



THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

Document: AGFSCB 29-009
Draft: **FIRST**
Source: AGFSCB Chair
Date: 6 February 2009
Meeting: Wellington, New Zealand

First Meeting 2009

11 February 2009

Lambton Room, The Intercontinental Hotel
Wellington, New Zealand

Meeting Paper 8-A

Executive Summary of the Report of the 4th SEACEN-ABAC-ABA- PECC Public-Private Dialogue for the Asia-Pacific Region

BASEL II IMPLEMENTATION AND THE DEVELOPMENT OF ASIA'S FINANCIAL SYSTEMS: CHALLENGES AND REGIONAL COOPERATION

Office of the Advisory Group Chair



**THE 4TH SEACEN/ABAC/ABA/PECC PUBLIC-PRIVATE
DIALOGUE FOR THE ASIA-PACIFIC REGION
BASEL II IMPLEMENTATION AND THE DEVELOPMENT OF ASIA'S
FINANCIAL SYSTEMS: CHALLENGES AND REGIONAL COOPERATION**

**CONFERENCE REPORT
EXECUTIVE SUMMARY**

On 18-19 August 2008, the Asian Bankers' Association (ABA), the APEC Business Advisory Council (ABAC), the Pacific Economic Cooperation Council (PECC) and the South East Asian Central Banks (SEACEN) Research and Training Centre jointly held the 4th annual dialogue between financial supervisory agencies and representatives of the Asia-Pacific region's financial industry. It was held in Kuala Lumpur and hosted by SEACEN, and attended by 75 representatives from financial regulatory agencies, international organizations and the region's financial industry. Following are the key points arising from presentations and discussions.

Challenges and issues in the financial environment and their implications for macroeconomic policy

- The sub-prime mortgage crisis in the US has led to a significant tightening in global financial markets, which has affected lending practices in the Asia-Pacific region. The economic slowdown in the US, Europe and Japan is causing a marked downward trend in Asian exports and manufacturing activities, which is expected to become stronger over the next several months.
- No existing central institution can address all the problems that affect global financial systems, but growing cooperation among key international bodies helped formulate and implement measures to safeguard the stability of financial markets. This crisis has underscored that issues affecting financial stability cannot be confined within domestic borders, and that banking regulators need to more closely collaborate globally in order to address liquidity, risk management and other important concerns.
- Lack of timely and high-quality data on complex financial instruments and cross-border short-term capital flows played a role in the inability of regulators and market players to anticipate the extent of the financial turmoil. For regulators, this underscores the importance of promoting further improvements in disclosure, understanding of risks and risk management of financial institutions. For financial institutions, key issues are the adequate understanding of their loan portfolio and other financial institutions who are their customers; a cross-product group risk management system; and the cultivation of talent in risk management functions.
- The crisis is expected to induce a rethinking about the currently fragmented US financial regulatory system and reforms to address this structure as well as the way major investment banks are supervised.
- While capital account liberalization remains a key objective, it is important for developing economies to ensure that domestic financial systems are strong

enough to be able to deal with capital flows and to provide confidence to investors, and that the process is undertaken in the appropriate sequence.

- The failure of market players to understand the extent of financial institutions' problems was related to an over-reliance on credit rating agencies. This underscores the importance of due diligence.
- While developed economies emphasized the need of Asian emerging markets affected by the crisis in 1997-98 to bear the costs of adjustment so as to avoid moral hazard, regulators and policy makers have been more forthcoming in intervening to rescue financial institutions affected by the current turmoil. This underscores the dilemma confronting governments, when faced with an actual crisis, between preventing disruptions in the market that can lead to wider economic dislocations and avoiding moral hazard that can lead to the future recurrence of crises.

