Asia-Pacific
Economic Cooperation

THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

Document: AGFSCB 28-017
Draft: **FIRST**
Source: ABAC Australia
Date: 8 May 2008
Meeting: Moscow, Russian Federation

Second Meeting 2008
14 May 2008
The Atrium
Hotel Baltschug Kempinski
Moscow, Russian Federation

Meeting Paper 5-A

REGIONAL FINANCIAL SYSTEM STABILITY

Prepared by Kenneth Waller, Senior Advisor
ABAC Australia

ADVISORY GROUP ON APEC FINANCIAL SYSEM CAPACITY BUILDING SECOND MEETING, 14TH MAY 2008, MOSCOW

ITEM 5

REGIONAL FINANCIAL SYSTEM STABILITY

Background

In 2006, ABAC advised APEC Finance Ministers and Leaders on measures to improve on data collection concerning capital flows to enhance early warning systems and to improve data dissemination to financial markets. The advice was based on a report commissioned from Professor Kim Dietrich of the Marshall School of Business, USC. The financial crisis now impacting on global markets underscores the importance of improved data collection and market dissemination of data and better coordination of information on cross-border financial flows between major capital market regulators and international agencies.

Against that background, at the Jakarta meeting, the Advisory Group was advised by Mr. Akira Ariyoshi of the IMF's Tokyo office, of work being undertaken by the IMF on improving data for securities markets in emerging economies in Eastern and Central Europe and that similar work in the APEC could be extended through cooperation with ABAC. The meeting was also informed that the ADBI will be releasing a report in May on measures to deal with capital flows. That meeting also noted that some new approaches may be needed in regulatory arrangements while some members observed that priority should be given to better data collection. The Group asked that participants identify a way forward on the matter. As a consequence, Mr. Waller subsequently arranged to discuss the issues with Mr. Ariyoshi of the IMF and Professor Kim Dietrich of the Marshall School of Business, USC, in Melbourne on 5th March. A copy of a note of that meeting is shown at Attachment A.

Issues

The following points of a regulatory nature are relevant to further consideration of this matter:

- as the sub-prime crisis unfolds, reviews of financial regulation are underway in major capital markets and these will almost certainly lead to greater consolidation of powers of regulators in markets as attempts are made to widen the regulatory net around previously unregulated or "lightly" regulated entities

- the Financial Stability Forum is promoting intensive international cooperation to enhance financial stability together with the IMF and international standard setting organizations, including the BIS, IOSCO, IAIS, and others, and in April recommended a series of measures to strengthen prudential oversight of capital, liquidity and risk management, changes to the role of credit rating agencies and related matters (please refer to attached Executive Summary of the FSF April report and to Chapter V of that report on Strengthening the authorities' responsiveness to risks)

- enhanced regulatory arrangements in banking in the Asian region is probably one of a number of factors that helped provide the region with a degree of resilience in the current crisis; other important factors include the yet limited degree of integration with global capital markets, large current account surpluses and greater exchange rate flexibility

The factors noted above together with recapitalization of some major private western financial institutions, major liquidity support by central banks, efforts to improve lending and credit practices, write-downs and massive increases in provisions, should contribute to more stable regional and global financial systems. At this point it is difficult to know when stability will be restored and what the final bill will be for reputations, tax payers, shareholders and borrowers. Regulatory and other changes will not stop risk taking and nor should they, and nor will they preclude innovative financing techniques from entering capital markets. At best, system support and regulatory reforms will help establish a period in which markets can be restored, grow and prosper, until new fault lines occur.

What is increasingly clear from the present crisis is that no body or group of organizations has all the insights into financial innovation and its impact on regulatory arrangements and, notwithstanding the work of FSF and the other international regulatory agencies, it is likely that that will remain the case.

Given the priority APEC Leaders and Finance Ministers place on strengthening financial systems, further work in improving data and the dissemination of data on capital flows and work on other aspects of financial market strengthening, for example to deepen regional bond markets and risk management and governance in banking is warranted. Attachment A, confirms that the IMF would be interested in working with ABAC to look at ways to develop better data systems, particularly in regard to private financial sector activities. Such work could also explore ideas to improve data dissemination through the formation of a "shadow group" of experts which could bring together serious advice on emerging financial issues and ways to make such advice publicly available without adding to market instability. Professor Dietrich has expressed a keen interest in this work and he could be asked to undertake work in consultation with the IMF along these lines.

Recommendations:

- agree that terms of reference be drawn up for consideration at the Hangzhou meeting on a review that could be undertaken, involving Professor Kim Dietrich in consultation with the IMF, on ways to improve data on private sector financial flows and on ways that a "shadow" group might be formed, and that the TORs take into account the ADBI report expected in May and emerging international financial market regulatory developments

- agree that Professor Dietrich be approached to provide preliminary advice on the drafting of the TORs and to advise his availability and conditions on which he might undertake the review

Ken Waller
Senior Advisor
ABAC Australia Secretariat ***5th May 2008***

ATTACHMENT A.

