



# THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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### **ADVISORY GROUP**

# **2008 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS**

Office of the Advisory Group Chair



# THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

## **2008 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS**

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### *Summary of Recommendations*

The Advisory Group on APEC Financial System Capacity-Building was established in 2003 to promote regional capacity-building efforts and public-private sector collaboration to help develop sound and stable financial systems. Since then, it has been conducting regular discussions with the participation of international public and private sector institutions and organizations for this purpose. 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 following conclusions and recommendations.

**Financial inclusion and microfinance.** In many developing economies, a majority of the adult population – as high as 60-70 percent in certain cases – remain without access to financial services. Microfinance has emerged as a potent tool to address this issue, and its ability to do so has grown in recent years with the expanded use of technology and financial innovation, increasing sophistication of microfinance institutions, and policy reforms. The development of microfinance remains uneven across the region, and there is very significant potential in regional cooperation to assist economies in providing a favorable environment for promoting financial inclusion through microfinance.

- *The Advisory Group recommends that APEC Finance Ministers launch a policy initiative to promote financial inclusion, focused on providing an enabling legal, policy and regulatory environment for microfinance, in collaboration with the private sector. In developing this initiative, APEC Finance Ministers should consider the conclusions of the ABAC/Advisory Group Report “Commercially Sustainable Microfinance: A Strategy for Promoting Financial Inclusion in APEC.”*

**Bond Market Development.** Following the successful First APEC Public-Private Sector Forum on Bond Market Development in May 2007 in Melbourne, the Second Forum was held in Cusco, Peru on 9 July 2008. The Advisory Group has reviewed the conclusions of this Second Forum, which focused on the bond markets of Chile, Mexico and Peru. There is much value in the sharing of bond market development experiences among economies, and the dialogue between public and private sectors.

- *The Advisory Group recommends that APEC Finance Ministers endorse the conclusions and recommendations of the 2<sup>nd</sup> APEC Public-Private Sector Forum on Bond Market Development and the continuation of the forum, with the Third Forum to be held in Singapore in 2009.*

**Infrastructure Public-Private Partnerships.** Successfully promoting infrastructure PPPs requires a transparent process that can reduce uncertainty on the part of the private sector and improve understanding of the process on the part of the public sector and communities. It also requires steps to address the challenge of limited skills, particularly in the financial analysis of projects and negotiation of appropriate frameworks. There is much potential for greater public and private sector involvement from APEC economies in ongoing work in this field, such as the work of ABAC, the Asian Development Bank (ADB), ADB Institute, International Finance Corporation (IFC) and PECC, through a coordinated regional approach. Training policy makers and regulators is needed to deepen the skills base in the region's economies.

- *The Advisory Group recommends that APEC Finance Ministers support the establishment of a Regional Infrastructure Dialogue among key representatives from government, private sector, relevant international institutions such as the ADB, the IDB, the IFC and the World Bank, and local communities, with the objectives of strengthening planning capabilities for infrastructure requirements and promoting best practice governance arrangements within government and the private sector in the region, and support capacity building training initiatives for the region's policy makers and regulators in infrastructure management and financing arrangements.*

**Strengthening Regional Financial Stability.** The failure of regulators and markets to anticipate the degree of turbulence arising from the sub-prime crisis underscores the need to better understand ongoing innovations and developments in financial markets. There is a need for responses that strike a healthy balance between regulation and transparency on the one hand and fostering efficiency and innovation on the other. Keeping in mind that the nature of financial crises is likely to continue changing as the financial landscape evolves, further efforts are needed to help deepen understanding by regulators and financial market players of changes in the financial environment, particularly in light of the sub-prime crisis, as well as improve collection and dissemination of data on private sector financial flows to enhance early warning systems. The Advisory Group is working with finance system specialists in cooperation with the ADBI, the IMF and other agencies to review ways to enhance reporting and dissemination of data of relevance to both the public and private sectors.

- *The Advisory Group recommends that APEC Finance Ministers support collaboration between public and private sectors in improving understanding of current financial markets and the collection and dissemination of data on private sector financial flows and encourage official involvement and support for the Advisory Group's work with the ADBI, the IMF and other institutions on these matters.*

**Improving Credit Reporting Systems.** Studies considered by the Advisory Group, in particular those presented by the Asia-Pacific Credit Coalition, provide strong evidence that greater participation by data furnishers in a private consumer credit reporting system and the use of full-file (as opposed to negative-only) and comprehensive (as opposed to segmented) credit reporting promote increased and more socially equitable access to credit and improved lending performance. Concerns

about privacy, identity and confidentiality need to be addressed, through legal and policy reforms and the use of technology, to ensure public support for such systems.