The implementation of Basel II in the Asia-Pacific region

- The implementation of Basel II presents an opportunity for banks to enhance their competitiveness and will strengthen financial systems as risk is more closely aligned with capital. Successful financial institutions are implementing Basel II in a strategic way, using improved risk infrastructures to create competitive advantages through the application of new business and management tools, particularly in the process of moving into new markets or products.
- While implementation of simpler approaches has been without major problems, banks in the region face a number of challenges with the use of IRB approaches. Key problems include knowledge gaps, the requirement for skilled human resources and the lack of default and loss data for model development and validation, among many others.
- The full benefits of Basel II implementation can only be attained if it is well-understood, well-integrated with financial structures, institutional practices and supervisory systems, and adapted to local conditions, and if the preconditions for effective implementation are put in place. Implementation should focus on the new role of risk management and strengthening the financial structure, corporate governance and banks' data capabilities, instead of strict regulatory compliance.
- Success in implementing Basel II requires supervisory authorities to have extensive consultations with the banking industry when formulating policies and setting rules, providing information to banks on the implementation process, and publishing implementation guidelines and rules.
- Supervisory authorities face a number of important challenges in using IRB approaches. These include limited resources; correctly interpreting and applying Basel principles; the lack of available technical support in the region; the process of harmonizing home-host requirements and approval processes; continually improving models post-IRB approval; and promoting greater emphasis on risk management systems and controls verification.
- The sub-prime mortgage crisis has called attention to a number of issues related to Basel II implementation, such as the regulatory use of ratings, the underestimation of risk involved in structured credit securitisation, the procyclicality of Basel II; and how supervisory review could help address risks that are not fully captured by Pillar I.
- Considerable diversity with respect to Basel II implementation timelines accounts for a number of cross-border implementation issues. Among these are application timelines for reporting, scope of application for subsidiaries, cross-border

consistency of requirements for more advanced approaches to credit risk and acceptance of risk mitigation techniques, and implementation timelines for advanced approaches to market and operational risk, among several others.

- For regulators, a key issue in cross-border implementation of Basel II is how to deal with differences in implementation timetable and national discretion. Effectively addressing this issue would require close collaboration between home and host supervisors. This underscores the importance to the region of the role of supervisory colleges and regional forums.
- There is an overlap between Pillar 3 and IFRS 7 with respect to several types of risks, but IFRS 7 also covers liquidity and commodity risks, which are not covered by Pillar 3. Synergy between Pillar 3 and IFRS should be harnessed in a number of areas, such as common education of senior management, common verification and internal audit regimes, availability of skilled resources, and improved data quality and availability, among others.
- Challenges facing regulators in implementing IFRS include those related to IAS 39, particularly in bridging traditional cost-based accrual accounting and a system that is more reliant on market values, accounting volatility in financial statements with the use of the fair value option in derivatives, and striking the right balance in disclosure and transparency requirements.
- Challenges facing banks in implementing IFRS include impairment measurement of loans, implementation costs, human resources limitations, earnings volatility, impact of different definitions of accounting capital and regulatory capital differ on capital management, impact of directors' legal obligations concerning financial reporting, and implications on taxes and share prices.
- Convergence toward IFRS is inevitable, but it should be seen in the context of local conditions and challenges. Given this reality, it is important for each economy to understand its impact and the challenges that are specific to its environment and adopt a measured approach toward implementation, rather than rushing to achieve convergence within a single time frame.
- Integrated risk reporting for Basel II and IFRS is an important issue for financial institutions given various information requirements— management reporting for management and the board, regulatory reporting for supervisors, and financial reporting for capital markets and rating agencies. Banks can benefit from designing frameworks for risk disclosure to be broader than the regulatory requirement, in order not just to disclose financial position and risk profile, but also to improve investors' understanding and for internal purposes.

Corporate governance

- Good corporate governance in financial systems is important due to the pivotal role of the financial sector as mobilizer of public funds, channel for monetary policy transmission, provider of risk protection and enabler of business activities. This underscores the need to maintain the financial sector's integrity and public confidence for the sake of financial stability.
- Strong corporate governance is an important pillar of financial institution strength because effective boards of directors complement the regulatory oversight. Regulatory and supervisory frameworks alone cannot guarantee financial stability. Strong corporate governance acts as a first line of defence against any impending crisis and unethical business practices.
- Governments can promote good corporate governance by strengthening guidelines for corporate governance, processes for appointment of directors and

chief executive officers and embedded risk management expectations in prudential guidelines. Principles-based regulatory frameworks and self- and market-based regulation promote a culture of checks and balances and promotes responsibility, accountability and independent and objective judgment.

