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Advisory Group

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

A DIALOGUE JOINTLY ORGANIZED BY

THE SOUTH EAST ASIAN CENTRAL BANKS' RESEARCH AND TRAINING CENTRE
THE APEC BUSINESS ADVISORY COUNCIL
THE ASIAN BANKERS' ASSOCIATION
THE PACIFIC ECONOMIC COOPERATION COUNCIL

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INTRODUCTION

Since 2005, 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 have jointly held an annual dialogue between financial supervisory agencies and representatives of the Asia-Pacific region's financial industry. These dialogues focus on issues that are important to the healthy development and stability of the region's banking systems, in particular the effective implementation of Basel II, and how collaboration between the public and private sectors could help in the achievement of this objective.

This year's dialogue was attended by 75 representatives from financial regulatory agencies, international organizations and the region's financial industry. It took place in the midst of a global economic and financial turmoil arising from the sub-prime mortgage crisis in the US and renewed inflationary pressures stoked by sharp increases in energy and food prices. Within this context, the region's banking systems continue to face important challenges in implementing Basel II, strengthening corporate governance, improving credit reporting systems, achieving higher levels of financial inclusion and designing and implementing effective regional capacity-building measures to help address these challenges. These issues were dealt with in the course of the dialogue.

In her keynote address, Ybhg. Tan Sri Dato' Dr. Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, shared her views on the impact of the current economic turmoil on Asia and the implementation of Basel II in the region. Among the issues she cited are the following:

- Having recently gone through a period of robust growth, Asian economies will be affected by the slowdown in developed markets but will likely not suffer as much as they did during the Asian financial crisis. Asian economies are well-positioned to weather the turmoil because of growing intra-regional trade, increased infrastructure spending supporting domestic demand, and strong economic fundamentals with lower levels of indebtedness, higher external reserves, stronger financial systems and improved fiscal positions.
- The implementation of Basel II presents an opportunity for banks to enhance their strengths and 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.

- However, 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. Rather than focusing on a strict regulatory compliance approach, implementation should focus on the new role of risk management in banking institutions, together with efforts to strengthen the financial structure, corporate governance and data capabilities within banking institutions.
- The sub-prime mortgage crisis has called attention to a number of issues related to Basel II implementation. These include the use of ratings in the regulatory framework and whether this has discouraged investors from exercising due diligence; the underestimation of risk involved in structured credit securitisation; the pro-cyclicality of Basel II; and how supervisory review could ensure that adequate capital buffers are provided by banks for risks that are not fully captured by Pillar I. The importance of these issues will differ among economies depending on the stage of development of financial markets, banking systems and supervisory structures.
- The impact of Basel II on developing economies is greater for a number of reasons. First, commercial bank credit playing a greater role in these economies, there is a higher correlation between the banking and the other sectors' performance. Second, the more advanced approaches that are calibrated to the environment of G-10 economies could exacerbate a credit crunch in developing economies during downturns by inducing systemic misperception of risk in these economies. Third, strong incentives for internationally active banks to adopt advanced approaches could leave local banks in emerging markets at a competitive disadvantage, given capability gaps in adopting advanced approaches in these markets.
- Malaysia's experience underscores the importance for developing economies of pursuing Basel II implementation as part of an overall financial development program; otherwise highly fragmented banking systems and weak risk management in domestic financial institutions could lead to adverse market outcomes. In this respect, Asian economies are taking correct steps in undertaking initiatives to develop their bond and equity markets to have a more diversified financial system, as well as in supporting regional monetary and financial surveillance and promoting cross-border crisis management and resolution arrangements. These efforts contribute to reduce any procyclical impact of Basel II, facilitate adjustment of risk parameters to local experiences and reduce the prospects for future financial system disruptions.
- Basel II highlights the importance of corporate governance in banking institutions, by raising expectations on oversight by the board and senior management, their understanding of the institution's risk profile, and their role in ensuring capital adequacy requirements are met and strong risk control frameworks are in place, especially when adopting advanced approaches. This calls for supervisors to pay more attention to banks' risk management control functions and governance, and for improved market disclosures subjecting governance practices to closer scrutiny by the market. These developments have increased the demands on capabilities and performance of board members.

- Platforms for open and active dialogue between public and private sectors, such as this dialogue, are important in providing further insights on the various issues related to the effective implementation of Basel II.

The various sessions that followed focused on a number of issues (for details, see the program of the dialogue, presented at the end of this report as Appendix A). Session 1 discussed the challenges and issues in the financial environment and their implications for macroeconomic policy. Sessions 2-4 focused on different aspects of Basel II implementation in the region. Session 5 discussed corporate governance. Sessions 6-8 covered a number of capacity-building issues related to credit reporting standards, financial inclusion, bond market development and infrastructure. In reflecting the presentations and discussions in the dialogue, this report follows the outline of the program.

I. CHALLENGES AND ISSUES IN THE FINANCIAL ENVIRONMENT AND THEIR IMPLICATIONS FOR POLICY

The presentations in this session[1] focused on the situation in global financial markets, their impact on Asia's economies and the responses that have so far been undertaken by regulators at the international level. Over the past twelve months, a dramatic swing from optimism to pessimism has occurred in financial markets, as it became apparent that problems once thought to have remained confined to the property sector in the US proved to have much wider repercussions, and led to a significant tightening in global financial markets that have already affected the advanced industrial economies.

Three channels through which these developments could affect Asian economies were identified. The first is through the exposure of Asian banks to credit derivatives and structured investment vehicles that lie at the heart of the financial turmoil. With ample liquidity in the region, this does not appear to pose a very serious threat. The second is through their impact on the lending appetite of financial institutions in the region. The tightening in global financial markets have modestly impacted Asian markets, but lending practices in the region are now trending toward greater conservatism, which will certainly have an impact on businesses, most especially on the small and medium enterprise sector.

The third channel is the indirect impact of these developments through the economic slowdown in the major export markets of Asian developing economies, namely the US, Europe and Japan. There has been a marked downward trend in Asian exports and manufacturing activities, which is expected to become stronger over the next several months. The much talked about decoupling of Asian economies from the US has proven to be an illusion, with Asia remaining insulated so far only due to still strong domestic demand, although its extent varies greatly across economies and may not be sustained. For the banking sector in Asian economies, this will be the first real test of its strength after several years of reforms and consolidation.

A very challenging period lies ahead, with looming prospects of stagflation. Inflationary pressures are expected to persist over the next several months, with the elevated prices of agricultural products and energy affecting headline inflation. At the

[1] Presentors in this session were Mr. Cheung Tai Hui (Regional Head of Economic Research for Southeast Asia at Standard Chartered Bank), who provided an overview of the developments in the global economy, and Ms. Delora Ng Jee (Deputy Comptroller of International Banking Supervision at the Office of the Comptroller of the Currency), who presented a review of international supervisory policy responses to developments in the financial environment from a banking supervisory perspective.

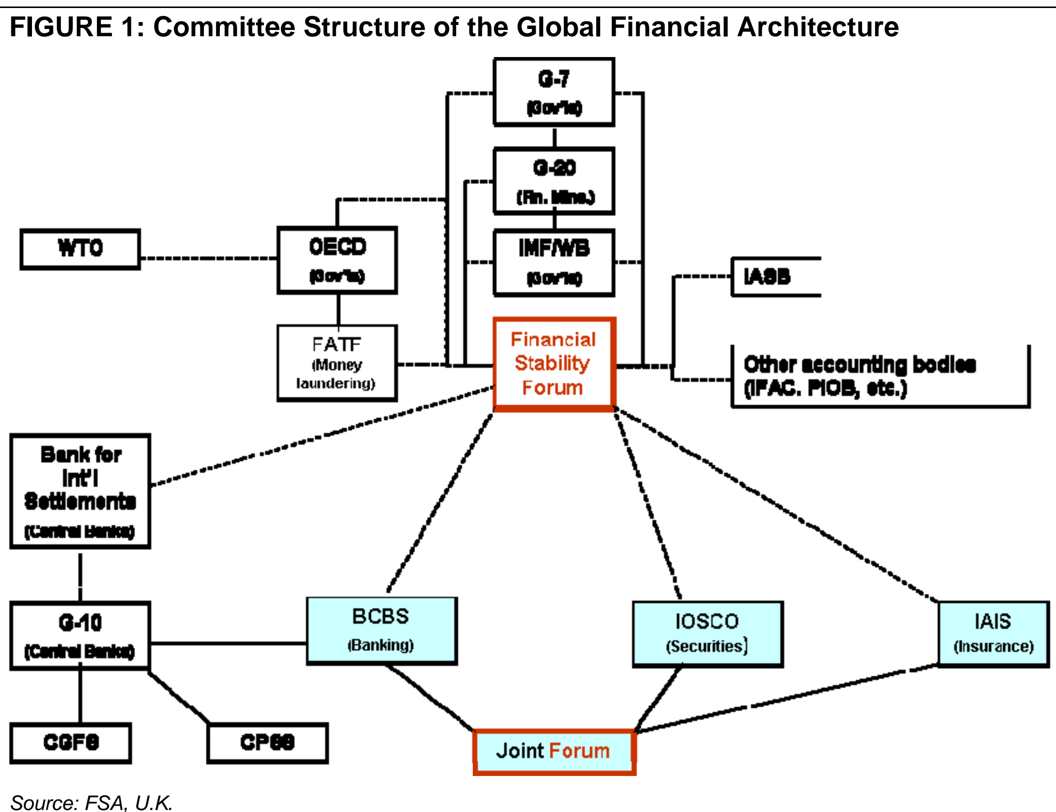
same time, downward pressures on economic growth are coming from the impact on the downturn on Asian exports. Nevertheless, the emergence of another financial crisis in Asia remains very unlikely, as international investors continue to see generally sound macroeconomic policies across the region, in particular, continued fiscal discipline even in the face of populist political pressures.

With these developments having a profound global impact, various international bodies have become involved in formulating and implementing measures to safeguard the stability of financial markets. There is no existing central institution that can address all the problems that affect global financial systems, but an increasing measure of cooperation and coordination among key international bodies has developed in response to the rapid advance of globalization in recent years (See Figure 1).

These bodies include groupings of key economies such as the Group of 7 (G-7) governments, the Group of 20 (G-20) finance ministers, and the Group of 10 (G-10) central banks. They also include institutions closely associated with the G-10 – the Bank for International Settlements (BIS) and three important committees, the Committee on the Global Financial System (CGFS), the Committee on Payment and Settlement Systems (CPSS) and the Basel Committee on Banking Supervision (BCBS), which plays a key role in the supervision of banks.

Alongside the BCBS are the other associations of financial sector supervisors, the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO), as well as organizations that deal with accounting standards, the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC). Key international organizations such as the International Monetary Fund (IMF), the World Bank (WB), the Organization for Economic Cooperation and Development (OECD) and the World Trade Organization (WTO) are also involved to varying extents.

FIGURE 1: Committee Structure of the Global Financial Architecture



Source: FSA, U.K.

Three organizations that play crucial roles in coordinating efforts to address the current global financial turmoil are the Joint Forum (JF), which includes the three associations of banking, securities and insurance regulators; the Financial Stability Forum (FSF), which involves the BCBS, IOSCO and IAIS as well as a number of other international institutions and organizations; and the International Liaison Group (ILG).