- ***The Advisory Group recommends that APEC Finance Ministers consider measures to promote full-file comprehensive reporting to private credit bureaus that also effectively address concerns about privacy, identity and confidentiality and ensure public support for such systems, through legal and policy reforms and the use of technology.***

#### **Strengthening Risk Management and Governance in Banking Systems.**

Participating institutions in the Advisory Group, including ABAC and PECC, continue their work in collaboration with other regional institutions to promote effective implementation of Basel II and governance in banking systems. This year marks the fourth annual dialogue between bank regulators and the region's financial industry hosted by the SEACEN Centre and co-organized by ABAC, the ABA and PECC. Sustained participation by commercial banks and the region's bank regulatory authorities is key to ensuring robust risk management systems and governance in banking systems.

- ***The Advisory Group recommends that APEC Finance Ministers support continued participation of banking supervisory agencies in the annual regional public-private dialogue on Basel II implementation and strengthening banking systems hosted by SEACEN.***

# THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

## **2008 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS**

The financial system plays a central role in each economy, and is an important element of development. The achievement of the APEC vision of free and open trade and investment hinges on the long-term stability of financial systems and their capacity to effectively channel savings to provide resources for the operation and growth of enterprises and the development of the required infrastructure. The free flow of capital throughout the region contributes to the efficient allocation of these resources, enhancing benefits for borrowers, creditors and investors.

As recent events have demonstrated, maintaining a sound and stable financial system in the face of the rapid and continuing evolution of the financial industry remains a challenge for developed and developing economies alike. For the latter, however, the task of building diversified, efficient and robust financial markets – a task that has taken advanced economies decades to accomplish – has become more urgent as the gathering speed of economic globalization increases the requirements for the safe and effective management of capital flows and their successful deployment to promote competitiveness and equitable growth.

In underscoring the importance and urgency of this task, the Asian financial crisis has precipitated various reform and capacity-building efforts to strengthen and develop financial systems. Nevertheless, while much progress has been achieved over the past decade, there is still a long way to go for many developing member economies. There is no lack of capacity-building initiatives in the region, with a wide variety of institutions involved in such undertakings. 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.

The Advisory Group on APEC Financial System Capacity-Building was established in 2003 to address these challenges. Since then, it has been conducting regular discussions with the participation of international public and private sector institutions and organizations for this purpose. 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 six major sections. These deal with (a) promoting an enabling legal, policy and regulatory environment for financial inclusion through microfinance; (b) the development of local currency bond markets in the Asia-Pacific region; (c) measures to promote public-private partnership in infrastructure development; (d) regional cooperation to promote financial stability; (e) improving the region's credit reporting systems; and (f) strengthening risk management and governance in banking systems.

## **I. PROMOTING AN ENABLING LEGAL, POLICY AND REGULATORY ENVIRONMENT FOR FINANCIAL INCLUSION THROUGH MICROFINANCE**

The Advisory Group, in collaboration with ABAC, organized a workshop on how APEC can help promote an enabling environment for financial inclusion in the region. This workshop, held in Jakarta, Indonesia on 23 January 2008, generated a report identifying reforms and capacity-building initiatives that can be implemented by APEC economies, which is being circulated as a separate document entitled *Commercially Sustainable Microfinance: A Strategy for Promoting Financial Inclusion in APEC*. Its key messages are as follows.

Since their emergence, microfinance institutions (MFIs) have undergone remarkable growth, which has accelerated particularly during the previous half-decade, as MFIs enormously expanded their client base and their linkages to banking systems and capital markets. Given microfinance's already significant contributions to financial inclusion in many developing economies, this rapid transformation has brought about a greater appreciation of its potential not just as a tool for promoting equity and development but also as a commercial undertaking. This reassessment focuses on a number of characteristics that define microfinance today.

- First, microfinance has proven to be profitable. A growing number of MFIs that started out as traditional non-government organizations (NGOs) have made the leap to become regulated deposit-taking institutions. Measured by return on assets, these institutions have outperformed the commercial banking sector in four out of six developing regions. 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.
- Second, microfinance is increasingly attracting mainstream financial firms. Commercial banks now use 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. Growing involvement of investment banks facilitate funding through capital markets. 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.
- Third, the scope of microfinance has considerably expanded. Bancosol of Bolivia provides one example. Having started out in 1992 with small loans to micro-enterprises, it has grown into a full-fledged financial institution providing



consumer and housing loans, savings accounts, life and health insurance, utility bills payments and international money transfers.

Behind this transformation lie a number of key factors –technology, innovation, the changing nature of MFIs, and policy reforms. MFIs have been quick to take advantage of information technology (IT) connectivity, automated teller machines (ATM) and point-of-sale (POS) technology, mobile telecommunications, smart cards and biometric information to reach a wider clientele. Today, 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 their early origins as traditional NGOs to become licensed financial institutions that are 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 became a fully authorized bank in 2006. When Compartamos launched an initial public offering (IPO) on the Mexican stock exchange in 2007 (the first IPO of a Latin American MFI), its net worth was assessed at US\$1.6 billion.

