Finance Ministers with the endorsement of ABAC and PECC, provide insights and recommendations that reflect views widely shared by government officials, financial sector leaders and academic experts on key issues that need to be addressed to facilitate expanded private sector domestic and cross-border investment and issuance in the region's local currency bond markets.

The 2006 symposium² was aimed at promoting the participation of a wider circle of investors and issuers from both sides of the Pacific in the region's bond markets, as well as trans-Pacific collaboration in capacity-building to facilitate local currency bond market development in the region. It brought together current and potential investors, issuers and other participants in the region's bond markets, as well as relevant regulators and officials from both sides of the Pacific.

Discussions in these meetings highlighted key challenges: the need to improve liquidity in local currency bond markets; to improve the market infrastructure through robust, clear and transparent policy and legal frameworks as well as enforcement, particularly with respect to creditor rights and transparency; and to increase the diversity of investors, issuers and instruments. In addition, these discussions also affirmed that fundamental issues such as liberalized capital flows, more flexible exchange rate regimes, derivatives markets, expanded market access for issuers, investors and other participants, and a stable macroeconomic environment remain important.

At their meeting in Hanoi in September 2006, APEC Finance Ministers welcomed the proposal submitted by ABAC to facilitate in-depth discussions with individual economies on how the public and private sectors may collaborate to develop their respective bond markets (with special attention on corporate bond markets). This has resulted in the holding of the First APEC Public-Private Sector Forum on Bond Market Development in Melbourne on May 8, 2007.

Following ABAC's proposal, this took the form of a dialogue on the development of bond markets in individual developing APEC member economies and the promotion of cross-border transactions in these markets. It involved both developed and developing member economies of APEC, as well as international financial and

¹ *Developing Bond Markets in APEC: Moving Forward through Public-Private Sector Partnership* (May 10-11, 2004, Taipei), co-organized by PECC with the APEC Business Advisory Council (ABAC) in collaboration with the Asian Bankers' Association and the Association of Credit Rating Agencies in Asia; and *Developing Bond Markets in APEC: Toward Greater Public-Private Sector Regional Partnership* (June 21-22, 2005, Tokyo), co-organized by PECC with ABAC and the Asian Development Bank Institute.

² *Bond Market Development in the Asia-Pacific: Broadening Regional Business and Cooperation Opportunities* (November 29, 2006, Washington, D.C., USA), co-organized under the umbrella of PECC by the Chinese Taipei Pacific Economic Cooperation Committee and the US Asia-Pacific Council.

development institutions. The task of organizing the Forum was given to the Advisory Group, which developed the program in collaboration with senior finance officials and drafted a report, for the purpose of facilitating the sharing of information and experiences among member economies.

The first Forum, which was successfully concluded, focused on the bond markets of Indonesia, the Philippines and Vietnam. Subsequent similar dialogues with other developing APEC member economies are planned. While the first Forum has been an important step forward in promoting effective public-private sector collaboration in the development of the region's bond markets, the eventual success of this initiative will be measured by the extent and quality of participation by relevant policy makers and regulators, experts and financial market players in subsequent years and by the responses in terms of policies to enhance market developments by those economies participating in the dialogues.

Another issue to be addressed is the multiplicity of initiatives in the region involving different regional organizations and institutions. While these initiatives presently complement each other quite well, it is desirable to promote greater synergy and to effectively harness the potential for public-private partnership. To address this issue, governments in the region, through regional organizations, may consider adopting a common set of general principles for bond market development cooperation. A set of general principles, based on extensive discussions initiated by PECC and ABAC at the Taipei and Tokyo conferences, has been submitted to the APEC Finance Ministers for consideration, and is attached as an annex to this report.