The FSF recently published its report and recommendations on enhancing market and institutional resilience, which identified major weaknesses that need to be addressed. These include underwriting standards, risk management, due diligence, performance of credit rating agencies, remuneration practices in the financial sector and disclosure. The ILG, which coordinates with the Basel Committee's Accord Implementation Group, has done a preliminary assessment of the current financial turmoil and related policy considerations.

The JF has focused on a number of key issues in the past, such as customer suitability (how supervisors deal with the risk of retail financial products), group-wide identification and review of risk concentrations in financial institutions, and an update on its 2005 work on credit risk transfer, particularly with respect to collateralised debt and loan obligations and asset-backed securities that have been involved in the subprime mortgage crisis. New initiatives focus on the use of credit ratings by regulatory authorities and on off-balance sheet vehicles.

The current financial crisis has underscored even more profoundly than in the past 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 that transcend borders. It is important to have effective avenues of communication. International bodies such as the JF and FSF can facilitate timely attention by supervisors across borders and disciplines.

Discussions during the open forum focused on a number of key issues.

One is the growing importance of sovereign wealth funds (SWFs) in the global financial systems and the need for supervisors and international bodies dealing with financial stability to take this into account.

Another is the lack of timely and high-quality data on complex financial instruments as well as cross-border short-term capital flows, which played a role in the inability of both regulators and market players to anticipate the extent of the financial turmoil generated by the US subprime mortgage crisis. 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 implications of the current crisis on the regulation of the financial industry in the US were also discussed. 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.

Given the periodic incidence of financial crises that have cross-border impact, developing economies that still maintain capital account restrictions are reluctant to move forward on capital account liberalization due to concerns about their vulnerability to contagion. Capital account liberalization brings very significant benefits and so remains an objective that developing economies should continue to pursue. Nevertheless, it is important for 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. For example, foreign direct investment flows should be liberalized ahead of portfolio investment flows.

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.

A final topic of discussion was the contrast between policy stances on the issue of moral hazard during the Asian Financial Crisis and that of the present day. It was noted that 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. The discussions underscored the dilemma faced by regulators and policy makers, 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.

II. ISSUES RELATED TO THE IMPLEMENTATION OF BASEL II IN THE ASIA-PACIFIC REGION

A. TOWARD INTERNATIONAL BEST PRACTICES IN IMPLEMENTING BASEL II

Presentations in this session[2] provided banking industry and regulatory perspectives on Basel II implementation in the Asia-Pacific region, and in particular, the frameworks for supervisory policy, approaches to self-assessment of objectives and performance, and the application and challenges of the concept of economic capital. These issues were discussed based on the actual experiences of two major Asian banking organizations, the Mitsubishi UFJ Financial Group (MUFG) and the Chinatrust Commercial Bank (CTCB), and of the Hong Kong Monetary Authority (HKMA).

The MUFG adopted a Basel II project management structure in 2006 that consists of a cross-entity committee and several working groups. The Basel II Implementation Office, which is responsible for group-wide implementation, falls under the direct supervision of the Basel II Project Committee, which is a subcommittee of the Group Executive Committee. The Implementation Office oversees Basel II implementation in the three major entities within the Group that are undertaking implementation – the holding company (MUFG), the Bank of Tokyo Mitsubishi UFJ (BTMU), and the Mitsubishi UFJ Trust Bank (MUTB). Other entities within the Group are the Mitsubishi UFJ Nicos, the Mitsubishi UFJ Securities and the UnionBanCal Corporation, a US subsidiary.

Cutting across these three entities are a number of working groups that were established to deal with specific areas of Basel II implementation. Four of these working groups have already accomplished their mission and been disbanded – the Workflow, Disclosure, Market Risk and Scope Working Groups. Five working groups

[2] Presentors in this session were Mr. Hideaki Tanaka (Chief Manager of the Basel II Implementation Office at the Corporate Risk Management Division of the Mitsubishi UFJ Financial Group) and Mr. Eric Kuo (Chief Portfolio Manager at the Credit Risk Management Group of Chinatrust Commercial Bank), who provided overviews of Basel II implementation in their respective institutions, and Mr. Steve Lau (Division Head of Banking Supervision at the Hong Kong Monetary Authority), who focused on Basel II implementation and the challenges to banks and regulators from a regulatory perspective and based on the experience of the HKMA..

are currently operational – the Credit Risk, Operational Risk, Capital Adequacy, Capital Planning, and Internal Audit Working Groups.

Since March 2007, the Group has been using the Foundation Internal Rating Based Approach (FIRB) for credit risk and the Standardized Approach (TSA) for operational risk. The supervisory review process is based on the Inspection Manual issued by the Japanese Financial Supervisory Agency (FSA). First disclosure under Pillar 3, which was for Fiscal Year 2006, was undertaken in July 2007, based on the Basel II Revised Framework published by the Basel Committee and being implemented in Japan. MUFG is currently preparing to move toward the more advanced approaches, the Advanced Internal Ratings Based Approach (AIRB) for credit risk and the Advanced Measurement Approach (AMA) for operational risk by March 2009, subject to changes depending on the supervisory approval process.

MUFG's experience in implementing Basel II highlights a number of challenges that banks in the region are facing in undertaking this process. Among these are the following:

- *Timing*: MUFG was created only recently as a result of a merger of the Mitsubishi Tokyo Financial Group and the UFJ Group (themselves the results of a series of previous mergers) as well as commercial banking subsidiaries. Changes that needed to be undertaken within the organization within a short period of time presented difficult challenges in preparing to implement Basel II.
- *Data requirements*: After the merger between MTFG and UFJ Groups, MUFG decided to maintain the rating systems used at MTFG. Consequently, the new entity had to retroactively assign to the customers of the former UFJ rating grades based on the new rating system and complete historical data on probability of default (PD) in order to comply with FIRB data requirements.
- *Differences in default definitions*. The definition of default under Basel II is different from definitions used for internal and tax purposes in Japan. Under Basel II, default includes the exposure in accrual status and the provisions for these exposures are general and not specific provisions. These result in difficulties in use test in pricing and lending practice and in estimating loss given default (LGD), as well as problems in the use of historical data.
- *Volatility of minimum required capital*: Given the risk sensitivity of Basel II, parameters such as PD and LGD are expected to be volatile, changing with the business cycle and at times due to unexpected factors. Because banks are not allowed to change rating systems and methods of estimating parameters without supervisory permission once they have received approval to use the IRB approach, the volatility of parameters will result in sudden changes in banks' capital requirements, which present challenges.
- *Promoting market discipline through education of market participants*. Japanese banks have been diligent in making Pillar 3 disclosures based on the Revised Basel II Framework. However, for this to lead to market discipline, it is important for market participants to be educated not just on Pillar 3 but also on Pillar 1 issues. Supervisors and the industry are developing a joint forum to help educate the market, but this is a process that is likely to yield results only after a considerable period.
- *Requirement for skilled human resources*: MUFG maintains a decentralized global data system due to the relatively small size of most of its overseas subsidiaries, which entail significant requirements for hiring and retaining skilled human resources. The group-wide aggregation of data for Basel II implementation requires a considerable number of personnel with risk

management and data management skills, while the periodic estimation and validation of parameters and rating systems require quantitative skills.

There was also a discussion on the use of economic capital (also known as risk capital) as a tool for gauging the unexpected loss of a bank's credit portfolio, and other key functions in Asian emerging market banks, based on the experience of Chinatrust Commercial Bank. The distinction between regulatory and economic capital is that the former refers to the minimum level of capital needed to meet regulatory requirements, while the latter refers to the maximum level of unexpected losses that can potentially emerge from all sources that the bank can absorb, while remaining solvent, at a given level of confidence and over a given time horizon.

The concept of economic capital, which has many applications, is used by CTCB for a number of key applications. First, it is used in risk governance (determining the risk appetite of the bank). The amount of economic capital held by a bank reflects its risk appetite by making explicit how much risk the institution is willing to take. It is linked to the bank's target credit rating – the higher the rating, the greater the amount of economic capital required.

Second, it is used in the internal capital adequacy assessment process to comply with Pillar 2 of Basel II, in particular with its first and second principles. Principle 1 states that banks "should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining capital levels." Principle 2 requires supervisors to "review and evaluate banks' internal capacity adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. In Taiwan, the regulatory authority requires banks using the IRB for credit risk to also measure their economic capital, given that Pillar 1 requirements are primarily for regulatory purposes and not necessarily for the purpose of bank capital planning and overall risk management.

Third, economic capital is used in dealing with credit rating agencies (CRAs). CRAs consider capital ratios as only one of several factors in assigning ratings (historically, capital ratios have tended to be inversely correlated to ratings, with highly rated banks being more leveraged than those with lower ratings). CRAs tend to reward disclosure of economic capital; one global rating agency even revising its rating methodology to reward such disclosure, as well as stress testing. Other factors that CRAs consider important are an extensive franchise, a diversified business mix, robust risk management and stable and predictable earnings.

Fourth, it is also used in internal performance management and investor communication, including capital allocation, strategic decision-making process, limit setting and pricing. Economic capital is a component of two important measures – risk-adjusted return on capital (RAROC) and economic profit (also known as shareholder value added or SVA), which extend the traditional return on equity measure by incorporating risk and used by both investors to distinguish between different risk-return profiles and bank management for business planning.

In CTCB, economic capital is compared to the regulatory capital under the AIRB approach for various industries to identify concentration risk by determining whether Basel II AIRB underestimates or overestimates unexpected losses. Where economic capital is determined to be greater than the regulatory capital for a certain industry, the bank undertakes further studies to understand the industry's profitability and outlook as well as relationships and business strategies. Where the opposite is the case, the bank considers the prospects for expansion considering the industry outlook, market size and cross-selling opportunities.

Using the AIRB approach to measure RAROC, the bank uses the latter as a key performance measure to assess whether the return exceeds the bank's hurdle rate

(using cost of capital), as well as economic profit to measure how much value is contributed by various industries. By analyzing the relationship between RAROC and capital usage, the management is able to obtain a picture of how to allocate limited capital across industries, focusing on industries that contribute the most to risk-adjusted profit.

There are a number of key issues involved in using the economic capital model. One is the accuracy of the model. Success in implementation requires an adequate prior understanding of the model and the assumptions. Surveys indicate that about two-thirds of banks are using vendor models instead of those developed in-house. Different models produce different results based on features of each vendor model. The time horizon for estimating economic capital is also important, since a longer tenor requires more economic capital. Banks need to understand the methods used in estimating economic capital and develop confidence internally before communicating with regulators and rating agencies.

A second is whether a bank should aim for a lower economic capital. The level of economic capital a bank aims for depends to a large extent on the credit rating it wants to have. The higher the rating a bank wants to have, the more economic capital it needs to hold. In addition, it is more useful for a bank to focus on using it together with return data to measure risk-adjusted profitability to gauge the performance of the portfolio and the efficiency with which shareholder funds are being used.

A third issue is whether economic capital is useful in attracting investors. Investors normally look at simpler indicators, such as earnings per share (EPS), since RAROC is not directly correlated to share prices. However, economic capital and risk adjusted performance measures (RAPMs) indicate how well a bank knows its risks and whether it is returning value to shareholders. The use of RAPMs will eventually be reflected in the EPS by improving the transparency of the banks' risks and by providing an alternative indicator for investors to measure the bank's performance.