Finally, policymakers now realize that providing an enabling policy environment is more effective than providing government credit and guarantee programs as a strategy to promote commercially sustainable microfinance. The experience of the Philippines, where microfinance began to take off only after the government abandoned a three-decade long directed credit program that failed to produce results, has been instructive.

Growing interest in the role of the policy environment is evidenced by various initiatives to collect information on the policy and regulatory environment for microfinance. An example is the project *Microscope on the Microfinance Business Environment*, which was launched by the IDB and the Andean Development Corporation in cooperation with the Economist Intelligence Unit to provide information on the quality of the policy and regulatory environment, the investment climate as well as the overall institutional development for microfinance in several Latin American economies, based on a set of benchmarks upon which comparisons can be conducted.<sup>1</sup>

*For developing economies, the importance of microfinance lies in its potential to address the issue of financial inclusion.* In many of these economies, large majorities of the adult population are still unserved by the banking system, compared to only less than 10 percent in the advanced economies. With MFIs having demonstrated their capabilities to reach these clients even in the most remote areas, microfinance has proven to be an effective tool for linking these large, unserved population groups with mainstream banking and capital markets. How policymakers are 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.

Government has an important role to play in the process of promoting financial inclusion, and this is to provide an enabling environment that addresses legal, policy and regulatory barriers in order to facilitate the development of microfinance (including enabling the application of new technologies) and increase its access to commercial funds. They can accelerate progress toward financial inclusion by identifying the most critical policy solutions.

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<sup>1</sup> The website can be found at <http://www.iadb.org/mif/microscope.cfm>.

A study that examined alternative policy measures to promote financial inclusion identified six sets of access policy solutions that governments in the region could consider. These refer to policies and regulations governing correspondent banking agents, mobile phone banking, entry barriers to the financial sector, the governance and management of publicly-owned financial institutions, financial identity regulations and financial consumer protection.

APEC can play a key role in promoting financial inclusion within the Asia-Pacific region, with microfinance as an instrument of choice, by incorporating it in its agenda. For initiatives to succeed, however, microfinance should be treated not as a social welfare measure, but as part of APEC's suite of policy tools to advance economic and financial reforms. On account of financial inclusion being a central task of financial sector development, its significance to the development of banking systems and capital markets and the role that financial regulation and financial institutions would have to play in this process, its appropriate place should be within the APEC Finance Ministers' Process.

An APEC financial inclusion initiative could focus on providing an enabling legal, policy and regulatory environment, through improvements in measuring levels of financial inclusion in member economies, policy dialogue, mutual learning among market players and regulators, sharing of experiences and knowledge among member economies and engaging international standard setters in the policy discussions, as well as capacity-building activities. In addition to the significant microfinance expertise already available in the region, strong private sector collaboration is important for the successful design and implementation of critical measures, both at the regional and domestic level.

Thus, a meaningful involvement of key groupings such as the APEC Business Advisory Council (ABAC), the Pacific Economic Cooperation Council (PECC) and the Advisory Group on APEC Financial System Capacity-Building in a financial inclusion initiative undertaken by the APEC Finance Ministers would be very desirable. The wide variety of successful experiences among its member economies can help APEC make a meaningful contribution to the growth of financial inclusion in the region through the promotion of commercially sustainable microfinance.

**The Advisory Group recommends that APEC Finance Ministers launch a policy initiative to promote financial inclusion, focused on providing an enabling legal, policy and regulatory environment for microfinance, in collaboration with the private sector. In developing this initiative, APEC Finance Ministers should consider the conclusions of the ABAC/Advisory Group Report *Commercially Sustainable Microfinance: A Strategy for Promoting Financial Inclusion in APEC*.**

## **II. THE DEVELOPMENT OF LOCAL CURRENCY BOND MARKETS**

Much attention has been focused in recent years on the development of local-currency bond markets, particularly in East Asia and within the framework of the Asian Bond Market Initiative (ABMI). During the past four years, various public-private sector dialogues on the development of local currency bond markets in the region have been conducted, which underscored the importance of bond markets for financial stability and sustained and equitable economic development.<sup>2</sup>

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<sup>2</sup> Notable among these were the following conferences: *Developing Bond Markets in APEC: Moving Forward through Public-Private Sector Partnership* (May 10-11, 2004, Taipei), co-organized by PECC with the APEC

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. 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.

Aside from producing important insights and a compendium of key recommendations, these exercises have been very useful to both public and private sectors – the former obtaining a better picture of which measures are likely to successfully encourage private sector activity to deepen and increase the liquidity of bond markets, and the latter a better grasp of how markets are likely to develop in response to measures being planned and undertaken by authorities.

