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A Public-Private Sector Initiative

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Summary Report of The 3rd SEACEN/ABAC/ABA/PECC Public-Private Sector Dialogue

Office of the Advisory Group Chair

The 3rd SEACEN/ABAC/ABA/PECC Public-Private Sector Dialogue

STRENGTHENING FINANCIAL ARCHITECTURE IN THE ASIA-PACIFIC REGION

Singapore, 11-12 July 2007
Hosted by the Monetary Authority of Singapore

SUMMARY AND RECOMMENDATIONS

Introduction

This third dialogue in a series was convened in conjunction with the 9th SEACEN Conference of Directors of Supervision of Asia Pacific Economies, generously hosted by the Monetary Authority of Singapore, and attended by around 80 participants from regulatory agencies in the region, representatives of regional and international financial institutions, and academic finance and legal specialists.

The dialogue was of very high quality and participants actively engaged in discussing the many complex issues on the agenda – a copy of which is attached to this summary. The dialogue reinforced the value of such engagement between senior public and private financial sector, multilateral and academic experts.

Major issues discussed

The main focus of the dialogue was to assess developments on major issues which arose in the second dialogue last year on implementing Basel II in the region's financial systems. The challenges facing regional and international financial architecture were also considered as were other issues, including governance and risk management, building capital markets, in particular bond markets, cross-border insolvency and informal workouts, consumer financial issues and capacity building.

The dialogue was timely, a decade after the Asian financial crisis, to assess the qualitative changes that have occurred since the crisis to enhance the region's financial systems, including greater exchange rate flexibility, the growth of international reserves, and strengthened banking systems, and significant growth of local currency bond markets.

Notwithstanding the importance of gains made, there was broad recognition that banking systems need further enhancement, particularly in improvements in risk management and governance and that greater cooperation is needed between regulators and between banks and regulators, and that regional architecture should be strengthened.

There has been marked progress in understanding the central issues involved in implementing Basel II, but important challenges remain to be tackled by policy makers, regulators and banks. The dialogue provided highly constructive exchanges on approaches to capacity building of value to both regional banks and regulators.

Concerns arising from the diffusion of risk from the banking sector to non-bank financial institutions, combined with the integration of financial markets, was seen as a challenge to the region's institutions. This has become more pronounced by the impact on financial markets arising from US the sub-prime mortgage market and related hedge fund activities.

The following summarises additional key points:

- At the base of financial stability is a solid domestic supervisory system and a sound macroeconomic and legal framework, efficient markets; these are complemented by regional and international cooperation

- Banks need to think globally and to better understand the transmission mechanisms of potential external shocks
- There is a danger to smoothly operating markets if regulators were to over- react to adjustments now going through international financial markets; excessive intervention could cause undue “political risk” to banking systems
- Banks that are proactively embracing changes in organizational culture to adapt to the requirements of Basel II are benefiting in terms of improved performance, particularly through enhanced ability to price loans and estimate buffer levels for loan exposures, more cost-effective board and management oversight and allocation of capital and human resources, better performance measurement, reduced operational losses and improved discipline throughout the organization.
- In view of wide differences in methodologies and timetables, the use of national discretion and accounting and disclosure parameters throughout the region, greater coordination among supervisors and supervisory colleges would enhance progress on implementing Basel II.
- Basel II requires effective communication between regulators and banks. Inasmuch as there is no easy solution for undertaking this on a cross-border basis, it is important to maintain regular regional public-private sector dialogues as channels for communication.
- Regional authorities should consider ways to improve regional architecture which is lagging behind markets and because international arrangements may found to be wanting.
- The success of efforts to promote regional convergence of credit rating practices will require public sector actions to address structural differences in relation to the structures of domestic bond markets, accounting and disclosure standards and regulatory frameworks.
- There is considerable potential for further development of Asia’s local currency bond markets if public-private sector collaboration is expanded to cover the expansion of corporate bond markets, increased use of derivatives and structured finance, the extension of maturities and improving access to bonds denominated in the region’s currencies.
- Economies should give much greater weight to promoting regional bankruptcy and insolvency arrangements and informal workouts. Support and endorsement by central banks of the regional guidelines and model agreement for informal workouts developed by the ADB in cooperation with the ABA would promote their wider recognition and adoption by financial institutions operating in Asia, thus helping enhance investor confidence in the region.
- Economies should review privacy laws to allow the transfer of information to and between recognized credit review agencies so as to facilitate credit risk assessment.
- Pillar 2 of Basel II places responsibility on a bank and its supervisor to fully understand the various risks that a bank faces; risks differ from one bank to another and apart from the capital charges under Pillar 1, each bank is required to assess other risks, for example, reputational risk, “political risk” – the assessment of overall risk should be forward looking and be part of bank’s strategic planning; assessments should be qualtitative and not just seen as a “capital add-on” exercise
- Pillar 3 attempts to ensure greater transparency on a bank’s operations, governance and risk management processes; the consequential disclosure requirements to markets should facilitate greater discipline and more discernment about the comparative qualities of

banks; consistency in disclosure requirements across jurisdictions is important to allow markets to make meaningful comparative assessments of banks; similarly, jurisdictions need to move to adopt one internationally agreed accounting standards

