

THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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First Meeting 2008

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The Atrium, Hotel Baltshug Kempinski
Moscow, Russian Federation

MEETING REPORT

*First Draft
As of 3 June 2008*

Welcome and Introduction

The meeting started at 9:00 am. Participants included members and staffers of the ABAC Finance and Economics Working Group (FEWG) and a representative from the Asia-Pacific Credit Coalition (APCC). The Advisory Group Co-Chair, Mr. Yoshihiro Watanabe, presided over the meeting as Acting Chair in lieu of the Advisory Group Chair, Dr. Jeffrey L.S. Koo, who was unable to attend.

In his opening remarks, the Acting Chair welcomed the participants, conveyed the Advisory Group Chair's warm greetings, and gave an overview of the agenda items for discussion. He acknowledged the presence of Ms. Marlena Hurley, Advisor of TransUnion, who is attending the meeting on behalf of APCC, and welcomed the APCC as a new participant in the Advisory Group. He thanked the meeting host, ABAC Russia, for the hospitality and efficient preparations for the meeting.

Mr. Nikolai Samyltchev, Director for International Relations of VTB, delivered warm words of welcome on behalf of ABAC Russia.

Review of the First 2008 Advisory Group Meeting in Jakarta

The Advisory Group Coordinator, Dr. J.C. Parreñas, presented the second draft of the Report of the Advisory Group Meeting of 22 January 2008 in Jakarta, Indonesia. Major items in the report include the 2008 work program of the Advisory Group and discussions on the Second APEC Public-Private Sector Forum on Bond Market Development, public-private partnership in infrastructure, regional financial stability, the Jakarta Workshop on Improving the Environment for Commercially Sustainable Microfinance and the Fourth SEACEN/ABAC/ABA/PECC Public-Private Sector Dialogue on Basel II Implementation and Strengthening Banking Systems.

The Advisory Group approved the Meeting Report.

Update on the preparations for the Second APEC Public-Private Sector Forum on Bond Market Development, Cusco, July 9, 2008

The Advisory Group Coordinator updated participants on the preparations for the Second APEC Public-Private Sector Forum on Bond Market Development. The Forum is scheduled to be held on July 9, 2008 at the Libertador Palacio del Inka Hotel in Cusco, Peru. It is being co-organized by the Advisory Group and ABAC in collaboration with the Peruvian Ministry of Economy and Finance and the Asociación de Empresas Promotoras del Mercado de Capitales (Procapitales), the major private

sector organization promoting the development of the Peruvian capital market. Funding for hosting the Forum will come partly from the Ministry of Economy and Finance and partly from sponsorships to be solicited by Procapitales.

Update on public-private partnership for infrastructure development

Mr. Kenneth Waller, ABAC Australia Advisor, briefed participants about the Advisory Group's ongoing work on public-private partnership (PPP) for infrastructure development. He reminded participants that at the Jakarta meeting, the Advisory Group took note of the Asian Development Bank Institute's (ADBI) flagship study on *Infrastructure and Regional Cooperation*; a publication of the Pacific Economic Cooperation Council (PECC) entitled *Meeting the Region's Infrastructure Needs: Guidelines for Effective Public-Private Partnerships*; the ADBI's workshops on *Strengthening Private Sector Participation in Physical Infrastructure* and a PPP workshop series co-organized with the ADB involving governments and the private sector in identifying reforms to facilitate infrastructure projects. He also referred to a proposal for the establishment of a regional infrastructure dialogue (RID) presented to the Advisory Group meeting in Jakarta.

Mr. Waller reported that, with a view to encouraging linkages between the work of the Advisory Group and initiatives under way in the APEC Senior Finance Officials' Meeting (SFOM), the outcomes of the Advisory Group Jakarta meeting have been referred to the Australian Treasury, which is sponsoring this subject in SFOM. The Treasury has advised that a workshop under the APEC Finance Ministers' Process, *Building the markets to support PPPs*, will be held in Ho Chi Minh City, Vietnam on 19 May, co-sponsored by Australia, Indonesia and Vietnam. The ADB and ADBI were among those invited to contribute papers and to participate in this event.

Mr. Waller also mentioned that the Australian Treasury is preparing a discussion paper on capital market development and PPPs for the forthcoming 4th APEC Senior Finance Officials' Meeting (SFOM 4) to be held in Cusco on 10-11 July. He also conveyed to participants Ms. Beris Gwynne's report that she will attend a meeting of experts in Antwerp on 10-11 June to consider the structure and content of a PPP toolkit as well as a conference in Moscow in October to speak on evaluation and feedback mechanisms on PPPs. In view of her contribution to the work of the Advisory Group and noting that there are no funding implications, Mr. Waller suggested that Ms. Gwynne be designated as a Contributor to the Advisory Group when participating in these activities.