CTCB's experience highlights the importance to banks of continuous external communication with regulators, rating agencies and equity analysts, as well as internal communication within the organization in order to promote confidence in the process. Beyond using the economic capital concept, banks need to create value through active credit portfolio management in order to sustain growth through economic cycles and deliver stable and sustainable profit growth for the banks' investors.

The implementation of Basel II in Hong Kong provides valuable insights on the issues faced by emerging market regulators in Asia. The HKMA had begun preparations even before the accord was finalized, and implemented Basel II in line with the timetable set by the Basel Committee, i.e., at the beginning of 2007 for most approaches and at the start of 2008 for the AIRB approach. Detailed requirements were set for the three Pillars, validation of IRB systems, use of internal models for general market risk, supervisory review process and application of disclosure rules.

The implementation of Basel II is important for Hong Kong due to its status as an international financial center. There are more than 200 authorized institutions (AIs) in the territory, 68 of which are locally incorporated entities subject to capital requirements set by the HKMA and 23 of which are licensed banks. In addition, 70 of the world's 100 largest banks operate in Hong Kong. For these reasons, cooperation between home and host economy supervisors is important, particularly with respect to the use of the IRB approach by foreign bank subsidiaries.

In addition to ensuring adequate capitalization, the HKMA pursues other objectives in the process of implementing Basel II. It seeks to accommodate AIs with varying

levels of business complexity and risk management sophistication. It needs to provide flexibility for AIs to choose the approach that best suits their operations. The HKMA also sees Basel II implementation not merely as an exercise in regulatory compliance, but more importantly to provide incentives for banks to raise their capability to manage risks and so to enhance their competitiveness and the safety and soundness of the banking system.

The HKMA has made available all the Pillar 1 approaches to credit and market risk measurement provided for by Basel II. In addition, it also offers a Basic Approach for credit risk as an intermediate approach between the Standardized and the IRB approaches. For operational risk, the HKMA offers the Basic Indicator Approach, the Standardized Approach, and an Alternative Standardized Approach. So far, only few of the banks have opted for the more advanced approaches (4 banks have transitioned to the IRB approaches for credit risk and 3 banks are using the internal models approach for market risk.

The HKMA is actively assisting AIs in implementing Basel II in several ways. First, it has undertaken extensive consultations with the banking industry during the process of formulating policies and setting rules. Second, it regularly provided information to senior bank executives on the implementation process in Hong Kong. Third, it has published implementation guidelines and rules on major areas of Basel II implementation.

In implementing Pillar 2, the HKMA's efforts focus on the Internal Capital Adequacy Assessment Process (ICAAP) that each local AI is expected to establish. AIs are not required to use the economic capital model. This process covers all material risks not covered by Pillar 1 and is directed toward assessing risk management capabilities. There is flexibility in accommodating divergences in ICAAP practices to take account of different complexities of operations and deadlines for full compliance.

In undertaking supervisory review, the HKMA relies on scoring templates that have been developed in-house, focusing on residual material risks including concentration risk, banking book interest rate risk, liquidity risk, reputational risk and business cycle risk, but expecting to increasingly rely on the AI's ICAAP over time.

The implementation of Pillar 3 in Hong Kong reflects in addition to Basel II requirements also the impact of accounting changes and the expectations of users, and so covers information on capital, risk exposures, risk assessment processes and the capital adequacy of AIs. AIs are encouraged to demonstrate the robustness of their risk management systems. Accordingly, the scope and extent of required disclosures depend largely on the nature, size and level of complexity and sophistication of an AI's business.

The HKMA's experience so far indicates that for simpler approaches, implementation has been without major problems. With respect to the use of IRB approaches, key problems encountered include loose ends in meeting use test and inconsistent PD estimates. Banks face challenges with respect to knowledge gaps; the lack of default and loss data for model development and validation; inadequate awareness of the importance of data integrity; changing risk management practices, culture, internal control and oversight frameworks; the complexity of calculating the capital adequacy ratio, reporting mechanisms and IT systems to be developed; and how to develop expertise in the use of economic capital models for ICAAP purposes.

Supervisory authorities also face a number of important challenges. 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.

Summing up the experience of Basel II implementation in Hong Kong, the implementation of Pillar 1 is proceeding reasonably well; work on Pillar 2 implementation in the case of IRB banks still has some way to go, particularly with respect to those using economic capital models for ICAAP purposes; and the effects of Pillar 3 will be fully apparent after all IRB banks report their end-December 2008 positions.

B. ENHANCING REGULATORY COORDINATION AND RESPONSE TO CROSS-BORDER CHALLENGES IN IMPLEMENTING BASEL II

Two presentations[3] provided insights on the cross-border challenges that regulators and banks face in the implementation of Basel II. One provided a broad overview and the other a case of a major Asian bank with significant overseas operations.

There is considerable diversity among Asia-Pacific economies with respect to the implementation timeline of Basel II (see Figure 2 below). Nevertheless, by the end of 2009, the more mature banking economies in the region would have mostly completed preparations for implementing basic and advanced approaches for credit and operational risk. As far as the less developed economies are concerned, most would have done so by the end of 2010, although two major economies, China and India, will not be adopting Basel II.

FIGURE 2: Basel II Implementation Timeline in the Asia-Pacific *(as of August 2008)*

Economy	2007	2008	2009	2010	2011	2012	2013	2014	2015	None*
Mature Banking Economies										
Australia			○●□■							
Hong Kong	○□		●							■
Japan	○□		●■							
New Zealand			○●□■							
Singapore	●■	○□								
South Korea			○●□■							
Taiwan	○□		●■							
Emerging Banking Economies										
Indonesia			○□	●■						
Malaysia			○□	●■						
Pakistan			○□						●■	
Philippines	○□			●■						
Sri Lanka			○●□				■			
Thailand			○●□■							
China										○●□■
India										○●□■

LEGEND:
○ Credit Risk Basic Approach
● Credit Risk Advanced Approaches
□ Operational Risk Basic Approach
■ Operational Risk Advanced Approaches
*No timetable in the case of Hong Kong, no compliance with Basel II in the case of China and India

Source: KPMG Business Advisory Services Sdn Bhd, dialogue participants

In general, mature banking economies implementing Basel II have mostly reached the final stage of testing and validation for Pillar 1, both with respect to credit and

[3] These were presentations made by Mr. Eckhart Koerner (Director of Financial Risk Management at KPMG Business Advisory Services Sdn Bhd), who gave an overview on the cross-border challenges to Basel II implementation, and Mr. Hideaki Tanaka, a presentor in the previous session, who presented the experience of MUFG.

operational risk. Most emerging economies, in contrast, while having already gone through project planning and diagnostic review, will still have to complete assessments of detailed requirements, the design and building of systems and models, implementation and integration, before finally reaching the stage of testing and validation. Both mature and emerging markets are still several stages away from completing preparations for Pillar 2 and even further with respect to Pillar 3, with emerging markets in general lagging behind.

These and various other factors account for a number of cross-border implementation issues that need to be addressed. Among these are the following:

- the application timeline for Basel II reporting;
- the scope of application, particular in relation to subsidiaries;
- with respect to credit risk, consistency across jurisdictions of requirements for the more advanced approaches (e.g., default and loss definition, data history) and acceptance of credit risk mitigation techniques (e.g., in relation to valuation of real estate) by home and host regulators;
- market and operational risk requirements for the advanced approaches, in particular with regard to timelines for implementation;
- Pillar 2 ICAAP understanding of proportionality, especially in cases where a subsidiary is not as sophisticated as the headquarters; and
- Pillar 3 disclosure with respect to materiality, frequency and confidentiality.

The case of MUFG, which is the most globally active Japanese bank, illustrates a number of these issues. As of end-April 2008, there were 450 overseas offices of BTMU, spread across the globe, including 140 subsidiaries. The Basel II framework is applied to the whole banking group and banks within the group on a consolidated basis. No adoption at the individual branch level is required. With the exception of one subsidiary, the Union Bank of California, which is using AIRB for credit risk and AMA for operational risk, all the major overseas subsidiaries are using the standardized approach for credit risk. For operational risk, they use the standardized approach, although for reporting to host regulators, the Basic Indicator Approach is used instead.

Current rules applied by Japan's FSA require banks that adopt the IRB and AMA approaches for part of its holdings to extend these across the entire banking group. However, if its exposures in non-significant business units and asset classes are not more than 2 percent of total credit risk assets, a bank is exempted from the requirement with respect to the IRB approach. Similarly, if total gross revenue of its operations in immaterial business lines and entities comprises not more than 2 percent of the consolidated P/Ls, the bank is exempted from the requirement with respect to the AMA approach. Most subsidiaries of MUFG qualify for this exemption since they fall below the 2 percent mark.

MUFG uses a decentralized system for aggregating credit risk assets, which are calculated by each subsidiary, instead of a centralized system where the head office calculates these using data from subsidiaries. The subsidiaries report the results of their calculation to the head office, which then aggregates these results.

In using this decentralized system, the main cross-border issue for MUFG with respect to Pillar 1 arises from the adoption of AIRB and AMA by its major American commercial banking subsidiary (the UnionBancal Corporation or UNBC) under Basel II rules in the US. As the UNBC also needs to comply with Japanese rules, MUFG is responsible for articulating the differences between US and Japanese rules and communicating with the Japanese FSA regarding the consolidated basis for

compliance. Given this situation, flexibility of the home regulator is key to effective implementation.

There are no cross-border issues related to Pillar 2 so far, as there is no global standard or guidance on Pillar 2 and supervisory review processes in many jurisdictions still appear not to have fundamentally changed. With respect to Pillar 3, disclosure is made on a consolidated group basis in the home jurisdiction. Most host regulators exempt the subsidiary banks from Pillar 3 disclosure requirements, since Pillar 3 disclosure at the branch level is not useful from a market discipline point of view.

From a regulator's standpoint, the key issue arising from the cross-border implementation of Basel II in the region 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, particularly to come to an understanding of the extent of reliance on home supervisors with respect to foreign bank subsidiaries, each other's approval process and interpretation and practical application of Basel principles, as well as to share information on how these are undertaken. This underscores the importance to the region of the role of supervisory colleges and regional forums.

Discussions during the open forum focused on a number of issues. One is the use of national discretion as a challenge for banks in the cross-border implementation of Basel II, such as in the definition of default, which varies among jurisdictions. Another is the need for effective communication between home and host supervisors with respect to review and approval of banks' applications to use the IRB approach to ensure that there are no supervisory gaps. Home and host supervisors also need to maintain ongoing dialogue through bilateral or supervisory college meetings to address changes in bank rating systems.

C. BASEL II PILLAR 3 AND INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

In the session on Pillar 3 and IFRS, presentations[4] included an overview of Pillar 3 and IFRS, integrated financial and regulatory risk disclosure, and experiences in implementing Pillar 3 from the standpoint of a bank and a regulator.