RECOMMENDATIONS TO APEC FINANCE MINISTERS:

- *Endorse the holding of subsequent APEC Public-Private Sector Forums on Bond Market Development beginning in 2008, based on the format of the successful 2007 First Forum in Melbourne, in conjunction with the APEC Senior Finance Officials' Meeting, with discussions covering the bond markets of selected individual developing APEC member economies, and encourage wider participation of officials and responses by them to recommendations arising from the dialogues to enhance bond markets.*
- *Endorse the General Principles for Effective Bond Market Development Cooperation in the Asia-Pacific Region developed by ABAC and PECC to guide officials, regulators and the private sector in promoting synergy and public-private partnership in the development of bond markets.*

II. MEASURES TO STRENGTHEN AND DEVELOP BANKING SYSTEMS

The introduction of the New Basel Framework (Basel II) has underscored the importance of international cooperation among bank supervisory authorities as well as between public and private sectors. The complexity of Basel II, a consequence of regulators' desire to provide a risk-sensitive framework with a menu-based approach applicable to a wide variety of jurisdictions, coupled with the growing number of internationally active banking groups, necessitates closer cooperation among supervisory authorities to achieve effective cross-border implementation.

As bank supervisors increasingly rely on banks' own assessments of various risk components associated with exposure to calculate minimum capital requirements under the new framework, cooperation between public and private sectors also becomes more important to ensure the effective adjustment of Basel II to rapid

developments in financial markets and technology, in particular with respect to changes in the tools and techniques available to reduce risk.

In the Asia-Pacific region, these developments have spurred numerous efforts to strengthen regional cooperation in capacity-building. Regional organizations of central banks such as the Southeast Asian Central Banks Research and Training Centre (SEACEN) and the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), in collaboration with various multilateral and regional institutions and bank supervisory agencies from advanced economies, have been at the forefront of many of these efforts.

Regional private sector organizations such as ABAC, PECC and the ABA have also been very active in promoting public-private sector dialogues. The first such regional dialogue involving bank supervisors and the banking industry was held in Santiago, Chile in 2004. ABAC, ABA and PECC, in collaboration with SEACEN, co-organized subsequent dialogues in 2005 and 2006 in Kuala Lumpur, Malaysia, to be followed in July 2007 with a dialogue hosted by the Monetary Authority of Singapore.

The report of the 2006 dialogue, which has been disseminated to relevant officials and banking industry leaders,³ highlighted major issues confronting the industry today, which include the following:

- Good governance in banking systems is important due to the pivotal role of the banking sector in the economy. Lessons from recent major governance failures in the region as well as the introduction of Basel II are spurring regulators and banks to undertake adjustments to improve governance.
- Risk management frameworks and supervisory arrangements in the region's banking systems are improving. This process should intensify as banks accumulate more data for credit analysis purposes.
- There are apprehensions that the application within the region of sophisticated risk models based on past experiences may still be inadequate in dealing with rapidly changing environments, where risk is diffused and experiences with new products and technologies are limited. Emphasis on promoting good processes and understanding of risk factors, both current and prospective, on the other hand, is viewed as critical.
- While supervisors and banks seek to implement Basel II in the region, it is important to ensure that relevant systems and capacities are in place before the more advanced approaches, such as the Internal Ratings Based Approaches for credit risk, are implemented.
- Some common issues have emerged in relation to oversight of internationally active banks under Basel II. These relate to governance, regulatory reporting, Pillar 2 implementation, the local applicability of global and regional models, local systems' capabilities, outsourcing of processes such as internal audit and data collections and the supervision of banks using advanced approaches to risk measurement.

³ *The Implementation of Basel II and Developments in Banking and Supervision in the Asia-Pacific Region: Report of a Public-Private Sector Dialogue* [Jointly Organized by the South East Asian Central Banks Research and Training Centre, the Asian Bankers' Association, the APEC Business Advisory Council and the Pacific Economic Cooperation Council], August 8-9, 2006, Kuala Lumpur, Malaysia.