- Improving governance systems in banking remains a significant challenge; key issues include:
  - the balance of powers between boards and management and between independent audits and boards
  - the quality of boards and their capacity to understand and approve risk management procedures
  - delegations and controls
  - the role of Nomination Committees
  - the independence of external directors
  - educating and training board members
  - determining processes for assessing fit and proper persons to be dirctors

- Specific measures are necessary to support consumer interests; for example, banks and regulators should share experiences on the issuance of credit cards

- Capacity building by an institution – a supervisory agency or a bank – ought to start from a position of clearly determining the managerial task to be undertaken, the resources available and needed, the amount of information required and deciding the right strategy to accomplish a task; no one approach is common and each regulatory agency should define its role as appropriate to its own jurisdiction – with the objective of facilitating an appropriate response rather than seeking to find an ideal financial structure

- Key challenges confronting the region in terms of building capacities are those of enhancing credit analysis, dealing with risks arising from political interference in the financial system, those relating to bank conglomeration and, perhaps most challenging of all, improving corporate governance standards and procedures

- Supervisory agencies and banks are well advised to conduct self-assessments to determine their own capacity building needs and then to define a plan of action to address weaknesses; external expertise is available and should be sought, from the regional and international financial institutions and from other groups, such as those involved in this dialogue

Key Issues for further consideration by public and private sector finance groups in the region and by multilateral agencies

- Relevant regional and multilateral agencies and economies should consider ways to strengthen regional financial architecture to enhance regional financial stability, taking into account the greater diffusion of risk from banking to the non- banking sectors, the greater integration of markets and the risks these pose to the region's economies.

- Markets are capable of effecting adjustments to the current period of tightening of credit and liquidity; authorities should exercise great care in any intervention which could cause a "political" risk dimension to markets.

- Deeper interaction is needed between regulators and between banks and regulators, including through supervisory colleges, to promote common approaches to implementing Basel II

- Regulators and banks in the region ought to reinforce their efforts to improve risk management procedures and practices by determining what they are able to achieve given the resources and skills available to them; approaches should be seen in term of improving understanding and judgment of risk and of the procedures that are deemed to be appropriate in the circumstances confronting an economy, rather than pursuing a model of excellence

- Priority should be given to enhancing governance in the region's banking systems; particular areas of concern include the independence of directors, the composition of boards with the required skills and expertise, the balance of powers between boards and management, clearly defining the role of board committees and in particular the value of the Nominations Committee and the Audit Committee, and ways to train and select good board members
- The region's regulators and banks should consider steps to promote consumer interests in the region, and exchange views on credit card issuance
- Economies in the region should intensify regional efforts to develop corporate bond markets under the ABMI and APEC , including cross-border investment in these markets, in particular by supporting the APEC Public-Private Sector Forum on Bond Market Development, the work of the ADB in promoting local currency bond markets and the work of ACRAA in harmonizing credit rating practices and principles in the region, and by further expanding ongoing collaboration with the private sector under the ABF2 to the increased use of derivatives and structured finance.
- It is timely for economies to implement laws and policies to promote regional approaches to creditor rights and bankruptcy, and in particular to encourage wider adoption of the regional guidelines and model agreement for informal workouts by financial institutions operating throughout the region.

Summary Conclusions and Recommendations

The coordinators of the dialogue hold a strongly shared view that the public private dialogue was extremely valuable and highly beneficial to participants. We are confident that this series of dialogues does make a significant contribution to strengthening the financial systems, and in particular the banking systems of the Asia Pacific region. We see great merit in these dialogues continuing and we have agreed to continue the constructive partnership now established and to coordinate arrangements for a further dialogue in this series in 2008.

SEACEN, ABAC, PECC and ABA will distribute the report and this Executive Summary to interested parties, including importantly the regulators and bankers who participated in the dialogue and to the Basel Committee for Banking Supervision, requesting that recipients provide advice and observations on the report to the Coordinating Group.

In particular, ABAC will convey the reports and recommendations to APEC Finance Ministers through the APEC official processes, requesting:

i) that the report and this Executive Summary be made available to Central Bank Governors and to other appropriate regulatory and policy agencies in their jurisdictions for consideration and implementation of the key recommendations

ii) endorsement of the continuation of this series of dialogues in support of the implementation of Basel II and in support of measures to improve regional financial system capacities and to strengthen regional architecture

iii) that the report and responses to it be discussed with ABAC in the APEC Senior Financial Officials' Meetings.