The goal of Pillar 3 is market discipline through disclosure to enhance soundness and safety of the financial system. Better disclosure would lead to greater transparency of business and risk structures of banks, as well as positive incentives to strengthen their risk management and internal control systems. Through improved disclosure, investors would be able to distinguish between well-managed and badly-managed banks, and use this knowledge to update their portfolio strategy and their calculation of an appropriate risk premium. Well-managed banks would thus benefit from better market conditions, while badly-managed banks would be penalized by the market.

The goal of IFRS is to provide fair presentation of the financial position, performance and changes in financial position of an entity, facilitating economic decisions of a wide range of users, through high quality, transparent and comparable information in

[4] Presentors in the session on Pillar 3 and IFRS were Mr. Rajendra Theagarajah (Managing Director and Chief Executive Officer of Hatton National Bank), who provided an overview of Pillar 3; Mr. Koerner of KPMG, who talked about integrated financial and regulatory risk disclosure; Ms. Claudia Kuan (Manager at the Enterprise-Wide Risk Management Division of Chinatrust Commercial Bank), who presented the experience of her bank in the implementation of Pillar 3; and Mr. Walter Yao (Senior Manager at the Federal Reserve Bank of San Francisco), who discussed the implementation of Pillar 3 in the United States of America.

the financial statements. Three specific standards relating to banks are IAS 32, IAS 39 (which introduced and significantly extended the use of fair value in financial instruments) and IFRS 7 (which requires entities to provide disclosures in financial statements that will enable the users to evaluate the significance of financial instruments for the entity, the nature and extent of risks arising from the use of such instruments, and how the entity manages such risks).

There is an overlap between Pillar 3 and IFRS 7 with respect to several types of risks – credit risk, market risk, interest rate risk, equity risk and operational risk. IFRS 7 also covers liquidity and commodity risks, which are not covered by Pillar 3. IFRS has been revised to reflect the evolution of techniques in risk management and exposure, while Basel II allows banks to rely on disclosures made under accounting requirements to fulfil the applicable Pillar 3 expectations. Synergy between Pillar 3 and IFRS may be harnessed in a number of areas, such as improved common education of senior management, common verification and internal audit regimes, availability of skilled resources, experience of IFRS implementation, closer collaboration between finance and risk functions, improved data quality and availability, and universally enhancing qualitative risk disclosure.

There are still a number of challenges with respect to the implementation of IFRS. One set of challenges is related to IAS 39, particularly in bridging two accounting models – traditional cost-based accrual accounting and a system that is more reliant on market values. The use of the fair value option in derivatives can lead to the possible introduction of unnecessary accounting volatility in financial statements, while using fair value for a growing number of financial instruments can have a significant impact on a bank's investment portfolio.

The complexity of hedge accounting presents a challenge, as not all economic hedges will qualify, and those that do will require detailed documentation. With respect to impairment provisions, these will depend not only on the recoverability of loans but also of interest, and will entail revision of the current policy of interest suspension. There is also a different accounting treatment for purchased loan portfolios, which will depend on future intent, such as when loans are deemed as trading, available for sale and held to maturity. There are challenges in the fair valuation of liabilities, in particular with respect to liabilities that meet the definition of being held for trading, to their credit risk and to the gains or losses to income statements. Finally, the presentation of debt and equity would affect banks' earnings before tax.

Another set of challenges is related to disclosure and transparency. Increased disclosure implies that full information on the assumptions used to measure fair value will have to be made, but leaves open the question of how much disclosure is needed, as voluminous reports place the onus on readers. Inadequate disclosures will result in external auditors making qualifications on financial statements, the risk of non-compliance with accounting standards and possible violation of directors' legal obligations with respect to financial reporting and a poor corporate image. Excessive disclosures may on the other hand result in making valuable information available to competitors, managers becoming extremely risk averse and affecting profitability, and additional costs and effort.

Banks in the region face several challenges in implementing IFRS. These include the following:

- Impairment measurement of loans, with regard to realizable value of collateral, subsidized housing loans and vehicle loans given to staff and rescheduled loans and bullet payments.

- Implementation costs, particularly the cost of software, data collection and validation, construction of valuation models and cost integration of GL with subsidiary systems.
- Limited rating agencies to allocate appropriate capital against various categories of loans.
- Human resources limitations, especially capacity to implement a market value based approach.
- Earnings volatility, with earnings varying depending on the products and services offered by banks.
- Capital management, with respect to the need for banking regulators to redefine Tier 1 and Tier 2 capital whenever definitions of accounting capital and regulatory capital differ, and the difficulty in maintaining consistent payout due to possible volatility of earnings.
- Governance, in relation to directors' legal obligations concerning financial reporting and the need for high level of expertise and commitment complemented by training.
- Tax implications of the treatment of unrecognised gains and losses for purposes of taxation and the impact on earnings per share and share prices, as well as of the treatment of impairment losses.
- The current economic environment, characterized by high inflation and extreme volatility of domestic interest rates; heavy dependence on the banking sector for credit to the property sector due to underdeveloped capital markets and preference of savers for investment in property rather than corporate credit; and the relatively low return on equity of the banking sector with heavy dependence on credit income.

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 the information requirements driven by various stakeholders. Management reporting is driven by the information needs of senior management, controlling divisions and directors. Regulatory reporting is driven by requirements posed by supervisors to ensure market discipline and compliance. Financial reporting is driven by information requirements of capital markets, including rating agencies.

The experience of KPMG in the development of integrated risk reporting systems provides several observations on risk disclosure. First, synergies between Basel II and IFRS have been identified, particularly with respect to project management, overlaps in methodology (e.g., default definition, collateral management and impairment), capital management and disclosure, and data management and IT infrastructure). However, not many institutions are actively using them, due to the complexity (and cost of integration) of Basel II and IFRS projects, differences in time frame of implementation and responsibilities for both types of projects, and the lack of a common data base.

Second, risk and finance parameters continue to be used in managing banks, with a combination of accounting and regulatory driven performance indicators and the economic view for credit risk management, pricing, performance measurement and segment reporting. Third, greater convergence between the risk control and regulatory reporting functions in banking organizations is expected.

Efficient reporting systems would achieve a number of goals. These include compact and clearly structured reports that are focused on essentials; meaningful

presentations of business performance ex-post and ex-ante (including scenarios); content and format that are designed according to the needs of institutions and stakeholders and are customized to fit specific situations; in-depth comprehension of fundamental business and value drivers; consistent language that avoids discussions of definitions, methods and similar issues; illustration of the varying requirements and perspectives of internal and external stakeholders; and consistency of reporting.

Sample risk reports can provide a tool box for fulfilling risk disclosure requirements, with respect to both regulatory disclosure under Basel II and IFRS annual reports. The basic structure of a sample risk report would include information on capital, capital adequacy and types of risk (encompassing credit, operational, market, liquidity and other risks). It would provide both qualitative and quantitative information including tables referring to regulatory reporting and IFRS-specific tables.

Chinatrust Commercial Bank provided an example of how Pillar 3 is being implemented in the region's banking sector. Beginning in 2008, banks in Chinese Taipei are required to set up a "Capital and Risk Management" section on their home page for Pillar 3 disclosure. Disclosures related to capital structure and capital adequacy include scope of application, capital adequacy ratio and total eligible capital with separate disclosures of the composition of Tier 1,2 an 3 capital. Those related to risk exposure and assessment cover credit, market, operational and securitisation risk; risk strategy, policy and management; risk organization framework; risk measurement and mitigation; and risk exposure and required capital for each type of risk.

The bank's framework for risk disclosure has been designed to be broader than the regulatory requirement, in order not just to disclose its financial position and risk profile, but also to improve investors' understanding. The types of risk covered by the risk governance, management and measurement framework include not just credit-, market and operational risk, but also banking book interest rate and liquidity risk, which are not required under Basel II.

CTCB's full disclosures of the risk cycle are important also for internal purposes and for facilitating communication with investors. At the center of the process is an independent risk organization that undertakes risk monitoring (through regular risk reports and concentration monitoring), risk control (mitigation through collateral, insurance, hedging and securitisation), risk identification and measurement (including identification of risk drivers and measurement of credit, market and operational risk) and determination of risk appetite (including risk strategy, risk policy and limit setting).

Disclosures are undertaken for risk governance within the organization, risk management and measurement tools (which include credit model construction and implementation, the risk measurement framework, retail credit model construction and implementation, retail segmentation, credit risk concentration analysis, market risk measurement model construction and liquidity risk management) and risk management application.

A major challenge for Basel II implementation illustrated by the experience of CTCB is how banks can be encouraged to move toward more sophisticated risk measurement approaches. Comparing IRB and Standardized approaches with respect to a normal portfolio in G-10 economies and in Asian emerging markets, incentives for Asian emerging market banks to move toward the IRB approach are not as large compared to G-10 banks. There is a need for regulators in the region to ensure a level playing field for IRB banks.

From a regulator's standpoint, various implementation issues related to Pillar 3 need to be addressed. The experience of the United States provides some insights. After a

period of receiving comments from the banking industry, the Joint Final Rule on Advanced Capital Adequacy Framework was issued in November 2007. The Joint Notice of Proposed Rulemaking (NPR) to implement the Basel II Standardized Risk Based Capital Framework was issued in June 2008 with a 90-day comment period.

US banking regulations require only the largest or internationally active banks to adopt Basel II, and allow the use of only the Advanced IRB for credit risk and AMA for operational risk. Banks in the US are divided into three categories. Mandatory banks are those with either total assets exceeding US$250 billion or foreign exposure exceeding US$10 billion and are required to adopt Basel II. Opt-in banks are those not required but choose to adopt advanced approaches after assessing the costs and benefits of adoption; in this case they must adopt both AIRB and AMA and become subject to the same rigorous standards as the core banks. General banks are those who choose either to stay on the current risk-based capital standards under Basel I, or adopt the Basel II Standardized Approach as proposed by the June 2008 NPR.

There is a very strong disclosure culture in the US. Many Pillar 3 requirements already exist under current rules, which include current Securities and Exchange Commission and GAAP disclosure requirements. Nevertheless, US bank regulators have developed approaches to a number of Pillar 3 implementation issues.

- With respect to its application to entities, many subsidiaries of global firms operate in the US, but public disclosure requirements will generally be required only at the top-tier global consolidated level.
- With respect to frequency and timeliness, quarterly disclosures have already long been implemented in the US, with 45 days after the end of each quarter considered as “timely disclosure.”
- Regarding attestation requirements, regulators require the Chief Financial Officer, the Chief Risk Officer or an equivalent senior officer to certify that the disclosures are appropriate. These are similar to the requirements under the Sarbanes-Oxley Act with respect to financial statements.
- Regarding proprietary and confidential information, banks are expected to provide disclosures without revealing such information, but there are provisions for exceptional cases.
- With respect to the location of disclosures, regulators do not prescribe any fixed formats, and allow bank management discretion to determine the appropriate medium and location of the disclosures.

Regulatory agencies also require certain additional regulatory reporting of key risk parameter estimates through regulatory reports. These provide supervisors with data that are needed for assessing the reasonableness and accuracy of the bank’s calculation of its minimum capital requirements and the adequacy of capital in relation to its risks.