- Current efforts at coordination between home and host supervisors have been beneficial as supervisors prepare to implement Basel II. In particular, supervisory colleges have provided useful channels for improving the information on which regulators base decisions, reducing duplication and inconsistency, improving subsequent bilateral dialogue and increasing levels of trust among supervisory authorities. However, there is still scope for further improvements in coordination, based on frank and open communications.
- Effective implementation of Pillar 3 (market discipline) of Basel II in the region would require more work and experience. While increased transparency and disclosure should promote market discipline in banking systems, further thought needs to be given to how much data ought to be disclosed and how to ensure that disclosure requirements are sensibly balanced.
- Protecting consumers of financial services from unfair practices and fraud has become important due to the growing complexity of financial products, technological advances and innovations, and deregulation in the financial industry. Regulators are focusing on enhancing disclosure, promoting financial literacy and strengthening competition in the industry to deal with these challenges. With growing realization among financial institutions that they can benefit from adopting pro-consumer business strategies, there are very good prospects for public-private sector collaboration to improve financial consumer protection frameworks.
- There is a need to address the protection of creditor rights in the context of expanding cross-border business in the region. As part of various ongoing efforts, the ADB has developed a set of non-binding regional guidelines for informal workouts and an accompanying model agreement that is applicable within the region (in cooperation with the ABA), as well as a number of reform and capacity-building proposals to facilitate the operation of a region-wide informal workout regime.

It follows from these developments that the effectiveness of bank supervision under Basel II will be determined by the capacity of the region's supervisors and banks to handle stresses in conditions that will differ from those evidenced in past crises and by a high level of cooperation among them. Greater commitment to capacity-building in the form of public-private partnership is vital and necessary to deal with implementation challenges and risks. Further, the value of these partnerships should be judged by the responses by economies and their regulatory agencies to the recommendations arising from the dialogues to strengthen the region's banking systems.

RECOMMENDATIONS TO APEC FINANCE MINISTERS:

- ***Endorse the continuation of the Public-Private Dialogue for the Asia-Pacific Region on the Implementation of Basel II and Developments in Regional Banking and Supervision jointly organized by ABAC, ABA, PECC and SEACEN, and encourage wider participation of relevant officials from the appropriate regulatory agencies and ministries in their respective economies in subsequent dialogues, including responses by them to recommendations arising from the dialogues to strengthen the region's banking systems.***
- ***Undertake and promote further capacity-building measures based on public-private partnership among government and regulatory agencies, the financial***

industry and multilateral bodies in the following areas: (a) progress toward implementing Basel II; (b) developing best practices for supervisory colleges among member economies' bank supervisory authorities in the cross-border implementation of Basel II; (c) improving coordination among supervisory authorities in dealing with cross-border issues; (d) development of a financial consumer protection framework and a platform for cooperation on financial consumer protection issues; and (e) monitoring the development and implementation of policies and regulations to promote good governance in member economies' banking systems.

- *Endorse the wider adoption by financial institutions operating in the region of the non-binding regional guidelines for informal workouts and accompanying model agreement developed by the ADB in cooperation with the ABA, as well as the adoption of the related reform and capacity-building proposals to facilitate the operation of a region-wide informal workout regime.*

III. REGIONAL COOPERATION TO PROMOTE FINANCIAL STABILITY

Much work has been done to strengthen the region's financial systems since the Asian financial crisis of 1997-98, in terms of domestic reforms, regional cooperation initiatives and capacity-building measures. Sustained current account surpluses in many of the region's emerging markets, particularly in Asia, have enabled central banks to build up large foreign exchange reserves. Regional cooperation efforts have been intensified, such as within the framework of the Chiang Mai Initiative, with a view to dealing more effectively with future financial crises.

Concerns remain about short-term capital flows, particularly in relation to highly leveraged institutions (HLIs) including hedge funds, and the growing use of derivatives, as well as the lack of available data to assist governments and regulatory authorities in ensuring that volatile short-term capital movements do not destabilize financial systems. There is much active private hedge fund data collection activity and many sophisticated investors are well informed about hedge fund strategies and trading operations. Nevertheless, official data on hedge funds and firm reporting on derivative activity available to officials and regulators in developing economies are scarce.