At their meeting in Hanoi on 7 September 2006, APEC Finance Ministers welcomed a proposal submitted by ABAC that the Advisory Group, together with ABAC, facilitate in-depth discussions with individual economies on how the public and private sectors can collaborate to develop their respective bond markets (with special attention to corporate bond markets). These dialogues were to take the form of a series of one-day sessions, each focused on three or four developing member economies' bond markets.

The central objective is to hold a dialogue among interested economies, private sector market players and experts from international public and private sector organizations, aimed at identifying aspects in the policy and regulatory areas which could be addressed by authorities to enhance the environment for bond market development, and in particular, corporate bond issuance. The dialogues also aim to identify capacity building initiatives, including public/private partnerships to build the environment conducive to bond market development.

The first Forum was held on 8 May 2007 in Melbourne, Australia, back-to-back with the Second APEC Senior Finance Officials Meeting (SFOM II). This first forum, which focused on the bond markets of Indonesia, the Philippines and Vietnam, was successfully concluded, its results submitted to the APEC Finance Ministers and endorsed in the 2007 Report of the Advisory Group.

Following a positive review of these results, the 2nd APEC Public-Private Sector Forum on Bond Market Development was held on 9 July 2008 in Cusco, Peru in conjunction with the Fourth APEC Senior Finance Officials' Meeting (SFOM IV). The key conclusions from this forum – the full report of which has been separately circulated – are as follows:

- There has been very significant development of bond markets in Asia and Latin America as a result of policy and regulatory reforms over the past few years, but key challenges remain. These include issues such as improving market

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Business Advisory Council (ABAC) in collaboration with the Asian Bankers' Association and the Association of Credit Rating Agencies in Asia; *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; and *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.

infrastructure, improving access and standards of use (e.g., market entry, cross-border issuance and investment, regulatory and legal framework), enhancing transparency, strengthening risk assessment and risk management among financial institutions and regulatory authorities, and increasing market liquidity.

- While Asian financial integration, through such initiatives as the ABMI and the Asian Bond Fund (ABF), has been actively promoted by governments, the beginnings of financial integration in Latin America are being driven by cross-border investment and issuance related to cross-border foreign investment. The results of these transactions have benefited Latin American economies and demonstrated that foreign investors provide stability to markets. There is a need to facilitate regional financial integration in Latin America through closer collaboration among regulators and policy makers with more active support from international institutions such as the Inter-American Development Bank (IDB).
- While the past few years have seen governments actively undertaking reforms, the development of bond markets is a continuing issue that needs to be sustained in the face of innovations in financial services and the emergence of financial stresses that generate political pressure for policy and regulatory responses. Consequently, there is a need for institutional arrangements to ensure continued reforms and improvements on a long-term basis and spanning political cycles.
- Taxes have a significant impact on the development of bond markets, including cross-border investment and issuance. Given the importance of bond markets, governments should keep this in mind when undertaking tax policy changes.
- Within APEC, developed member economies can play an important role in promoting policies that lead to market development in developing member economies. A good example is the US Treasury's capacity-building program for capital markets. Consideration could be given to how the synergy of such programs with other regional efforts within APEC may be enhanced.
- International institutions such as the Asian Development Bank (ADB), the Inter-American Development Bank (IDB), the International Finance Corporation (IFC), the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD) and the World Bank (WB) play a very useful role in bringing onto the table the experiences not just of APEC economies, but also of non-member economies. APEC should consider how their programs can be more effectively deployed in conjunction with each other.
- Importance needs to be given to capacity-building in certain priority areas, such as securitization, legal frameworks, local pension funds, market infrastructure, participation of foreign investors and issuers, the impact of taxes on bond market development, and regional initiatives particularly with respect to harmonization of regulation and market practices. In the light of recent financial market turbulence, there is also a need to strengthen risk assessment and management among financial institutions, regulators and credit rating agencies.
- Within APEC, there is a need to deepen connectivity between various capacity-building initiatives and the actual implementation of reforms in member economies. In this process, there is a critical role for public-private sector collaboration in generating support for policy measures, particularly with respect to corporate bond markets.

**The Advisory Group recommends that APEC Finance Ministers endorse the conclusions and recommendations of the 2<sup>nd</sup> APEC Public-Private Sector Forum on Bond Market Development and the continuation of the forum, with the Third Forum to be held in Singapore in 2009.**

### **III. PROMOTING PUBLIC-PRIVATE PARTNERSHIP IN INFRASTRUCTURE DEVELOPMENT**

Attracting resources to promote infrastructure development is a key objective for many developing economies. There is a huge potential for public-private partnership (PPP) to contribute to this objective in a way that will benefit governments, the private sector and the public at large. There is much that the private sector could contribute to addressing the complex issues involved, inasmuch as there is already a wealth of experience available. The Advisory Group discussed these matters and identified a number of key issues that need to be addressed.