The ensuing discussions highlighted a number of issues that are relevant to banks and regulators in the region. One is the importance of training in the implementation of Pillar 3 and IFRS in developing economies. Although there are programs in place, in many developing economies, the availability of qualified people, e.g., to act as independent directors, remains a major challenge. Another issue is the need to avoid a “one-size-fits-all” approach to implementation and the importance of adapting regulatory frameworks to suit local conditions and challenges.

A third issue is the impact of the adoption of advanced approaches on lending to SMEs. The experience of banks in the region has shown a decrease in lending to SMEs with the adoption of such approaches. A fourth issue is the implementation of IFRS in the US. The US SEC is preparing a roadmap for the implementation of IFRS,

with foreign issuers being allowed to use IFRS without having to comply with GAAP. The IASB and FASB are currently working together to address convergence issues, and a study is being undertaken regarding the implementation of fair value accounting standards.

III. CORPORATE GOVERNANCE IN BANKING ORGANIZATIONS

The session on corporate governance revolved around issues discussed in the presentations,[5] which focused on facilitating cultural change in banking organizations and corporate social responsibility, the Indonesian experience in improving bank governance, corporate governance and financial system resilience, and making boards and regulatory agencies more responsive and effective.

Good corporate governance[6] in financial systems is important due to the pivotal economic role of the financial sector, as custodian and mobilizer of public funds, channel for monetary policy transmission, provider of risk protection and enabler of business activities. While every firm needs to practise sound governance, it is especially critical for banks because they are highly leveraged and rely extensively on deposits, so their boards have a responsibility for the sound stewardship of these funds. Banks are also more likely to be bailed out by governments for the benefit of their customer base and because problems in the banking system can pose systemic risks.

These factors underscore the need to maintain the financial sector's integrity and public confidence for the sake of financial stability. Recent experiences demonstrate that weak oversight, poor risk management, weak internal controls and market

[5] Presentations were made by Mrs. Juliet McKee (member of New Zealand PECC, company director and advisor on corporate governance), who discussed the issue of facilitating cultural change in banking organizations and corporate social responsibility; Mr. Saifuddien Hasan (Director of the Indonesian Banking Institute), who talked about the Indonesian experience in improving bank governance; Dato' Muhammad Ibrahim (Assistant Governor of Bank Negara Malaysia), who discussed corporate governance and financial system resilience; and Mr. J.P. Sabourin (Chief Executive Officer of the Malaysia Deposit Insurance Corporation), who gave a presentation on improving governance in banking and making boards and regulatory agencies more responsive and effective.

[6] The concept of good corporate governance has been described in different ways, highlighting its various aspects. Following are some descriptions that have been presented in the dialogue:

- Corporate governance is holding the balance between economic and social goals and between individual and communal goals. (Sir Adrian Cadbury, 1999)
- Corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders, and the stakeholders and spell out the rules and procedures for making decisions on corporate affairs. (OECD, 1999)
- Corporate governance is the system by which business corporations are directed and controlled by applying principles of transparency, accountability, responsibilities, independence and fairness. (Common understanding)
- Corporate governance is a set of rules, standards and organizational concept s in economics that regulate the behavior of companies, directors and managers. (World Bank)
- Corporate governance is a mechanism in which shareholders of a business entity exercise control over management and/or other parties within the company to ensure that all their interests are protected. (John and Senbet, 1983)

failures arising from lack of information and spiralling problems make financial institutions vulnerable and ultimately lead to financial system instability.[7]

Institutional failures due to weak governance increase taxpayers' costs and negatively affect the economy in significant ways. With the growing complexity of financial markets and systems, comprehensive governance practices throughout institutions have become necessary. This involves a number of key elements – skilled and capable directors, competitive demand for talent, strong risk management practices, effective checks and balances through controls and procedures, and clear accountability and responsibilities.

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 defense against any impending crisis and unethical business practices.

Governments have an important role to play in promoting strong corporate governance. The Malaysian experience underscored the importance of strengthening guidelines on corporate governance, robust processes for the appointment of directors and chief executive officers and embedded risk management expectations in prudential guidelines. Moving towards a principles-based regulatory framework and greater self- and market-based regulation also promotes a structure and culture of checks and balances, enhances responsibility and accountability, encourages objective views, independent judgment, and the pursuit of strategic objectives that are supported by corporate values.

Since the 1990s, a number of comprehensive reforms have been undertaken to strengthen corporate governance, in particular board effectiveness and accountability, audit committee effectiveness, internal and external audit functions, internal controls and shareholder protection.[8] Taking into account what we have learned from previous years, a focused and holistic approach to promoting good corporate governance could have the following components:

- Effective leadership (e.g., through requirements on financial institutions to have audit, risk management, nomination and remuneration committees).
- Promoting corporate values, culture and ethical values (embedded in various risk management and prudential guidelines).
- Shareholder activism (increased role of minority shareholder watchdog groups).
- Regulation and supervision (through revised guidelines on connected lending, internal audit functions and fit and proper persons).
- Consumer activism (e.g., by educating consumers, providing advisory services to consumers and greater emphasis on corporate social responsibility.

[7] Recent bank failures have been attributed to several of these factors. The collapse of Barings stemmed from lack of compliance, inadequate control procedures and unauthorized activities. In the case of HIH Insurance, an unquestioning corporate culture allowed poor management to continue unchecked. Peregrine Investment failed as the company overextended itself with insufficient regard for governance and risk management. The troubles of Oakwood Bank were rooted in a combination of poor internal controls and a lax board of directors. In the case of Northern Rock, poor credit and risk management practices played an important role.

[8] Among these are the Cadbury Report (1992), King Report (1994), Greenbury Report (1995), CalPERS (1996), Hampel Report (1998), Blue Ribbon (1999), OECD Principles (1999), Turnbull Report (1999), Sarbanes-Oxley Act (2002), Higgs Report (2003), The Smith Guidance (2003) and The Combined Code (2003).

- Enhancing transparency (e.g., through the requirement for the statement of internal controls and CG statement in the annual reports of financial institutions and proper accounts and financial reporting).
- Effective use of auditors (e.g., through greater emphasis on auditor independence and expectation of regulators on auditors).

The implementation of Basel II is expected to enhance corporate governance standards as minimum capital requirements are more closely aligned with banks' actual underlying risk, a culture of improved risk management is fostered and transparency is improved. Nevertheless, success in implementing Basel II still requires good corporate governance in order to avoid over-reliance on internal risk modules and on external rating agencies, address the low emphasis in Basel II on liquidity risk management and ensure that banks have sufficient capital.

In the case of Islamic finance, *shariah* governance is a critical element in ensuring compliance with *shariah* rules and principles and as a reference point for new principles and practices. Governance structures provide the mechanism for deliberation of *shariah* issues. They provide for harmonization and uniformity of *shariah* interpretations and reference points for court decisions, and give reasonable assurance to the public at large regarding the *shariah* compliance of products and services. *Shariah* committees at financial institutions provide checks and balances to ensure *shariah*-consistent policies and procedures.

Efforts to promote good corporate governance in financial institutions face a number of challenges. One is getting the right people to serve on boards and management, given the complexity of the business environment and new financial products. This requires finding competent leaders who also understand the business products and risks, have a healthy scepticism and know how to ask the right questions. The scarcity of talent needs to be addressed.

Another challenge is the need to establish a cadre of truly independent directors, and ensure substance over form with respect to their independence. Transparency issues form another set of challenges, including how to balance disclosure requirements, ensure understanding by users while safeguarding confidentiality of customers' affairs. It is also impossible to legislate integrity and ethics. 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.

The current financial crisis has underscored the need to strengthen governance in financial institutions. It 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. In this context, training and development of directors assume greater importance.

Enhancing corporate governance in banks requires addressing a number of issues. The first is promoting accountability. Boards and management should be held to account if their respective financial institutions experience serious problems as a result of flawed business strategies or models. The second is enhancing technical expertise and competence, independence and information flows. The complexity of new products, trading strategies and financial information poses a challenge to directors, who may not necessarily have sufficient expertise to understand them. The failure of boards to see risks can be due to inadequate information provided by management or unwillingness of directors to question management.

The third is independence of the board from management. Among the best practices in this area are the separation of the positions of CEO and Chairman; a process or

culture that requires management to provide the board with relevant, timely and clear information; use of internal and external auditors to ensure the integrity of internal control systems; adequate time and tools for directors to help supervise management; and the establishment by the board of appropriate risk management policies and appropriate controls.

The fourth is working with management, whereby the board and the CEO clearly understand their respective roles. The fifth is ongoing support and education. Effective boards are those that have access to industry experts who can provide inputs into management's risk appetite and highlight the risks involved, and those whose members are able to avail of continuous enhancement of their skills. The sixth is promoting attitudes among board members that lead them to promote integrity and actively challenge the management in a positive way.

Regulators have an important role to play in improving corporate governance in financial institutions. In order for regulators to understand and keep updated on market developments, they need continuous access to ongoing training and human resource development activities. There is a need to ensure that the regulatory burden is proportionate to the risks. The governance of regulatory agencies should follow international best practices and exceed the OECD corporate governance guidelines. Regulatory agencies should continuously assess themselves.

The experience of Indonesia illustrates the realities faced by developing economies in promoting good corporate governance in the region. Prior to the Asian financial crisis, governance practices in financial institutions left much to be desired, particularly with respect to independent directors, reporting on financing to related parties, risk management and the structure of directors' meetings. The financial crisis changed the situation, as IMF requirements in exchange for assistance included the implementation of good corporate governance as an integral part of bank restructuring.

In 1999, Indonesia set up a national committee on good corporate governance, which issued guidelines in 2001. Meanwhile, consultants were hired to help implement good corporate governance within the context of bank restructuring. In 2002, the government issued guidelines that would apply to state-owned banks. In 2003, the capital market regulator issued guidelines for public companies. In the same year, the central bank established good corporate governance as one of several pillars of the Indonesian banking architecture. In 2004, special guidelines were issued for the banking sector. In 2006, the central bank issued comprehensive rules on good corporate governance.

Within the Indonesian banking architecture that emerged from post-crisis financial reforms, good corporate governance forms one of the pillars of a strong and sound banking system, contributing to a healthy banking industry. The central bank pursues the improvement of good corporate governance in the industry through a comprehensive framework that focuses on the role of executive and non-executive directors, committees, compliance, internal and external auditors, risk management, related parties and top borrowers, the bank's strategic plan and transparency.

In line with the new emphasis on transparency, every bank is required to report its implementation of good corporate governance and a self-assessment. Reports are to be submitted to stakeholders, which include the central bank, the industry association, media, the consumer protection agency, economic research institutions and rating agencies. Banks are expected to include information on their weaknesses and corrective action plans in their self-assessment reports. The central bank rates corporate governance in banks using a scale of 1 to 5.

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. Efforts will have to focus on the factors that influence culture within the organization – the quality of leadership, the organizational structure, technology and systems and processes. Another key issue is promoting corporate social responsibility, in order to address the impact of the firms' activities on society, the economy and the environment, while finding the right balance between the interests of shareholders and those of stakeholders.