In 2006, ABAC commissioned a study on improving the quality of information on international capital flows, aimed to support early warning systems and ameliorate the impact of adverse volatile capital flows. The study was presented to the Advisory Group, focusing on a number of recommendations related to capacity-building, which are given below. It is important to keep in mind, nevertheless, that capital flows volatility is only one part of the problem facing emerging markets, that efforts should continue to focus on key underlying factors such as the quality and coherence of macroeconomic policy, and that capital restrictions do not fundamentally address the problems associated with the volatility of capital flows.

RECOMMENDATIONS TO APEC FINANCE MINISTERS:

- *Develop a code of conduct for statistical agencies in the region to increase market confidence.*
- *Endorse the IMF's Special Data Dissemination Standard (SDDS) as well as its balance sheet approach with special emphasis on improving data from the non-bank financial sectors of participating economies, as well as the holding of*

discussions by individual economies of Public Information Notices (PINs) after the conduct of IMF surveillance.

- *Endorse and undertake capacity-building activities to assist interested member economies in providing investor relations services, and individual economies that remain concerned about hedge fund and derivatives trading activities in establishing industry surveillance units that can become sophisticated observers of the market using multiple data sources.*

IV. MEASURES TO STRENGTHEN THE CAPACITY OF SMALL AND MEDIUM ENTERPRISES TO ACCESS FORMAL FINANCE

Small and medium enterprises (SMEs) play a significant role in economic development, generating employment and income, promoting deeper specialization and globalization. They are vital to alleviating poverty, creating entrepreneurial skills and promoting innovation. SMEs help build a dynamic, resilient, flexible and interlinked industrial system. However, in many economies, various factors impede SMEs' development. These factors include complex administrative procedures, lack of qualified human resources, inadequate access to technology, unfavorable market conditions and lack of access to formal finance.

SMEs' access to formal finance within the region has been the subject of a survey conducted in 2006 under the framework of the ABAC Finance Working Group by the Vietnamese Central Institute for Economic Management (CIEM) and the Bank for Foreign Trade of Vietnam, in collaboration with ABA and the Vietnam Chamber of Commerce and Industry. The survey report has been presented to and reviewed by ABAC in 2006 and the Advisory Group in 2007. Its major conclusions are as follows:

- Most banks in the region have significant experience in dealing with SMEs and are not necessarily biased against their loan requests. During the period 2001-05, the shares of loans to SMEs in total bank loans and in SMEs' total capital have increased. SMEs are more likely to receive long-term loans in the advanced than in the developing APEC member economies.
- Key obstacles to SMEs' access to bank loans are their lack of collateral and experience, inadequate accounting practices, high administrative and information costs and the lack of projects that banks find attractive, compared to larger enterprises.
- A number of governments have developed official strategies to promote SME development and various measures to provide credit guarantees, credit rating services and special funds for lending to SMEs have been adopted within the region. However, majority of both SMEs and banks still view government policies in the region as generally more favorable to large enterprises than to SMEs.

The recommendations of the survey report, which are presented below, incorporate elements from various discussions held with private sector representatives and experts. It is important to keep in mind that direct government support, such as through credit guarantees, are useful but should be considered only after commercial possibilities have been explored, and that improving SMEs' access to formal finance should go hand in hand with parallel efforts to improve SMEs' access to markets and technology, for these measures to be effective.