Mr. Waller noted a number of relevant developments. With PPPs for infrastructure becoming a priority agenda item for economies and for business; the demand for PPPs is certain to continue growing strongly. There is considerable activity within and outside the region on PPPs, particularly in respect to the private sector role in risk taking, financing and managing infrastructure development. APEC Ministers and officials have been informed of ABAC's continuing strong interest in the subject and in ABAC's willingness to support capacity building initiatives through PPPs.

Mr. Waller proposed that, at SFOM-4, ABAC's views should be emphasized in relation to the following issues: (a) the importance of PPPs as an emerging and critical component of the region's financing needs and its continued consideration as part of the APEC Finance Ministers' agenda; (b) the value of consultation with the private sector as economies seek to promote the use of PPPs and communities' confidence in the process; (c) the critical relevance of a legal and financial institutional framework and deep capital markets as fundamental prerequisites to the emergence of PPPs; (d) the preparedness of ABAC and the Advisory Group to support APEC capacity building initiatives to strengthen the legal, financial and regulatory infrastructures needed to promote PPPs; and (e) the need to consider an APEC Finance Ministers' initiative to promote a coordinated regional approach to PPPs involving economies, regional and international agencies and the business community.

Mr. Mark Johnson, ABAC Co-Chair and Chairman of the Australian Gas Light Company, informed participants that he will be attending an ADBI workshop in New Delhi that will examine key issues and challenges facing cross-border infrastructure development in Asia in its ongoing efforts to support regional cooperation and outline what the region needs to address in terms of policies and best practices to meet these challenges.

Participants noted the importance of addressing key issues in order to open up huge opportunities that will arise from the expansion of PPPs. Among the issues mentioned were the costs of tendering, the need to establish best practices in certain areas and the implementation of best practices in general. Participants agreed that a regional mechanism under which workshops could be organized to address these issues in a focused way would be desirable.

Participants took note of the developments described by Mr. Waller in his report and expressed agreement with his suggestions. They endorsed the concept of a series of high-level workshops that will bring public and private sector experts together. Finally, participants requested Mr. Waller to report on the outcomes of SFOM-4 at the next Advisory Group meeting.

Update on regional financial stability

Mr. Waller updated participants regarding the Advisory Group's work on regional financial stability. He called to mind ABAC's previous advice to APEC Finance Ministers and Leaders on measures to improve data collection concerning capital flows used in enhancing early warning systems and to improve data dissemination to financial markets. This advice was based on a commissioned report drafted by Professor Kimball Dietrich of the Marshall School of Business, University of Southern California. Mr. Waller noted that the financial crisis now impacting global markets underscores the importance of improved data collection and market dissemination as well as better coordination of information on cross-border financial flows between major capital market regulators and international agencies.

Referring to previous discussions at the Advisory Group's Jakarta meeting, Mr. Waller reported on a meeting he arranged with Mr. Akira Ariyoshi, Director of the International Monetary Fund (IMF) Asia-Pacific Office and Professor Dietrich on 5 March in Melbourne. Among the issues he noted arising from that meeting are the following:

- As the sub-prime crisis unfolds, reviews of financial regulation are underway in major capital markets that will likely lead to greater consolidation of regulatory powers as attempts are made to widen the regulatory net around previously unregulated or lightly regulated entities.
- The Financial Stability Forum (FSF) is promoting intensive international cooperation to enhance financial stability together with the IMF and other international standard-setting organizations. In April, the FSF recommended a series of measures to strengthen prudential oversight of capital, liquidity and risk management and promote changes to the role of credit rating agencies, among other related matters.
- The introduction of enhanced banking regulatory arrangements in the Asian region is probably one key factor that has 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.
- Together with the recapitalization of major private financial institutions, liquidity support from central banks, efforts to improve lending and credit practices, write-downs and massive increases in provisions, the above factors should contribute to more stable financial systems. At this point it is difficult to know when stability will be restored and what the final bill will be for reputations, taxpayers, shareholders and borrowers. Regulatory and other changes will and should not stop risk taking; neither will they preclude innovative financing techniques from entering capital markets. At best, system support and regulatory reforms are likely to help establish a period in which markets can be restored, grow and prosper, until new fault lines occur.
- It is becoming increasingly clear from the present crisis that no single body or organization has all the insights into financial innovation and its impact on regulatory arrangements. Notwithstanding the work of the FSF and other international regulatory agencies, it is likely that this will remain the case.
- Given the priority APEC Leaders and Finance Ministers place on strengthening financial systems, further work on improving data and the dissemination of data on capital flows, as well as on other

aspects of financial market strengthening, for example to deepen regional bond markets and improve risk management and governance in banks, is warranted.