IV. PROMOTING ROBUST CREDIT REPORTING STANDARDS

The presentations[9] in the session on promoting robust credit reporting standards focused on lessons for information sharing standards in the Asia-Pacific region, a discussion of best practices for efficient credit reporting systems and the experience of Thailand. Private sector groups, including ABAC and the Asia-Pacific Credit Coalition, have been supportive of promoting full-file and comprehensive credit reporting to private credit bureaus in the region, together with the development of a standard that meets the OECD Fair Information Practices (1980) that provides to data subjects rights of notice, access, choice, notification of adverse reactions, dispute and correction to ensure that only responsible and experienced actors will collect and maintain the data.

There has been a long history of investigation and study of information-sharing, and 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. The following data support these conclusions:

- In the US, acceptance rates climb as information moves to full-file from negative-only reporting in all cases.
- Using US data, default rates climb as information moves from full-file to negative-only reporting in all cases, as good risks are not effectively distinguished from bad ones.
- Data sharing improves the quality of information for risk provisioning allowed under Basel II. Consequently, there are lower default rates, lower capital requirements and lower credit constraints.
- Regarding the distributional consequences of full-file as compared to negative-only credit reporting, results using US data on real credit files show disadvantaged population segments (particularly racial-ethnic minorities, young people and low-income groups) gaining greater access than others. Simulations using Colombian data show that only women accounted for only 33% of acceptances under negative-only credit reporting, compared to 47% under a full-file reporting regime.

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[9] Presentors in the session on promoting robust credit reporting standards were Dr. Michael Turner (President, PERC), who made the presentation on lessons for information sharing standards in APEC; Mr. Anthony Hadley (Vice President for Government Affairs at Experian), who talked about best practices for efficient credit reporting systems; and Dr. Twatchai Yongkittiul (Secretary General of the Thai Bankers' Association), who discussed the Thai experience.

- Comprehensive credit reporting increases lending to the private sector by as much as 45% of GDP. Statistical tests show that an increase in private sector lending by 30% of GDP can increase GDP growth rates by 1%, productivity growth by 0.75% and capital stock growth by 0.75%. An increase in private sector claims by 50% of GDP lowers the growth of the Gini coefficient by at least 0.25%, lowers the growth of percentage of the population living under US$1 per day by at least 2%, and increases the growth of the lowest quintile's income share by at least 0.45%.

Comprehensive and full-file credit reporting also helps prevent identity theft. The significant decline of identity theft in the US between 2003 and 2008 has been achieved through a number of measures. Financial services firms have invested in internal neural networks that detect anomalies in spending patterns. There was an increase in investment in third-party information services for remote transactions that authenticate information on individuals in real time. Finally, data tools rely on compiled information from multiple sources aggregated to comprise "digital identities."

A survey using the World Bank's Doing Business Database illustrates that wealthier regions and the wealthier economies within APEC, have both strong creditor legal rights (with respect to collateral and bankruptcy) and extensive credit information. Efficient credit reporting systems are backed up by effective protection of creditor rights to enforce and take collateral, robust bankruptcy laws, consumer protection and privacy laws, case law and consumer education and financial literacy. The development of credit reporting systems also reflects cultural values related to indebtedness, financial privacy and information sharing, competition, economic development and opportunity, and future economic vitality.

Effective credit reporting systems share a number of characteristics. They maximize the value of cooperative databases; are based upon comprehensive data reporting; facilitate risk-based pricing; recognize the secondary uses of credit information; and evolve to meet consumer expectations, societal demands and technological advances. They are characterized by respect for consumer privacy by facilitating notice of data collection and use, choice of consumer participation, data integrity standards to ensure data accuracy and relevance, data security to guard against misappropriation and misuse, and accountability to ensure compliance with the law.

For credit reporting systems to be effective, it is important for consumer privacy regimes to embrace OECD guidelines. For example, in the European Union, information is a consumer's property right and cannot be collected nor used without consent. In the US, business owns the data, but consumers have rights about its use and disclosure. An APEC framework should allow each economy flexibility, while focusing on reducing harmful uses of data.

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.

A unique aspect of the US system that can be studied for adoption is the recognition of "permissible purposes" for which credit reporting data can be used. These are normally related to the extension of credit, account monitoring or collection, employment applications, pricing homeowner and automobile insurance, determining eligibility for a government license or other benefit, determining suitability of a potential investor, a business need initiated by the consumer, child support enforcement and marketing certain financial services.

Effective credit reporting systems also require that credit bureaus, data furnishers and data users fulfil specific obligations. Credit bureaus must ensure accuracy,

integrity and security of information in consumer files. They must also provide information only for a “permissible purpose.” Data furnishers must ensure the accuracy of the information reported to a credit bureau and participate in the consumer dispute process. Data users much obtain and use information only for a permissible purpose and notify consumers if they are taking adverse action.

A highly articulated consumer protection system is needed that has multiple layers of consumer notification. Disclosures of individual files to consumers should be made via Internet, telephone or in writing when a user or a report takes an adverse action or when a consumer suspects fraudulent activity. The system should also provide for credit monitoring and direct dispute with data furnishers, as well as help upgrade financial literacy.

In regard to consumer dispute and correction of erroneous information, consumers should be allowed to dispute the accuracy of information on file. Credit bureaus and data furnishers have a joint responsibility to investigate and delete inaccurate information, and must accomplish investigation within a reasonable period of time (30 days in the case of the US).

In the US, there are strict data security requirements. The Fair Credit Reporting Act governs the disposal of consumer reports and includes “Know Your Customer” requirements. Financial institutions are also required to establish information safeguards related to network security, access controls, monitoring, testing and employee training. There are also data breach notification guidelines and laws. There is also a comprehensive enforcement system with various levels. These include enforcement by the State Attorneys General, the Fair Trade Commission and banking regulatory agencies; civil penalties for negligent, knowing and wilful violations; consumer right of action for damages against violations; and criminal penalties for obtaining a consumer report under false pretenses.

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. These efforts include the North America Tri-Lateral Committee on Cross-Border Data Rues, the APEC Cross-Border Data Rules under the E-Commerce Steering Committee, and the work of the European Commission Expert Committee on Credit Data.

The experience of Thailand demonstrated how the establishment by law of a credit bureau, a private entity with a 25% government share, has led to a decline in payments default. However, certain features have limited the effectiveness of the system. First, the requirement of written consent for approval of each transaction represents an onerous burden, even after being allowed to be made in electronic form. Second, there is no comprehensive reporting. Third, the period for keeping the data is too short, having been reduced from 5 to 3 years with the introduction of new bankruptcy laws. Finally, there is a need to have more balance between the interests of lenders and borrowers.

The discussions on this subject underscored a number of key issues:

- First, there are clear advantages of full-file and comprehensive credit reporting to private credit bureaus, including increased access and a more equitable allocation of credit; improved lending performance; and increased private sector lending. Efficient credit reporting systems also lead to efficient account management and better prevention and detection of fraud.
- Second, 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.

- Third, improvements in credit reporting systems will require broader measures including protection of creditor rights, improvements in bankruptcy and case laws, consumer and privacy protection and promoting consumer education and financial literacy.
- Fourth, economies can benefit from regional efforts based on serious considerations of best practices in effective credit reporting systems, consumer privacy regimes, the use of voluntary data, recognition of permissible purposes, obligations required of credit bureaus, data furnishers and data users, consumer protection systems, resolution of consumer disputes arising from erroneous information, data security requirements and comprehensive enforcement systems.
- Finally, much work remains to be done, particularly in terms of formulating standards throughout the region and promoting active participation in outreach efforts (including to lawmakers), sharing experiences of best practices and methods of engaging policy makers, legislators and the public at large through the mass media.

V. PROMOTING FINANCIAL INCLUSION THROUGH MICROFINANCE

In this session, the presentations[10] included presentations on the report of a recently concluded regional workshop (Commercially Sustainable Microfinance: A Strategy for Promoting Financial Inclusion in APEC held in Jakarta on January 31, 2008), commercial banks' role in promoting financial inclusion, ideas for a regional cooperation initiative on financial inclusion; and a case study of the Philippines' experience in reforming the policy and regulatory environment for microfinance.

Microfinance institutions (MFIs) first came to prominence in the 1980s, offering small loans to low income households and individuals who did not have access to mainstream finance. Since then, microfinance has undergone remarkable growth, which has accelerated particularly during the previous half-decade, as MFIs significantly expanded their client base and increasingly became linked to banking systems and capital markets.

This rapid transformation has brought about a reassessment of the potential of microfinance not just as a tool for promoting equity and development but also as a commercial undertaking. This reassessment focuses on the following 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

[10] Presentations were made by Dr. Julius Caesar Parrenas (Coordinator of the Advisory Group on APEC Financial System Capacity-Building and Senior Advisor to the Chairman of Chinatrust Financial Holding Co., Ltd.), who presented the report of the recently concluded ABAC/Advisory Group workshop *Commercially Sustainable Microfinance: A Strategy for Promoting Financial Inclusion in APEC* held in Jakarta on January 31, 2008; Mr. Chandula Abeywickrema (Chairman of the Banking with the Poor Network and Deputy General Manager of Hatton National Bank), who talked about commercial banks' role in promoting financial inclusion; Dr. John Conroy (Special Consultant of the Foundation for Development Cooperation), who presented ideas for a regional cooperation initiative on financial inclusion; and Ms. Leny I. Silvestre (Managing Director for Supervision and Examination and Microfinance Committee Member of the Bangko Sentral ng Pilipinas), who gave a presentation on the Philippines' experience in reforming the policy and regulatory environment for microfinance.

institutions have outperformed the commercial banking sector in much of the developing world, especially in Asia and Latin America. In terms of loan portfolio quality using portfolio-at-risk for more than 30 days, data from six Latin American economies show MFIs outperforming their respective domestic financial sector averages. In most regions, MFIs 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 1997 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 is now a fully authorized bank worth US$126 million raising capital from debt and equity markets.

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.

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% 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 and

increase its access to commercial funds. They can accelerate progress toward financial inclusion by identifying the most critical policy solutions.

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.[11] 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 and sharing of experiences and 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 ABAC, 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 APEC economies – expansion of MFIs' activities to banking and capital markets in Mexico and Peru, policy reforms in the Philippines, rapid development of agent and mobile phone banking, just to name a few – can certainly help APEC make a meaningful contribution to the growth of financial inclusion in the region through the promotion of commercially sustainable microfinance.

Within this context, commercial banks can play an important role in promoting financial inclusion. Although they have played a dominant role in the region's financial sector for decades, their involvement in microfinance has so far been limited, especially given the relatively high operational costs and specialized human resources requirements of microfinance operations. However, commercial banks are now beginning to recognize the potential for developing specialized financial services geared to the requirement of microfinance clients, taking into consideration the salient features of microfinance, such as customer loyalty, regular repayment of the use of deposit services wherever available.

Commercial banks possess advantages, in that they have access to liquidity from various sources and existing infrastructure through branch networks. They are able to mobilize significant financial, technological and human resources and have the capacity to either downscale, retail or wholesale microfinance. Having already invested in information technology (IT) and other infrastructure, they are in a good position to develop IT solutions in microfinance.

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[11] Alfred Hannig and Stefan Jansen, Inclusive Financial System Reforms: *What Works, What Doesn't and Why? Synthesis Report,* GTZ, Draft, 2008.

Traditionally, commercial banks, particularly in developing economies, have mainly operated in urban areas. Commercial banks engaging in microfinance operations progressively enter into rural areas, designing deposit products to conform to income characteristics of rural villagers and micro-loans structured to fit cash flow generation patterns of micro-entrepreneurs.