First, functioning and sufficiently developed capital markets are needed to facilitate infrastructure finance. While there is an abundance of capital to finance the region's infrastructure needs given Asian economies' high savings rates, much still needs to be done to strengthen and deepen financial markets before they are able to effectively mobilize these savings. Transparency is critically important. With risks differing between asset classes, grassroots financing is likely to carry higher risk premiums than that involved in the purchase of existing assets.

Second, what is perceived by many developing economies as overly cautious attitudes of potential foreign investors in infrastructure projects is rooted in risk – particularly political risk – being an important consideration in decisions related to long-term cross-border investment in non-movable assets. Such investors' views are influenced by the quality of legal regimes, governance structures and overall frameworks that are important over the long term. From this perspective, advanced economies, which are normally seen as having governance structures that conform to acceptable governance benchmarks, such as those of the OECD, are usually still considered more favorably by investors than most developing economies.

Third, the private sector's experience in participating in PPP projects thus far indicates the prevalence of expectations on the part of local communities that infrastructure assets should be firmly controlled by the public sector. Given this, acceptance by communities is important for private sector investors who come to own certain facilities, such as for example hospitals. However, many private sector investors have yet to acquire the skills and capabilities that would facilitate such acceptance, and so are confronted with considerable political risk, especially given adverse attitudes that have been conditioned by unsuccessful experiences in the past.

Fourth, there is a real need for capacity-building efforts in the official sector, inasmuch as the development of private financing of infrastructure is still in its very early stages. In particular, developing economies lack sufficient experience in identifying infrastructure needs and evaluating economic and social payoffs in the use of sound analytics in infrastructure assessment. It is also important for public sector sponsors to acquire the capacity to effectively negotiate terms with concession holders based on the best information, as they risk a public backlash if they are seen to have provided concessions too cheaply. Governments must learn to deal with infrastructure at a more macro level and in a more integrated way and to develop a more rational approach to project design, enhancing public communications and consultations and

promoting sustainability. Nevertheless, the characteristics of infrastructure PPP have already been clearly identified and in certain economies, such as in the United Kingdom, there is already a wealth of experience and expertise that can be harnessed.

Fifth, the role of multilateral institutions is changing, as their traditional role of providing funds to developing economies is now being challenged by the increasing availability of private capital, while the need for the software dimensions of capacity-building has become a more important issue than funding in relation to cross-border infrastructure projects. Consequently, there is a growing realization within these institutions of the need to focus increasingly on providing advice to governments on these issues, such as improving the way governments measure, budget and account for guarantees they provide; improving the environment for risk allocation; and ensuring that governments are able to increase benefits by assuming risks they can control (rather than risks that are properly borne by investors), while providing strong incentives for investors to select projects carefully and to run them efficiently.

In addition, involvement of relevant international institutions, such as the ADB, the IDB, the IFC and the World Bank, should be solicited, as they can play important roles in assisting infrastructure development in emerging markets. In many of these economies, strong covenants and institutions that can provide funds of the required long term maturity and in the local currency are needed. International institutions could help bridge these gaps, and, as investors, could help promote good governance. They would have the credit standing to raise long-term debt while assisting in the development of local capital markets, particularly taking advantage of their ability to develop a long-term swap market to eliminate the currency mismatch in the host economy, given infrastructure revenues in local currency.

There is considerable activity within and outside the region on infrastructure PPP, particularly in respect to the private sector role in risk taking, financing and managing infrastructure development and focusing on such issues as the structure and content of PPP toolkits and evaluation and feedback mechanisms. Within the region, some examples of recent initiatives, completed and ongoing, are as follows:

- The ADB Institute (ADBI) is focusing research and capacity-building programs on infrastructure development. Its research program explores key issues and challenges of infrastructure development, including regional cooperation and identifying needs in terms of policies and best practices with respect to trade and logistics, policies and institutions, financing and savings mobilization and cross-border infrastructure networks. Under its capacity-building program, ADBI is undertaking workshops to provide an interactive setting for officials to engage with the private sector and to assist in identifying and implementing reforms to facilitate private sector engagement and support the development of potential infrastructure projects.
- PECC recently published a work entitled *Meeting the Region's Infrastructure Needs: Guidelines for Effective Public-Private Partnerships*, based on extensive research and discussions. The publication contains voluntary guidelines for effective PPP and a synthesis of recommendations to stakeholders at each stage of PPP developed by PECC.
- APEC is undertaking discussions, such as those during the workshop on building markets to support PPPs held in Ho Chi Minh City in May 2008 and recent

discussions at the APEC Senior Finance Officials' Meeting on PPPs and capital market development.