- The IMF has confirmed that it 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 who 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 indicated his availability to undertake work in consultation with the IMF along these lines.

Noting these considerations, Mr. Waller recommended that (a) terms of reference be drawn up for consideration at the Hangzhou meeting on a review that could be undertaken 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; and (b) an expert be selected to provide preliminary advice on the drafting of the TORs.

The Advisory Group Coordinator referred participants to a proposal from the ADB Institute regarding a research project it is launching that will deal with the implications of the subprime crisis and the region’s response. The project will examine the extent of the impact of the crisis on the region, including an assessment of how financial systems can cope with the pressure arising from the crisis. It will also examine current supervisory and regulatory frameworks for structured financial products in the region, and look into the possibility of regional cooperation to further strengthen financial systems. ADBI invited ABAC and the Advisory Group to participate in the project and make use of its output. Specifically, ABAC and the Advisory Group could help define the terms of reference and provide feedback on both the inception and the final report. The terms of reference will be developed during a brainstorming session that ADBI is proposing to hold in Tokyo. The schedules are not yet set, but the current proposal from ADBI is to hold the brainstorming session sometime in August. Mr. Waller and the Advisory Group Coordinator volunteered to jointly coordinate the involvement of the Advisory Group and ABAC in this research project.

In the discussions that followed, participants noted the importance of regulation and transparency in maintaining financial stability, but also agreed that a healthy balance between regulation and fostering efficiency and innovation would best serve the purpose of strengthening and developing markets. It was pointed out that the current financial crisis and the other previous ones significantly differ from each other in their characteristics, and that the nature of financial crises is likely to continue changing as the financial landscape evolves. Participants agreed that future research efforts should take this into consideration and avoid the mistake of looking backwards to previous crises in finding ways to prevent future ones. Participants also noted the importance of engaging experts from a wide range of institutions.

At the conclusion of discussions, participants endorsed the proposed collaboration of ABAC and the Advisory Group with ADBI on the sub-prime research project, and asked Mr. Waller and the Advisory Group Coordinator to see how this could be combined with the proposed collaboration with the IMF to improve data collection concerning capital flows used in enhancing early warning systems and data dissemination to financial markets.

Report of the Workshop on Improving the Environment for Commercially Sustainable Microfinance and consideration of further actions

The Coordinator briefed the participants on the results of the workshop held in Jakarta, Indonesia on 23 January 2008. This workshop was held to identify reforms and capacity-building initiatives that can be proposed for implementation by APEC economies, and was attended by representatives of a number of public and private international institutions. *The workshop report is attached as Annex A.* The Coordinator called attention to the very significant transformation of microfinance during the past few years, as it has become profitable; attractive to financial institutions; and is expanding its reach to cover a wide range of financial services.

He noted that a significant number of microfinance institutions (MFIs) have made the leap to become deposit-taking institutions under normal financial regulatory frameworks. Measured by return on assets, these institutions have been outperforming the commercial banking sector in four out of six developing regions – in East Asia, Latin America, Middle East/North Africa and South Asia. In terms of loan portfolio quality using portfolio at risk for more than 30 days, data from six Latin American economies show microfinance institutions outperforming their respective domestic financial sector averages. In most regions, microfinance institutions have stricter policies for bad debt provisions and have demonstrated a superior ability to withstand financial crises.

The Coordinator noted that more financial institutions are becoming increasingly involved in microfinance. Commercial banks are using a wide range of options, from offering front or back office functions, wholesale lending, outsourcing and investing equity, to establishing loan service companies and specializing in microfinance. Global banks are becoming increasingly involved, and funding through capital markets is growing. Microfinance investment vehicles are attracting a growing number of institutional and individual investors by offering geographic diversification with low volatility, low correlation and high asset quality.

He also noted the expanding scope of microfinance, as evidenced by the example of Bancosol of Bolivia, which started out eleven years ago with lending small amounts to microenterprises. Today, Bancosol is providing a wide range of services, including consumer and housing loans, savings accounts, life and health insurance, utility bills payments and international money transfers.

The Coordinator noted that the workshop identified four factors behind this transformation: (a) technology; (b) innovation; (c) the changing nature of MFIs; and (d) policy reforms. MFIs have been quick to take advantage of IT connectivity, ATM and point-of-sale technology, mobile telecoms, smart cards and biometric information to reach a wider clientele. Today, low-income clients can access financing through loan service agents, lottery agents, traders and processors, point-of sale networks including retail stores, ATMs and mobile phones.