REPORT ON DISCUSSIONS ON VOLATILE CAPITAL FLOWS.
MELBOURNE, 5TH MARCH 2008

Mr. Akira Ariyoshi, Director, Regional Office for Asia and the Pacific, IMF, Professor Kim Dietrich ,Marshall School of Business, USC and Ken Waller, Senior Advisor, ABAC Australia Secretariat, met in Melbourne on 5th March to review developments since ABAC reported to Finance Ministers in 2006 on measures to ameliorate the impact of adverse capital flows.

Mr. Ariyoshi noted that the 2006 Dietrich paper fairly closely reflected IMF concerns on data availability and short-comings. At the Fund's balance of payments meetings, groups of institutions consider what changes are needed to data currently reported. Two years ago a Securities Market Group was established, including the IMF, the World Bank and BIS, and institutions with knowledge and experience on capital market matters. There is a generally shared view that market intelligence on hedge fund data is inadequate and this is a matter of concern.

Professor Dietrich observed that the World Economic Outlook report of October 2007 had warned of the strength and depth of the pending emerging issues around the sub-prime market but that the Fund's opinions did not seem to be acted on. May be there is a gap between the WEO and the economic intelligence that underpins it and warning messages being transmitted to governments and the public at large. Mr. Ariyoshi noted that this issue had been discussed recently internally in the context of the General Financial Stability Report. It was apparent that most people now understood the origins of the sub-prime market but that there is a general lack of appreciation as to how this translated so quickly into a liquidity crisis and about the extent of the losses arising from the crisis.

In the context of Special Investment Vehicles which are off-balance sheet, it was noted that it would be impractical to attempt to ask all groups in financial markets about their individual accounting practices.

Professor Dietrich advised that the most interesting and challenging issue was that of communication; he asked how should the Financial Stability Forum take the publication of its assessments more seriously so that there is much wider dissemination of findings. He proposed that thought be given to establishing a special group or unit to better publicize key economic and financial findings and assessments.

He noted that the issue of collecting data for an early warning system, while critical, did not necessarily translate to policy actions. And while the WEO and its underlying assessments does provide the Fund and other agencies with leverage in promoting their role and policies, that did not necessarily resolve the problem of communicating to governments or private financial institutions the urgency of emerging problems.

Mr. Ariyoshi noted that banking supervisors collect data but this is confidential and held internally within a select group. Some is made available to G7 and others; banks are not named and while individual banks may have some idea of their potential losses, data is aggregated. Problems arise when losses are concentrated. The prospect of reputational risk clearly impacts on some banks' reporting. If private banks' estimates are based on a worst case scenario and these are published, then clearly it would impact on their share values.

Professor Dietrich noted that multilateral agencies were not in a position to "tell the whole story" of an emerging crisis. He wondered if a "shadow group" would be a useful addition to the international mechanism. The concept might be similar to a kind of "Shadow open Market Committee" which could facilitate understanding by sophisticated observers of markets to that they could better understand what is going on. Such a group of wise men would be in a position to provide a synthesis of developments and give a clear message to the public. Mr. Ariyoshi noted that high quality market intelligence was needed for such a concept to work but the reality is that the Fund is unable to develop deep interchanges with market participants. People who come into the Fund from financial markets lose their intimacy with markets in a relatively short period. While academics are good at conceptualizing, it is the day to day experience in markets that matters and buying that experience is extremely costly.

Mr. Ariyoshi noted that the kind of shadow group proposed would need to be related to a credible institution with funding resources. The Peterson Institute might be a possible model to think of. Credibility would be closely related to the quality of publications. Central banks would be constrained in what they could say and for that reason it would be inappropriate to involve them.

Mr. Ariyoshi observed that generally data from emerging markets, for example on bond issuance, is inadequate and it had recently been agreed that more measures are needed, including the standardization of data collection. While leading and local bond issues were drying up in the Baltic States, East Europe and in Asia, more information on activities might be being made available to the network of centralized securities depositories. He noted that the IMF is interested in outreach activities and in working with ABAC on the issues we had discussed, such as issues of data interpretation, the idea of a developing a shadow group and others from the private sector who might contribute to ideas on how to better gather and interpret data.

While the Fund does have confidential discussions with central banks and other authorities there are gaps in data and these can be improved upon. He noted also that the IMF is working with the Securities Institute on the standardization of data and support globally is growing for that work. The balance of payments reporting system is a reporting burden for each member country and does require private sector report to help make it more relevant.

Melbourne, 5th March 2008