Given its extensive experience in bringing together public and private sectors to address policy issues, APEC can play a more significant role in this process. One way of doing this is through a regional infrastructure dialogue under the APEC framework that can build confidence and mandate for governments to invest in infrastructure, enrich the vision of a long-term infrastructure plan that will secure long-term prosperity and underpin social stability, and champion a pragmatic agenda for early action based on genuine partnership with business and communities.

Such a dialogue could provide a seamless relationship and place for quality dialogue among government, private sector and community interests in infrastructure. It can sharpen "national interest" and planning capabilities for infrastructure requirements; promote best practice governance arrangements within government and the private sector. It can help demystify the role of the private sector and its capability to deliver public policy outcomes and bring forward financing solutions.

A regional infrastructure dialogue would be beneficial in several ways. Considering that infrastructure PPP is a new field that is not yet very transparent; it would help to make the process more transparent, reduce uncertainty on the part of the private sector, and improve understanding of the process on the part of the public sector. Such a dialogue would help address the challenge of limited skills, particularly in the financial analysis of projects and negotiation of appropriate frameworks. It would be useful in increasing awareness of the importance of infrastructure development and the role of PPP, compiling experiences and capitalizing on what already exists to provide a menu of options. It could also be linked to other regional initiatives promoting infrastructure PPP in the region.

**The Advisory Group recommends that APEC Finance Ministers support the establishment of a Regional Infrastructure Dialogue among key representatives from government, private sector, relevant international institutions such as the ADB, the IDB, the IFC and the World Bank, and local communities, with the objectives of strengthening planning capabilities for infrastructure requirements and promoting best practice governance arrangements within government and the private sector in the region, and support capacity building training initiatives for the region's policy makers and regulators in infrastructure management and financing arrangements.**

#### **IV. REGIONAL COOPERATION TO PROMOTE FINANCIAL STABILITY**

In response to concerns about short-term capital flows, particularly in relation to highly leveraged institutions (HLIs), 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, the Advisory Group considered a study in 2006 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 focused on a number of recommendations related to capacity-building. These included a code of conduct for statistical agencies in the region to increase market confidence; an endorsement of 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 and capacity-building activities to assist interested member economies in establishing investor relations services and industry surveillance units that can become sophisticated observers of the market using multiple data sources.

While endorsing these recommendations, the Advisory Group underscored the basic premises 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. For this purpose and where appropriate, economies may highlight the information and discussions from Public Information Notices (PINs) after the conduct of IMF surveillance.

The current situation of financial markets underscores the continued 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. Related to this, the Advisory Group notes the following issues:

- 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 2008, 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 timely recognition of losses and the recapitalization of financial institutions where necessary, liquidity support from central banks and efforts to improve lending and credit practices, 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 should they preclude innovative financing techniques from entering capital markets. Systemic support and regulatory reforms are likely to help establish a period in which markets can be restored, grow and prosper, while realizing that new fault lines will likely still 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 rapid pace of financial market development is a challenge to regulators and market players, as they strive to update their understanding of financial markets. This challenge has been exemplified by the failure of regulators and markets to anticipate the degree of turbulence arising from the subprime crisis, to which lack of data was a major contributing factor. In trying to address this problem, it is important to carefully consider what kind of data would be useful and need to be collected. International reporting standards remain important, inasmuch as not only the successful application of the IMF balance sheet approach to uncover mismatches in economies' balance sheets is contingent on the availability of the relevant data, but also that data of individual institutions rather than aggregate data could be crucial in some cases.
- While noting the importance of regulation and transparency in maintaining financial stability, the Advisory Group agrees that a healthy balance between regulation and fostering efficiency and innovation would best serve the purpose of strengthening and developing markets. The current financial crisis and the other previous ones significantly differ from each other in their characteristics, even as the nature of financial crises is likely to continue changing as the financial landscape evolves. Future research efforts should take this into consideration in order to avoid the mistake of looking backwards to previous crises in finding ways to prevent future ones.

There is interest on the part of international institutions to work with the private sector on these issues. The IMF has expressed an interest in collaborating with the Advisory Group and 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. The ADB Institute and the IMF are working with the Advisory Group and ABAC to study the full impact of the subprime crisis and inflation on Asian economies and financial markets and how economies can formulate appropriate policy responses.

**The Advisory Group recommends that APEC Finance Ministers support collaboration between public and private sectors in improving understanding of current financial markets and the collection and dissemination of data on private sector financial flows and encourage official involvement and support for the Advisory Group's work with the ADBI, the IMF and other institutions on these matters.**

## **V. IMPROVING THE REGION'S CREDIT REPORTING SYSTEMS**

Fundamental to the development of a strong financial sector is an underlying consumer-driven economy. Corporate activity and macro-economic growth ultimately trace their source to consumer activity, which generates the demand for corporate products, and in turn for more complex financial services that facilitate the

development of those products. Robust consumer demand is facilitated by an ample supply of consumer credit, and credit bureaus play an important role in ensuring a sound and stable basis for its continued growth.