MFIs are evolving from very traditional NGOs to licensed financial institutions now serving as bridges between large investors and low-income borrowers. An example is Banco Compartamos of Mexico, which started out in 1990 as an NGO with capital of US\$50,000 and is now a fully authorized bank worth US\$126 million raising capital from debt and equity markets.

Policy makers are now realizing that providing an enabling policy environment is more effective than providing government credit and guarantee programs. The experience of the Philippines has been instructive, where microfinance began to take off only after the government abandoned a three-decade long directed credit program that failed to produce results.

The Coordinator noted the workshop's conclusion that an important reason for APEC to concern itself with microfinance is its impact on financial inclusion. In many developing economies, the majority of the adult population (e.g., about 60% in Indonesia and 70% in the Philippines) are still unserved by the banking system, compared to less than 10% in developed economies. There are a variety of reasons for this, but the fact is that MFIs are able to reach these clients better than traditional banks. Microfinance has proven to be an effective tool for linking these large, unserved population groups with mainstream banking and capital markets. How APEC is able to harness this tool will have a significant impact not just on social equity and economic growth, but also on the development of the financial sector.

The workshop identified the provision of a favorable legal, policy and regulatory environment to promote commercially sustainable microfinance as the key issue. In this respect, the workshop recommended that Finance Ministers (a) adopt financial inclusion, focusing on microfinance, as part of their agenda; (b) undertake initiatives to provide an enabling policy environment; and (c) engage the private sector in this task through ABAC and the Advisory Group.

The Coordinator also outlined proposals to help move the work on this issue forward. It was proposed that (a) as ABAC makes its recommendations to the APEC Finance Ministers, ABAC members could lobby their respective finance ministries to support this proposal; (b) the report be disseminated to key officials and opinion leaders in APEC economies, through its publication, and through dialogues with

selected officials, such as the dialogue with financial regulators in Kuala Lumpur this coming August, and a conference or videoconference in collaboration with the ADBI.

After the Coordinator's presentation, the ABAC Chair, Mr. Juan Raffo, suggested that microfinance be included as a topic for discussion at the upcoming APEC CEO Summit in Lima, Peru. ABAC FEWG having already endorsed the workshop report for submission to APEC Finance Ministers, participants confirmed their agreement with the recommendations of the workshop report and the suggested next steps.

Improving the region's credit reporting systems

The Advisory Group Coordinator introduced the topic by referring to a paper submitted by the Asia-Pacific Credit Coalition (APCC), in conjunction with its suggestion to collaborate with the Advisory Group and ABAC to promote improved credit reporting systems used by credit bureaus across the region. *The paper is attached as Annex B.* The APCC has requested Ms. Marlena Hurley, Advisor of TransUnion, to attend the Advisory Group meeting and make a presentation on the Coalition's behalf. Ms. Hurley presented the APCC paper, based on extensive research, which contained the following key points:

- In presenting information about potential borrowers to lenders, credit bureaus allow interest rates to be fine-tuned to reflect the risk of individual borrowers, leading to lower average interest rates, greater lending through reduced rationing and lower rates of delinquency and default. However, the extent to which these results are achieved depends on the structure of credit reporting, bureau ownership and the type of information reported.
- The report distinguishes between the following types of credit reporting:
 - *Negative-only reporting versus full-file reporting.* Negative-only reporting is the reporting of only negative information, or adverse payment data on a consumer, such as defaults, delinquencies, collection, bankruptcies and liens. Full-file reporting is the reporting of both negative information and positive information, which includes information on the timeliness of payments, including whether payment was on time, indeterminately late or delinquent, payment information which contains the payment date relative to the due date, oftentimes also data on account type, lender, date opened, inquiries, debt, and can also include credit utilization rates, credit limit and account balance.
 - *Segmented versus comprehensive reporting.* Segmented reporting is a system in which only data from one sector, e.g., retail or banking, are contained in reports. Comprehensive reporting is a system in which payment and account information, are not restricted by sector and contains information from multiple sectors, e.g., utilities payments.
- Greater coverage of a population through greater participation by data furnishers in a private consumer credit reporting system and the use of full-file and comprehensive reporting are associated with (a) increased access to credit, in the form of a greater acceptance rate for a given default level; (b) a more equitable allocation of credit, in the form of a greater proportion of those traditionally underserved (ethnic minorities, women and lower-income groups) being accepted; and (c) improved lending performance, in the sense of lower default rates. In addition, greater participation by data furnishers in a full-file system increases private sector lending.
- The implications of these effects on economic performance are significant. Broader-based lending and wider access to capital improves economic growth, growth in the capital stock and productivity and lower income inequality.
- Based on these findings, the APCC is proposing that APEC undertake measures to promote full-file comprehensive reporting to private credit bureaus in the region.