RECOMMENDATIONS TO APEC FINANCE MINISTERS:

- *Undertake capacity-building measures to assist developing member economies in (a) formulating and implementing policies governing access to formal finance that do not discriminate between large firms and SMEs; (b) promoting improvement of accounting standards among SMEs; (c) disseminating information about alternatives to bank loans as a source of financing; (d) promoting training for SMEs to better access venture capital, equity and over-the-counter markets; and (e) providing support to SMEs such as through guarantee schemes and special funds (after commercial possibilities have been explored) in a way that avoids moral hazard, adverse selection and other problems frequently associated with such government assistance.*
- *Endorse reform of laws governing collateral, in line with those already in place in developed economies, particularly the inclusion of movable properties.*



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ANNEX



GENERAL PRINCIPLES FOR EFFECTIVE BOND MARKET DEVELOPMENT COOPERATION IN THE ASIA-PACIFIC REGION*

PREAMBLE

The development of local currency bond markets is essential to sustained economic growth in the Asia-Pacific region. Robust bond markets strengthen economies against financial instability. They play a crucial role in development, providing critical financing for infrastructure and meeting the needs of expanding enterprises and ageing populations. Increased cross-border investment and issuance in these markets would help accelerate their development and make the region more attractive to international investors by providing wider choice, diversification opportunities and higher returns.

The following general principles are being proposed as a guide to effective cooperation in developing these markets based on the views and experiences of public officials, private sector experts and market players. These principles are also intended to promote consistency among the number of initiatives that are currently being undertaken within various organizations, and to ensure the consistency of their outcomes with the broader vision of free and open trade and investment throughout the Asia-Pacific region.

I. PUBLIC-PRIVATE PARTNERSHIP

1. The public and private sectors should work to enhance each other's effectiveness in playing their respective roles in the development of the market and collaborate in those areas, whether at the domestic or regional level, where partnership between them can be fruitful.

In general, the public and private sectors each have proper roles to play in development. In a healthy market economy, the private sector normally engages in innovation and competition, while the public sector provides sound legal and policy frameworks, regulation and supervision. However, there is much scope for both sectors to enhance each other's effectiveness in playing their respective roles.

Markets and institutions have developed more rapidly where the private sector has been properly involved in the design of regulation and market infrastructure, and where it has been engaged in promoting ethical and efficient market practices and conventions, market surveillance and competitive pricing. Policies that encourage the involvement of foreign expertise in bond market activities, such as in the development of the credit rating industry, bond indices and sophisticated financial instruments, reinforce these benefits.

There are also areas where direct collaboration between the public and private sectors can be fruitful. Experiences of emerging markets in the region illustrate that without a robust investor and issuer base, as well as a sufficient number of market makers and a wide variety of financial instruments, it would

be difficult to achieve market depth and liquidity. Coordination between government and private sector can thus be instrumental in expanding the investor base and the variety of product types.

II. GLOBAL AND REGIONAL INTEGRATION

2. Economies should aim to eliminate unnecessary restrictions, omissions of law or practice and legal, fiscal and regulatory discrepancies that hinder cross-border investment and issuance in bond markets. Where they exist, capital account restrictions should be reduced and eventually removed, in tandem with measures to strengthen the domestic financial system.

Intra-regional cross-border investment and issuance in Asia-Pacific bond markets are limited by various restrictions, omissions of law or practice and legal, fiscal and regulatory discrepancies. Restrictions that apply to foreign firms, which impede their participation in domestic bond market making processes, also hinder the flow of investor funds and issuance. Cross border investment and market liquidity are severely impacted by capital controls aimed at restricting the movement of capital in and out of markets.

Reducing and eventually removing these restrictions will help promote long-term capital flows. However, they may also give rise to increased flows of volatile short-term capital, and should therefore be accompanied by measures to strengthen the domestic financial system against instability. In addition to capital account liberalization, each economy should also adopt a foreign exchange regime that best facilitates cross-border capital transactions within the context of its own development strategy.

3. In developing domestic and regional bond market infrastructure, economies should aim to achieve region-wide convergence toward relevant global standards and practices. Where current international norms do not sufficiently take into account important characteristics of markets in the region, regional efforts should be undertaken toward appropriate improvements in these global norms.