- Corporate governance is a joint effort, whereby authorities should continue to promote standards, while the private sector actively plays an important role in promoting a culture of good governance in financial institutions. An important issue for many emerging economies in the region is that the success of promoting good corporate governance in banking organizations will likely hinge on the ability of management to facilitate cultural change.
- The current financial crisis has brought to the fore concerns about the ability of directors to spot dramatic deterioration in markets, understand exposures to credit risks, ensure that actual practices match the corporate governance mechanisms in place, and know whether management is hiding risks from the board.

Capacity-building

(1) Regional cooperation in credit reporting

- Studies have shown that full-file and comprehensive credit reporting increases lending to the private sector, especially among lower-income segments more than other reporting regimes, and results in better loan performance than segmented and negative-only reporting. In addition, private credit bureaus with comprehensive data were found to increase lending to the private sector. Comprehensive and full-file credit reporting also helps prevent identity theft.
- Efficient credit reporting systems are backed up by effective protection of creditor rights, robust bankruptcy laws, consumer protection and privacy laws, case law and consumer education and financial literacy. They also require consumer privacy regimes to conform to OECD guidelines, credit bureaus to ensure accuracy, integrity and security of information in consumer files and provide information only for a “permissible purpose;” data furnishers to ensure accuracy of reported information and participate in the consumer dispute process, and data users to obtain and use information only for a permissible purpose and notify consumers if they are taking adverse action.
- An Asia-Pacific regional framework for economic cooperation in credit reporting can build on existing efforts to recognize the global nature of data transfers and ensure business certainty and respect for consumer privacy. Promoting voluntary contributions by data furnishers across the region can be achieved through reciprocity agreements among data contributors across a range of industries, including financial services, retailers, utilities and telecommunications.

(2) Promoting financial inclusion

- With its rapid transformation, the potential of microfinance as a tool for promoting financial inclusion has grown significantly. This is of great importance to developing economies, where large majorities of the adult population are still unserved by the banking system. How policymakers are able to harness microfinance will have a significant impact on social equity, economic growth, and financial sector development.
- 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.

- Commercial banks can play an important role in financial inclusion through their capability to contribute to the long-term sustainability of microfinance, which needs uninterrupted flow of funds and resources to reduce traditional donor dependency. For commercial banks to play this role, however, reforms to improve the legal, policy and regulatory environment have to be undertaken, particularly to facilitate the development of four key types of microfinance products – micro-savings, micro-credit, micro-remittance and micro-insurance.
- APEC can play a key role by incorporating financial inclusion in its agenda, with a focus on providing an enabling legal, policy and regulatory environment through improvements in measuring levels of financial inclusion in member economies, policy dialogue and sharing of experiences and capacity-building activities, in collaboration with the private sector.

(3) Developing local currency bond markets

- Growth of local currency bond markets has been very significant in Asia and Latin America, coming as a result of policy and regulatory reforms over the past few years. Key challenges include improving market infrastructure, market access, cross-border issuance and investment and regulatory and legal frameworks, enhancing transparency, strengthening risk assessment and risk management in financial institutions and regulatory authorities, and increasing market liquidity.
- The development of bond markets is a continuing issue that needs to be sustained, especially in the face of financial innovations and the emergence of financial stresses. Consequently, there is a need for institutional arrangements to ensure continued reforms and improvements on a long-term basis that can span political cycles.
- Taxes have a significant impact on the development of bond markets, and so governments should keep this in mind when making tax policy changes. APEC could help address this issue by undertaking a survey of individual member economies, holding regional discussions on the impact of taxes, and regularly reviewing relevant taxes within a regional context.
- Advanced economies can play an important role in promoting policies that lead to market development in developing economies. International financial and development institutions also play a very useful role in bringing onto the table the experiences of a wide range of economies across the globe. APEC should consider how to more effectively achieve synergy among these various efforts.
- Close collaboration between public and private sectors is key to the success of efforts to develop domestic financial markets. Significant benefits can be gained from sharing of best practices and implementing mechanisms for cooperation with the private sector and regular roundtables involving officials, market players and financial experts.

(4) Promoting public-private partnership in the development of infrastructure

- The main problems facing the development of infrastructure in Asian developing economies are the lack of functioning and sufficiently developed capital markets for channelling savings to infrastructure financing and political risk, which makes foreign investors overly cautious with projects in developing economies.
- Investors' decisions are heavily influenced by the quality of legal regimes, governance structures and overall frameworks that are important over the long term. Advanced economies with governance structures that conform to certain

global benchmarks such as those of the OECD are considered much more favorably by investors over most developing economies.