These activities entail adjustments to accommodate micro-loans on unsecured basis, where traditional collateral requirements have to be partially or fully removed. An effective downscaling strategy would require know-how about appropriate lending technology and new organizational structures for providing banking services for micro-enterprises, as well as recruitment of committed staff who are able to build strong relationships with rural microentrepreneurs.

In serving the low-income segment of the population, commercial banks would need to differentiate among five strata composing this segment. At the bottom layer are the poorest, who depend on the earnings of others. Above them are the labouring poor who are employed full-time as unskilled labor. The upper three strata consists of the self-employed poor, who work for their own account and also employ others; the entrepreneurial poor whose enterprises employ five or more people; and the near poor, who have stable wage employment characterized by low-earning power.

Those within these upper three strata are the natural focus of commercial banks' microfinance operations. By focusing on these strata, commercial banks create opportunities over time to grow and graduate microfinance clients to small- and medium-scale customers and lay the foundation for future commercial customers.

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.

However, even while such reforms are still in the process of being put in place, there are innovative ways for commercial banks to undertake microfinance operations, such as through the deployment of owner-managed micro-banking units under a franchise banking model. This could help overcome difficulties posed by the lack of regulations and legal and regulatory frameworks governing microfinance, as commercial banks already fall within existing legal and regulatory frameworks, and franchisees undertaking microfinance operations under such a model can be treated as bank branches.[12]

For many developing economies, migrant worker remittances offer significant opportunities for commercial banks in developing microfinance services. Latest available figures from the World Bank indicate that global remittances now reach close to US$300 billion, half of which are carried out through informal channels. In Asia and Oceania, an estimated 100 million migrants contribute close to US$150 billion in remittances annually, with a significant portion benefiting rural areas, where many of the migrant workers come from.

Currently, a large number of migrant workers and their dependents remain without access to basic financial services through the commercial banking system. Due to

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[12] Under such a model, microfinance operators would operate as franchisees, with the banks as franchisors. Benefits would include easier deposit mobilization as a result of the franchise of a commercial bank's brand and the ability to offer microfinance services to customers that are at the same level of quality as those services offered by the commercial bank to their other customers.

various regulatory obstacles and the low commercial value of their transactions, migrant workers are also not served by commercial banks in the economies where they work.

For commercial banks to tap this market, legal and regulatory frameworks need to be reformed in a number of areas. One is to enable migrant workers to access financial services where they are working during the period of their work assignment, particularly money transfers, savings, credit cards, and short-term micro-loans for the benefit of dependents in their home economies. Another is to facilitate cross-border guarantee of micro-finance facilities, so that, for example, a migrant worker can obtain a foreign currency loan in the host economy for the construction of a house in his home economy. Incentives could also be provided to attract migrant workers to use commercial banks for remittances and facilitate lower costs for such transactions.

Taxation is another issue that is of relevance to commercial banks' role in financial inclusion. Taxation policy has been used successfully in developing economies to promote the development of and investment in agriculture. Ways of applying this to promote commercial banks' microfinance operations need to be considered, particularly to encourage commercial banks to invest in long-term funding, capacity-building and investment in technology.

The Philippines' experience provides insights on how governments can deal with various policy and regulatory issues in promoting financial inclusion. The Philippines has had a long experience in dealing with these issues, starting in the 1960s when various directed credit programs were initiated to address the problem of unequal access to credit and the exclusion of particular segments of society, especially in the agriculture sector, from the credit market. The proliferation of these programs through the next three decades, however, failed to provide sustainable and effective solutions, and instead resulted in large losses to the government arising from subsidies and administrative costs, as well as in distortions in the credit markets.

Calls for a more consistent enabling credit policy environment led to the formulation by the National Credit Council of the National Strategy for Microfinance in 1997. This strategy veered away from active participation of government line agencies in the implementation of credit and guarantee programs. Instead, it focused on the provision of an enabling policy environment and capacity-building, the adoption of market-oriented financial and credit policies (including the use of market-oriented interest rates), and enhancing the role of private MFIs in the provision of financial services to low-income groups.

In support of this strategy, the government enacted laws and issued various executive orders and agency circulars. These provided for the rationalization of government-directed credit programs; capacity-building assistance to MFIs that did not involve seed funding, equity infusion or partnership funds from the government; a purely wholesale role for government financial institutions; the promotion of sustainable, community-based private MFIs, an emphasis on savings mobilization; and a recognition of the peculiar characteristics of microfinance.

There are presently three major types of providers of retail microfinance services in the Philippines: (a) microfinance cooperatives (numbering about 50 significant ones); (b) NGOs with microfinance operations (numbering about 500, with 30 conducting sizeable programs); and (c) rural and thrift banks (numbering over 200). Cooperatives typically provide savings, credit and remittance services to group members, NGOs provide credit, insurance and remittance services, while banks provide mainly savings and credit to the general public. Banks can engage in microfinance by establishing a microfinance-oriented bank, a microfinance-oriented branch, or by offering microfinance as one of its products.

MFIs currently reach around 3 million clients in the Philippines, estimated to comprise two-thirds of the potential market. The landscape of microfinance in the economy is rapidly undergoing major changes, with an expanding range of financial services, a shift away from directed credit and donor dependence toward more market-oriented approaches and financially self-sufficient institutions, a change in emphasis from evolving programs to evolving institutions, and growing commercialization with the entry of new players.

The Philippines' regulatory framework for microfinance covers all types of MFIs, whether bank or non-bank. Deposit-taking institutions, including microfinance NGOs that collect savings beyond the compensating balance, are subject to prudential regulation and supervision, which focus on portfolio quality, outreach, operational efficiency and sustainability, and information transparency.

A number of institutions comprise the regulatory structure. The Cooperative Development Authority is the regulatory authority for credit cooperatives. The central bank (Bangko Sentral ng Pilipinas) regulates and supervises all banks including those with microfinance operations. The Framework also envisions the Microfinance Council of the Philippines, a network of microfinance institutions, to serve as the repository of information for microfinance NGOs. NGOs are not supervised but need to register with the Securities and Exchange Commission.

A uniform set of standards was developed for all MFIs that is applicable to the pecularities of each institution. These were designed for use by regulators, investors, donors, creditors, policy makers and as internal tools for MFIs themselves, and could be used for a rating system that may eventually be developed for the microfinance industry. These standards, with the acronym PESO, consist of portfolio quality, efficiency, sustainability and outreach. Portfolio-at-risk (PaR) is used as a measure of portfolio quality, while the other three components use other applicable ratios. PaR is the outstanding principal amount of all loans that have at least one instalment past due.

The General Banking Law of 2000 mandates the central bank to set the rules and regulations for microfinance within the banking sector. The law also specifically mandates the recognition of peculiar characteristics of microfinance, which include unsecured and cash flow-based lending, frequent amortization and market-based interest rates.

The central bank's policy approach is governed by the objectives of allowing banks to have a wider scope for sustainable microfinance operations and protecting the interests of depositors and microfinance clients and the financial system as a whole. The central bank follows a three-pronged approach, which focuses on the development of a microfinance-friendly policy and regulatory environment, capacity-building through microfinance training within the central bank and the banking sector, and promotion and advocacy.

The central bank has issued to date 14 circulars providing incentives and setting rules and regulations. These cover a wide variety of topics, including the definition of microfinance loans, allowing the establishment of microfinance-oriented banks and branches, opening of the rediscounting facility, adoption of best practices, involvement of large banks in microfinance and liberalized branching to expand outreach to those yet unserved by the banking sector. They also include measures to promote innovation and flexibility in the delivery of microfinance services, such as the approval of the use of microfinance technology to provide other financial products, including micro-agriculture finance, and the use of ICT.

Within the central bank, a high level Microfinance Committee is responsible for all its policies and programs concerning the industry. An Inclusive Finance Advisory Staff

under the Office of the Deputy Governor implements and coordinates various programs and initiatives that promote increased financial inclusion. The central bank also has a Microfinance/SME Finance Specialist Group which is in charge of the supervision and examination of the microfinance operations of banks.

Capacity-building and training programs are being implemented to develop the industry. An active promotion and advocacy program involves information campaigns to improve knowledge and skills in the industry, the creation of networks and linkages to support cooperation and partnerships among stakeholders, as well as other initiatives to promote business development and financial literacy.

The introduction of the new strategy, regulatory framework, performance standards and supervisory approaches has led to the steady development of microfinance in the Philippines. There are now 227 rural, cooperative, thrift and microfinance-oriented banks operating in the Philippines with over 860,000 borrowers and a combined loan portfolio amounting to PHP6billion and collecting over PHP 2 billion in savings from microfinance clients. Commercial banks are increasingly entering the market generally by providing wholesale loans to retail microfinance institutions.

The openness of the Bangko Sentral to innovation has proven very beneficial for the industry. At present, new microfinance products such as Micro-Agri Products and Housing Microfinance Products have been approved by the BSP in response to the specific needs of microfinance clients. Banks are also increasingly using ICT in their operations, which now include mobile phone micro-payments, deposits and withdrawals, among others.

In pursuing the development of microfinance, policy makers and government officials faced and were able to overcome three sets of challenges. The first was related to the paradigm shift from directed credit and government lending to market-driven private sector lending. The second was related to misconceptions about microfinance, such as mistaken beliefs that low-income borrowers are unable to pay, costs are too high or microfinance operations are not viable, among others. The third was related to the existence of legal and regulatory barriers.

The Philippine experience provides a number of useful lessons for policy makers. The first is that strong private sector collaboration from the beginning is needed to succeed in pushing for critical reforms. Such reforms would then encourage greater private sector participation in microfinance, ensuring a more competitive and sustainable environment. The second is that success can be achieved through less government intervention and a greater emphasis on creating an enabling environment that address legal and regulatory barriers. The third is that capacity-building assistance is more important for MFIs than subsidized credit funds. The fourth is that setting performance standards is very useful for the development of microfinance.