Capital flows from within and outside the region will be crucial for the development of the region's bond markets. Thus, economies should aim for convergence with global standards and practices that govern various aspects of bond market activity, including standards for financial reporting and auditing, market regulation and supervision and credit rating practices, among others, rather than the establishment of regional standards. However, in order to promote intra-regional capital flows, efforts should be made to coordinate convergence efforts on a region-wide basis.

Asia-Pacific economies should also be involved in the process of setting and further developing global standards and norms in order to ensure that these adequately reflect local realities and that they are effective in promoting stable and robust financial systems in the region. Economies should make use of regional collaborative mechanisms among relevant agencies, creating or expanding them where necessary, to provide regional contributions to the work of global standard-setting bodies.

III. DOMESTIC-LEVEL COORDINATION

4. Each economy should ensure effective coordination of measures undertaken by various agencies related to the development of the bond market, establishing, where necessary, a high-level coordinating body with clear terms of reference for this purpose.

Coordinating bodies overseeing efforts to develop bond markets could be very useful given the fact that the range of issues involved spans a number of public sector agencies. Among these are agencies responsible for funding, debt management, taxation and macroeconomic management, economic planning agencies, central banks, securities market regulators, budget ministries, and public sector and local government debt issuers.

This reflects the fact that bond market development is closely inter-related with other economic activities and may involve trade-offs with sovereign debt management and macroeconomic policy

objectives, as well as overall financial sector development strategy. The *APEC Compendium of Sound Practices*, endorsed by the APEC Finance Ministers in 1999, which outlined a road map for bond market development, suggests the creation of high-level coordination committees at the initial stage of the process, involving these various institutions.

IV. REGIONAL-LEVEL COOPERATION

5. Economies should put in place effective mechanisms for regional policy coordination and cooperation to address the various interlocking measures required for the development of local currency bond markets and of cross-border investment and issuance in these markets.

Regional policy coordination and cooperation are required to address a number of interlocking measures required for bond market development. Among these are the convergence of market infrastructure and practices including credit rating practices and accounting standards, the establishment of arrangements for cross-border recognition of insolvency administrations, promoting a regional framework as well as improving the environment for informal workouts, and capacity-building measures in various areas.

Regional cooperation has proven to be a useful instrument in accelerating reforms in individual economies through peer pressure, in promoting convergence of standards and practices, and in addressing cross-border issues. Maintaining effective cooperation mechanisms within the framework of existing regional bodies, supported by adequate resources, is important for sustained progress over the long-term time frame of capital market development in developing economies.

6. Efforts should be coordinated among various regional and sub-regional organizations that are actively involved in regional cooperation for bond market development, with the aim of promoting complementation and synergy among their activities and ensuring the consistency of all efforts with the vision of free and open trade and investment throughout the broader Asia-Pacific region.

The existence of a number of regional organizations within the Asia-Pacific region, with different but overlapping memberships and activities, reflects the region's diversity and complex history. Several of these organizations undertake various activities that contribute to bond market development. Ensuring that these activities are mutually complementary, consistent with each other and well-coordinated are important to achieve smooth progress and the eventual success of their efforts. Of particular importance is the objective of ensuring the consistency of all these efforts with APEC's vision of free and open trade and investment throughout the broader region.

As the emergence of deep and liquid bond markets is dependent on the participation of a sufficiently large base of investors and issuers, as well as market makers and other key participants such as credit rating agencies, the involvement of economies from both sides of the Pacific should be encouraged. Mechanisms for continuous information exchange, coordination and undertaking of mutually-reinforcing activities among regional organizations will be useful in ensuring the effectiveness of these efforts.

V. STRENGTHENING MARKET MECHANISMS

7. Bond market development efforts should be focused on the development of efficient, transparent and competitive markets that are supported by a robust system of complete, timely and meaningful disclosure, open to many players, both domestic and foreign, and enable participants to properly price risk.