Over the past decades, credit bureaus have assumed a core role in the financial infrastructure of economies by helping lenders acquire a more precise knowledge of a borrower's likelihood of repaying. Lenders' inability to accurately infer the risk profile of borrowers often causes low-risk borrowers to face high interest rates that act as subsidies for high-risk borrowers. These rates price many low-risk borrowers out of the market. On the other hand, high-risk borrowers receive subsidies and are thereby drawn into the market. Average prices go up to reflect the disproportionate presence of high-risk borrowers, resulting in higher delinquency rates and leading lenders to ration loans.<sup>3</sup>

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. In this context, distinctions between the following need to be made:

- *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.
- *Public versus private credit bureaus.* Although there is no theoretical reason why a public bureau cannot behave like a private one, there are practical reasons. Public bureaus have been set up largely and primarily for supervisory purposes, to monitor the safety and soundness of the financial sector and determine whether reserves are sufficient, rather than primarily to facilitate greater and sustainable lending. Private bureaus, by contrast, are set up to ease lending, and the reasoning behind the data collection by private bureaus lies primarily in reducing information asymmetries and to improve risk assessment in lending. By this account, private bureaus are complements to public bureaus.

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<sup>3</sup> The Advisory Group acknowledges the very significant contribution of the Political and Economic Research Council (PERC) to these discussions, in particular the arguments presented in the paper by Michael Turner, Robin Varghese and Partick Walker, *The Structure of Information Sharing and Credit Access: Lessons for APEC Policy* (A PERC Briefing Paper for The Asia-Pacific Credit Coalition), July 2008.

A study undertaken by the Political and Economic Research Council (PERC) for the Asia-Pacific Credit Coalition (APCC) and considered by the Advisory Group presents the following conclusions:

- To most accurately judge risk, lenders generally need to know more than the past credit failures of the applicant. Systems that only report serious delinquencies do not capture many moderately late payments (30 to 60 days past due) that are often indicative of a borrower's risk. In addition, positive credit information provides a low-cost way of gathering data on applicants who have paid in a timely fashion, and it provides information on those who may often face discrimination, such as lower-income borrowers, women, racial minorities, and the young. Full-file reporting also allows creditors to measure a borrower's capacity to carry a loan by revealing the individual's existing lines of credit, associated balances, and credit limits.
- In many ways, the issue of comprehensive reporting versus segmented reporting is akin to that of full-file versus negative-only reporting. More information allows for better predictions. In addition, comprehensive reporting provides a low-cost way of gathering data on those who apply for loans in another sector.
- There is a sizable reduction in the ability of lending systems to identify the good risks from bad risks with shifts from a comprehensive full-file data to negatively only or segmented data. Evidence from US data indicates that for a 3 percent default target, a negative-only reporting system would accept 39.8 percent of the applicant pool, whereas a full-file system would accept 74.8 percent of the applicant pool. Similar simulations conducted in a number of countries with comparable results verify the robustness of such findings.
- With respect to the distribution of credit by demographic characteristics, studies strongly suggest that individuals in underserved social segments are the most likely to benefit from expanded information sharing. One study using US data concluded that ethnic minorities, the young, and low-income groups experience greater increases in acceptance rates with full-file information than the rest of the population. Another study using data from Colombia found an increase in the share of women among the pool of borrowers when switching to a full-file system (33 percent of the borrower pool under a negative-only system compared to 47 percent in a full-file system).
- There are potentially enormous benefits to adding non-financial payment data, such as utilities payments, to consumer credit files. These non-financial services are broadly utilized in many countries, across socioeconomic groups and among many individuals that may not have participated in the formal credit markets and, thus, have little or no traditional credit history on file. The use of such data has the potential to make available affordable credit from mainstream financial markets to historically underserved consumers and entrepreneurs, considering that in the USA, for example, some 35 to 54 million consumers lack credit files or have too little information to assess risk and thereby remain outside the credit mainstream. A study conducted by PERC concluded that when payments for energy utility and telecommunications are included in credit files, those without multiple credit accounts in the past and are least likely to be in the credit mainstream (ethnic minorities, lower income households, younger individuals, and older individuals) are the ones most likely to benefit.