Participants expressed agreement regarding the benefits of moving toward full-file comprehensive reporting, but noted that concerns regarding privacy, identity and confidentiality need to be adequately addressed in order to ensure political support for this proposal. Participants also stressed the importance of harnessing information technology to make more information available while

protecting the privacy of individuals. In response to these comments, Ms. Hurley noted that many economies have already put in place very strict data protection laws with which credit bureaus must comply.

In conclusion, participants welcomed the inclusion of this issue in the work program and report of the Advisory Group, and requested APCC in collaboration with interested Advisory Group participants and the Coordinator to further develop the proposal, taking the above comments into consideration and report back at the next meeting in Hangzhou.

Update on preparations for the Public-Private Dialogue on Basel II Implementation and Strengthening Banking Systems.

Mr. Waller referred participants to the paper containing the proposed topics for the 4th Dialogue, which will be held on August 18-19 in Kuala Lumpur. The topics are as follows:

- Challenges and issues in the financial environment and their implications for macroeconomic policy, including (a) a broad review of the robustness of regional banking systems in handling the current liquidity and credit constraints now facing global banking systems; and (b) measures to achieve/maintain financial stability, including improving financial information to enhance regulators' capabilities to monitor short-term capital flows and to strengthen investor confidence in markets.
- Promoting international best practices in implementing Basel II, including (a) frameworks for prudential supervisory policy in developing economies; (b) approaches to self-assessment of objectives and performance by banking regulatory agencies; and (c) the economic capital concept, its application and challenges
- Enhancing regulatory coordination and response to cross-border challenges in implementing Basel II, including (a) promoting regulatory coordination in implementing Basel II in the region; and (b) the robustness of the cross-border banking frameworks and principles.
- Basel II Pillar 3 and IFRS, including (a) sharing of disclosure standards; (b) improving financial information; transparency, disclosure and convergence of data requirements and reporting standards, particularly those that would help convergence of credit rating practices and credit assessment; (c) privacy laws and information flows; and (d) supervisory implications of the implementation of IFRS 7 and IAS 32 and 39.
- Corporate governance, including (a) the role of corporate governance in bank safety and financial stability; (b) improving governance in banking and making boards and regulatory agencies more responsive and effective; (c) facilitating culture change in banking organizations; and (d) corporate social responsibility.
- Promoting robust credit reporting standards, including (a) the role of credit bureaus; (b) privacy issues; (c) capacity-building to develop best practices; and (d) moving toward an Asia-Pacific regional framework.
- Financial Inclusion/Microfinance, including (a) promoting a conducive legal, policy and regulatory framework; and (b) regional cooperation.
- Capacity building and public-private partnership, including (a) strengthening and developing corporate bond markets; (b) promoting creditor rights and informal work-out mechanisms; (c) protection of consumer interests.; and (d) infrastructure public-private partnership.

Mr. Waller encouraged those present to participate in the dialogue.

Consideration of possible work on capacity-building issues related to greenhouse gas emissions trading

The Advisory Group Coordinator reminded participants that in the 2008 work program, it was agreed to consider whether there are capacity-building issues arising from the Tokyo environmental finance symposium that should be included in the future agenda of the Advisory Group. He noted that one of the conclusions of the symposium is that effective contribution by developing economies to

environmental finance requires capacity-building measures. Currently, developing economies are able to participate in the Kyoto Protocol through the Clean Development Mechanism, but the short experience so far has revealed major shortcomings, for example in terms of ensuring additionality, measuring baselines and the design of the mechanism.

The Coordinator noted that in view of still ongoing discussions on the post-2012 global climate change response mechanism, it would be desirable for the Advisory Group to continue to monitor this issue and begin working with the financial industry to develop ideas on how APEC can contribute to capacity-building.

Participants expressed their agreement with the proposal.

Next meeting

The Advisory Group coordinator announced that the next regular meeting of the Advisory Group will take place in conjunction with the 3rd 2008 meeting of ABAC in Hangzhou, China. The Advisory Group meeting has been scheduled from 3:00 to 5:00 pm on Wednesday, August 5, 2008 at the Hyatt Regency Hangzhou Hotel.

Adjournment

There being no other matters to discuss, the Acting Chair thanked the participants, as well as ABAC Russia and the staff for the excellent preparations, and declared the meeting adjourned at 10:55 am.