- Acceptance by local communities is important for private sector investors who come to own certain facilities, but many private sector investors have yet to acquire capabilities that would facilitate such acceptance, and so are confronted with considerable political risk, given that local communities tend to expect the public sector to control infrastructure assets.
- The public sector in developing economies lacks sufficient capacity to identify infrastructure needs, evaluate economic and social payoffs and negotiate terms based on the best information. However, opportunities for capacity-building abound, as the characteristics of infrastructure public-private partnerships have been clearly identified and there exists a wealth of experience that can be used.
- Multilateral institutions can play an important role by providing advice to the public sector and by using their credit standing to raise long-term debt and develop a long-term swap market to eliminate currency mismatch, given that infrastructure revenues are in local currency.

Conclusions and recommendations

The resilience of Asian emerging markets in the face of the current financial crisis, in comparison to other developing regions, underscores the value of reforms that have been undertaken in response to the previous Asian financial crisis. The current financial crisis also demonstrates that issues affecting financial stability cannot be confined within domestic borders, and that closer global collaboration among regulators and with the private sector is needed to effectively address liquidity, risk management and other key concerns.

For developing economies, Basel II implementation is best undertaken as part of an overall financial development program to avoid adverse market outcomes arising from highly fragmented banking systems and weak risk management in domestic financial institutions. Asian economies are correctly undertaking initiatives to develop their bond and equity markets to have a more diversified financial system, as well as to support regional monetary and financial surveillance and promote cross-border crisis management and resolution arrangements.

Despite significant achievements, further reforms are needed to strengthen and develop financial systems in the region. In addition, the ongoing evolution of the financial industry, driven by a continuous process of innovation and globalization, calls for continued work on regulatory frameworks, intensified capacity-building efforts and enhanced cooperation between regulators and officials and the financial industry, at the domestic and regional levels.

Platforms for open and active dialogue between public and private sectors, such as this dialogue, are important in providing further insights on various issues related to the continued strengthening and development of financial systems, including the effective implementation of Basel II, the development of capital markets, financial inclusion and the financing of infrastructure.

Based on the presentations and discussions during the dialogue, officials and regulators in the region are advised to consider the following recommendations:

- ❖ ***Regulators, officials, central bank officials, the private sector and multilateral institutions should Intensify and further develop regional financial cooperation efforts, particularly in the following areas:***
 - ***Identifying, sharing and disseminating best practices in the implementation of Basel II by banks and supervisory authorities.***

- *Improving disclosure, understanding of risks and risk management of financial institutions.*
- *Cross-border implementation of Basel II, particularly issues arising from different implementation timetables, use of national discretion, supervision of foreign bank subsidiaries and interpretation and practical application of Basel principles.*
- *Capacity-building to assist developing economies in promoting strong corporate governance through strengthening guidelines, voluntarily moving towards a principles-based regulatory framework and greater self- and market-based regulation.*
- *Promoting full-file and comprehensive credit reporting to private credit bureaus in the region, together with standards providing data subjects rights of notice, access, choice, notification of adverse reactions, dispute and correction, and encouraging voluntary contributions by data furnishers across the region through reciprocity agreements among data contributors across a range of industries.*
- *Launching an APEC financial inclusion initiative to focus on providing an enabling legal, policy and regulatory environment for innovative solutions in microfinance.*
- *Strengthening local currency bond markets, promoting cross-border investment and issuance in the region, and broadening the investor base, especially for corporate bonds.*
- *Capacity-building to assist developing economies in effectively identifying infrastructure needs, evaluating economic and social payoffs and negotiating terms.*
- ❖ *ABAC, ABA, PECC and SEACEN should distribute the report of the dialogue widely to relevant institutions and organizations in the public and private sectors, and request their further advice and observations for consideration in the fifth dialogue to be held in 2009.*
- ❖ *ABAC should convey the report and recommendations to the APEC Finance Ministers and seek their endorsement for the continuation and further strengthening of this series of dialogues as an important regional capacity-building initiative.*