- Using data from 129 economies, one study concluded that private bureaus increased lending by 21 percent (vs. 7 percent for public bureaus, although the latter was not a statistically significant increase). In lower-income economies, private bureaus increased lending by 14.5 percent compared with 10.3 percent for public bureaus. Another study found that private sector lending increased by more than 45 percent of GDP with a shift from 0 percent to 100 percent coverage of credit-eligible adults by a full-file private bureau. Using data from 170 banks across Latin America, an IDB study found that banks that loaned primarily to consumers and small businesses and that used private bureau data had nonperformance rates that were 7.75 percentage points lower than banks that did not, while no such effect of any magnitude for the impact of public bureaus were found.
- 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 Advisory Group recommends that APEC Finance Ministers consider measures to promote full-file comprehensive reporting to private credit bureaus that also effectively address concerns about privacy, identity and confidentiality and ensure public support for such systems, through legal and policy reforms and the use of technology.**

## **VI. STRENGTHENING RISK MANAGEMENT AND GOVERNANCE IN BANKING SYSTEMS**

In 2005, ABAC, PECC, the Asian Bankers' Association (ABA) and the South East Asian Central Banks Research and Training Centre (SEACEN) launched a dialogue between the region's financial regulatory authorities and the financial industry to help strengthen risk management and governance in banking systems. The dialogue has been held annually since then. The Advisory Group considered the report of the third dialogue, which was held on 11-12 July 2007 in Singapore and attended by around 80 participants from regulatory agencies in the broader Asia-Pacific region, representatives of regional and international financial institutions, and academic finance and legal specialists.

The main focus of the dialogue was to assess developments related to the implementation of 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, cross-border insolvency and informal workouts, consumer financial issues and capacity building. The following are the key conclusions arising from the dialogue:

- Since the Asian financial crisis, significant qualitative changes have enhanced the region's financial systems, including greater exchange rate flexibility, the growth of international reserves, strengthened banking systems, and significant growth of local currency bond markets. Notwithstanding these gains, however, there was broad recognition that banking systems need further enhancement, particularly with respect to improvements in risk management and governance. Concerns arising from the diffusion of risk from the banking sector to non-bank financial institutions, combined with the integration of financial markets, have become more pronounced with the impact of the subprime crisis on financial markets.

- Efforts to strengthen financial stability should continue to focus on fundamental issues. Governments should strive to build and maintain a solid domestic supervisory system, a sound macroeconomic and legal framework and efficient markets; complemented by regional and international cooperation. Financial institutions should strive to think globally and to better understand the transmission mechanisms of potential external shocks. As markets are capable of effecting adjustments in response to the tightening of credit and liquidity, authorities should exercise great care in any intervention that could result in undue political risks.
- There has been marked progress in understanding the central issues involved in implementing Basel II, but important challenges remain to be addressed by policy makers, regulators and banks. The following are some key aspects of the current situation in the region with respect to the implementation of Basel II:
  - 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.
  - There is broad recognition that Pillar Two places responsibility on banks and supervisors to fully understand the various risks that differ from one bank to another. Apart from the capital charges under Pillar One, banks are required to assess other risks such as reputational and political risk, and conduct assessments of overall risks that are forward looking as part of strategic planning; including qualitative assessments.
  - There is also greater appreciation for the role of Pillar Three in ensuring greater transparency of banks' operations, governance and risk management; the importance of disclosure requirements in facilitating greater discipline and improved discernment about the comparative qualities of banks; and the need for consistency in disclosure requirements across jurisdictions in order to allow markets to make meaningful comparative assessments of banks. Consequently, there is growing support for jurisdictions to move toward adopting a single set of internationally agreed accounting standards.
  - Deeper interaction is needed among regulators and between banks and regulators, including through supervisory colleges, to promote common approaches to implementing Basel II. Coordination among supervisors is important in view of wide differences in methodologies and timetables, the use of national discretion and accounting and disclosure parameters throughout the region. Regular regional public-private sector dialogues to promote communication between regulators and banks are needed for the effective implementation of Basel II.
  - Regulators and banks in the region need to reinforce efforts to improve risk management procedures and practices by determining what they are able to achieve given the resources and skills available to them. There is agreement that approaches should be chosen in terms 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.

- Improving governance systems in banking remains a significant challenge, to which priority should be given. 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 – in particular the value of Nomination and Audit Committees – and ways to train and select good board members.
- Specific measures are necessary to support consumer interests, including the sharing of experiences among banks and regulators in the region on matters related to credit cards issuance.
- Economies should give much greater weight to promoting regional bankruptcy and insolvency arrangements and informal workouts. Support and endorsement by financial regulatory authorities 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.

The dialogue provided highly constructive exchanges on approaches to capacity building of value to both regional banks and regulators. Participating institutions in the Advisory Group, including ABA, ABAC and PECC, are continuing their work in collaboration with other regional institutions to promote effective implementation of Basel II and governance in banking systems. Sustained participation by commercial banks and the region's banking regulatory authorities is key to ensuring robust risk management systems and governance in banking systems.

**The Advisory Group recommends that APEC Finance Ministers support continued participation of banking supervisory agencies in the annual regional public-private dialogue on Basel II implementation and strengthening banking systems hosted by SEACEN.**