Markets will attract investors if there is competition among market participants and if they are open to many players, both domestic and foreign. Such markets are generally characterized by a robust investor and issuer base, a sufficient number of market makers, a wide variety of financial instruments, sound macroeconomic policies and an open economy and financial sector. Open financial sectors also allow economies to benefit from foreign expertise in the development of market

infrastructure and financial instruments. Ideally, jurisdictions should have a competition regulator with full authority to intervene against anti-competitive market activity.

Regulation should focus on maintaining and enhancing transparency and market integrity, which are important for the soundness of market-based structures with multiple participants such as bond markets, as well as for investor confidence. This involves maintaining a robust system of clear, complete, timely and meaningful disclosure and developing transparent processes and a conducive environment for assessing the risk and return in trade instruments.

Enabling the appropriate pricing of risk by market participants is a key objective that is crucial for facilitating genuine risk assessment and efficient capital allocation, avoiding moral hazard and ensuring financial stability. Subsidies that could distort market pricing signals should be avoided. Any credit enhancement scheme deemed necessary should be carefully designed to avoid moral hazard and corruption of markets.

VI. THE ROLE OF GOVERNMENT

8. Governments should provide an enabling environment for market participants to engage in bond investment, issuance and trading. This includes sound macroeconomic policies, tax regimes that are conducive to the growth of the market, the promotion of good corporate governance, the formulation and enforcement of clear and sound laws, market rules and regulations, and the development of robust clearing and settlement systems.

The success of bond market development efforts will depend on the extent to which liquid and efficient markets adequately providing cost-effective long-term capital to issuers and attractive financial instruments to investors are created. Necessary prerequisites to the creation of such markets include sound macroeconomic policies, a sound legal and institutional framework that offers adequate protection to investors' rights, and good corporate governance. Taxation treatment is highly influential in market players' decisions, and should be reviewed to determine whether tax regimes are conducive to the holding and trading of bonds.

Areas where government can support the development of the market include providing effective insolvency and creditor rights systems, supervisory arrangements; a framework for promoting corporate governance, financial controls and integrity through clear rules and penalties; robust accounting standards and practices, effective regulatory oversight, judiciary systems and civil procedures. The government also needs to promote the development of the supportive infrastructure (repurchase market, securities laws, documentation standards). Regulators must be able to balance the treatment of interests of all key market participants.

9. Economies should maintain a government bond issuance program to support the yield curve, involving the issuance of bonds across a broad range of maturities in sufficient sizes to attract wide investor participation and effective communication with investors to understand their needs.

Sound policies and institutional frameworks are not necessarily sufficient to ensure the provision of adequate market supply and demand by market participants. A broad institutional and retail investor base is needed, and government bond markets usually play an important role in the development of private long-term debt markets through their role in ensuring market liquidity and facilitating risk management.

A common thread in the recent development of most markets in the region has been a steady development with sovereign bonds as the central focus of the market continuing as a major but diminishing component with the growth of commercial debt issues. Experiences of economies in the Asia-Pacific region illustrate how government bond issuance may be used for market development purposes even in a situation of fiscal surplus. However, care should be taken so that corporate borrowers are not crowded out by government bond issuance in times of large fiscal deficits and low savings.

VII. COOPERATION IN THE CONTEXT OF REGIONAL DIVERSITY

10. Collaborative efforts should be designed to take into account the disparities in levels of market development among economies while promoting progress toward region-wide integration.

There are wide disparities not only between developed and developing economies within APEC, but also among developing economies with respect to the level of development of local currency bond markets. A number of emerging markets have made significant advances in developing robust policy and regulatory frameworks, market infrastructure and key components of deep and liquid bond markets. Others are still in the early stages of development where many key requirements have not been adequately met.

For emerging markets that have reached a more advanced stage of development, collaborative efforts should focus on enhancing market depth and liquidity, as well as promoting reforms to facilitate cross-border investment and issuance. For the less-developed markets, the focus should be on addressing more fundamental issues such as disclosure and accounting standards, reducing barriers to issuance, protection of creditor rights, increasing the savings rate and enforcement of laws and regulations.