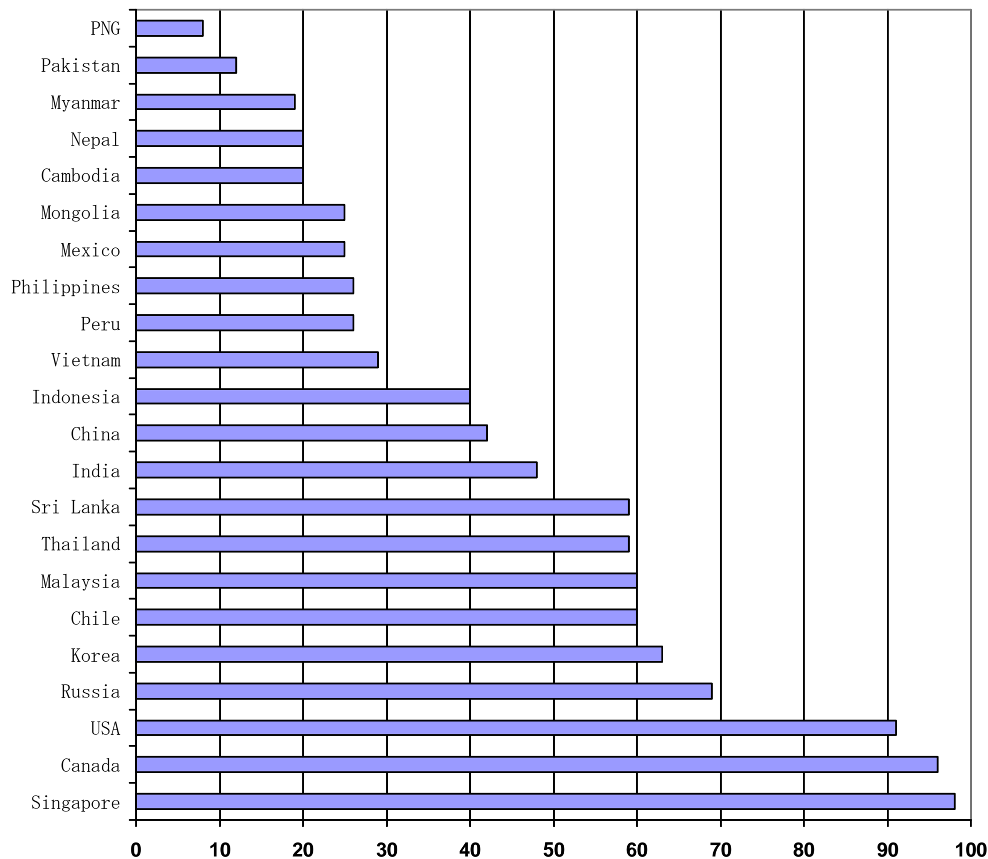
With the creation of an enabling environment and the establishment of a firm foundation for growth, Philippine policy makers are focusing their attention on a number of future challenges that will need to be addressed. The first is the threat of policy reversals, including a politically-motivated return to the use of subsidized credit programs. The second is insufficient access of microfinance clients to support services such as training, business development and financial literacy. The third is inadequate capacity of MFIs with respect to internal controls, governance structures, ability to access commercial funds, lending methodology and technology and support networks. The fourth is the lack of sharing of credit-related information through a comprehensive credit bureau.

MFIs will continue to face the challenges of continuously adapting to new technology and developments in the market as well as adopting innovations in products and

services. There is also still a long way to go in reaching population segments that are yet unserved by the financial sector, especially in the Philippines' many remote rural areas.

Studies on financial inclusion show that there is wide variation in access to finance within the region and that a number of economies have very low access. (*See Figure 3.*) Among the factors accounting for low financial access are geographic isolation, low population densities, gender discrimination, special challenges associated with post-harvest and off-farm economic activities in smallholder and peasant agriculture and inability of many lower-income households to meet lenders' requirements for formal physical collateral.

FIGURE 3: Composite Measure of Access to Financial Services in Selected Economies (Percentage of the adult population with access to an account with a financial intermediary)



Source: World Bank (2008), *Finance for All?*; Presented in the paper contributed by John Conroy, *APEC and Financial Inclusion: A Regional Cooperation Initiative*.

The figures above also imply that by adopting the recommendation of ABAC and the Advisory Group to undertake a financial inclusion initiative under the Finance Ministers' Process, APEC can contribute significantly to promoting financial inclusion, as several of its member economies (notably Papua New Guinea, Mexico, the Philippines, Peru, Vietnam, Indonesia and China) have high levels of financial exclusion, while others (Thailand, Malaysia, Chile, Korea and Russia) can benefit from increased levels of financial inclusion. The development of microfinance can bring not only distributional equity benefits to the region, but also economic efficiency and financial system stability benefits as well.

An important aspect of an APEC financial inclusion initiative would be the measurement of financial inclusion levels in member economies, where much remains to be done to collect and publish data that are comprehensive, comparable and suitable for policy analysis. Another would be comparative surveys of policy frameworks for promoting financial inclusion to encourage policy dialogues and the exchange of experience among participants, as well as capacity-building measures geared toward officials and finance professionals.

VI. CAPACITY-BUILDING AND PUBLIC-PRIVATE PARTNERSHIP

In this session, the presentations[13] included presentations on regional capacity-building initiatives involving the private sector. There has been a trend of growing private sector participation in the work of organizations such as APEC, ABAC and PECC. Considering this trend, ABAC and PECC in 2003 launched the Advisory Group on APEC Financial System Capacity-Building, in cooperation with a number of international organizations.[14]

In 2008, the Advisory Group addressed six topics in its work and annual report. These six topics were: (a) financial inclusion through microfinance; (b) local currency bond markets; (c) infrastructure public-private partnership (PPP); (d) regional financial stability; (e) credit reporting systems; and (f) risk management and governance in banking systems.

With respect to financial inclusion, which has been discussed in the earlier section, the Advisory Group noted that APEC has tremendous potential to address this issue, particularly for the benefit of Asian economies. This is particularly in view of the fact that there is much to share from the successful experience of Latin American economies. For this reason, the Advisory Group recommended that the APEC Finance Ministers agree to launch a financial inclusion initiative.

Regarding local currency bond markets, since the Asian financial crisis, the private sector has clearly seen the need for reforms and capacity-building to help develop local currency bond markets and to promote regional financial integration. This has been reflected in the many reports and position papers of ABAC, the ABA and PECC from as early as 1999. Several regional initiatives were launched in 2003 to help develop bond markets – the Asian Bond Market Initiative (ABMI), the Asian Bond

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[13] Presentations were made by Dr. Julius Caesar Parrenas (Coordinator of the Advisory Group on APEC Financial System Capacity-Building and Senior Advisor to the Chairman of Chinatrust Financial Holding Co., Ltd.), who presented the work of the Advisory Group and ABAC on capacity-building; and Ms. Susan Hopkins (Senior International Advisor for Large Bank Supervision of the Office of the Comptroller of the Currency, USA).

[14] The Advisory Group is an informal grouping that was established for two purposes: to promote synergy among parallel efforts of a number of institutions that address financial sector capacity-building needs of emerging markets; and to promote public-private sector collaboration. Advisory Group meetings include participants from public sector institutions such as the ADB, ADB Institute, the BIS, the Inter-American Development Bank, the IFC, the IMF, the OECD and the World Bank, as well as development institutions. They also include regional private sector organizations representing various sections of the financial sector, such as the Asian Bankers' Association, the Association of Credit Rating Agencies in Asia and the Asia-Pacific Credit Coalition. Finance and central bank officials, particularly those who are involved in the APEC Finance Ministers' Process, are also invited to meetings. The Advisory Group releases an annual report on capacity-building measures for financial sector development, which is submitted to the APEC Finance Ministers. In addition, it undertakes specific activities, such as co-organizing the annual APEC Public-Private Sector Forum on Bond Market Development, as well as various workshops and policy dialogues.

Fund (ABF) and APEC's work on bond market infrastructure. These initiatives addressed many of the private sector's proposals.

ABAC, PECC, ABA and since 2003, the Advisory Group, have continued to push for further measures, this time focused on public-private sector collaboration. In 2004, they jointly organized a conference in Taipei, which brought together regulators and the financial industry. This was followed by a second conference in Tokyo in 2005, and third in Washington DC in 2006. In 2005, ABAC started a regular informal dialogue with the APEC Finance Ministers during the latter's annual meeting, and in 2006 convinced the APEC Finance Ministers to launch a public-private sector forum on bond markets as part of their regular work program.

In 2007, the first forum was held in Melbourne in conjunction with the meeting of the APEC senior finance officials. This first forum focused on the Indonesian, Philippine and Vietnamese bond markets. In July 2008, the second forum was held in Cusco, APEC being under the chairmanship of Peru. It focused on the Chilean, Mexican and Peruvian bond markets. The Advisory Group and ABAC also initiated discussions with the Singapore Ministry of Finance and the Monetary Authority of Singapore (MAS) on the holding of a third forum in 2009.

Following is a brief summary of the results of the Cusco bond market forum:

- In recent years, governments have increasingly relied on local debt markets to meet their financing needs. Over the past ten years, the outstanding stock of emerging market domestic debt securities has risen six times from US$1 trillion in 1997 to US$6 trillion by the end of 2007. This has been fueled by a number of factors, including low interest rates, increased activity of pension funds and global asset managers, improvements in market access, the decline of home bias, and new benchmark investment indices for emerging market bonds.
- Growth of these markets has been very significant in Asia and Latin America, coming as a result of policy and regulatory reforms over the past few years. However, key challenges remain. These include issues such as 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 past few years have seen governments actively undertaking reforms, However, 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 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 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. To reduce the negative impact of taxes, the Advisory Group proposed a number of measures that regional organizations can undertake. The first is undertaking a survey of individual member economies. The second is holding regional discussions on how to address adverse impacts of taxes. And the third is a regular review of relevant taxes within a regional context.
- Advanced economies can play an important role, especially in promoting policies that lead to market development in developing economies. There was a discussion on the US Treasury's capacity-building programs for emerging bond markets, and this discussion provided insights on how

these programs can be best undertaken and what the key success factors are.

- International institutions like the ADB, the IDB, the IMF, the OECD and the World Bank also play a very useful role in bringing onto the table the experiences of a wide range of economies across the globe. Examples are the ADB's role in the ABMI, the IDB's support for capital market development in Latin America, the IMF's research and capacity-building programs to assist emerging market economies, the OECD's roundtables for capital market regulators, and the World Bank's GEMLOC project. The report proposed that consideration be given on how these various programs can be more effectively deployed in conjunction with each other and with other capacity-building efforts in the region.

- Discussions of the Latin American experience at the Cusco forum underscored once again the positive contributions of closer collaboration between the public and private sectors to the success of efforts to develop domestic financial markets. The report noted that emerging markets could significantly benefit from exchanges of information on best practices and implementing mechanisms for cooperation with the private sector. It also proposed that governments consider holding regular roundtables involving relevant officials and regulators, the local financial industry and private sector organizations, as well as financial experts.

- Finally, the report noted that there is a need to deepen the connectivity between various international capacity-building initiatives and the actual implementation of reforms in individual economies. For this reason, it was suggested that connectivity should be reviewed at the regional level, for example in APEC, focusing on how regional and international capacity-building activities can more effectively support individual governments' reform efforts.

On how to more effectively promote public-private partnership in the development of infrastructure, the Advisory Group identified a number of issues that need to be addressed.

- First, the problem is not scarcity of capital, which is in fact abundant in Asia, given the region's high savings rates. The problem is the lack of functioning and sufficiently developed capital markets that are needed to effectively channel savings to the financing of infrastructure.

- Second, there is a good reason why foreign investors are overly cautious with respect to infrastructure projects in most developing economies, and that is the consideration of political risk involved in long-term cross-border investment in non-movable assets. When it comes to infrastructure, investors' decisions are heavily influenced by the quality of legal regimes, governance structures and overall frameworks that are important over the long term. This is the main reason why advanced economies with governance structures that conform to certain global benchmarks such as those of the OECD are considered much more favorably by investors than most developing economies.

- Third, the private sector's experience thus far when it comes to infrastructure PPPs is that local communities still tend to have expectations that infrastructure assets should be firmly under the public sector control. Because of these types of attitude, acceptance by communities is an important requirement for private sector investors who come to own certain facilities, such as for example hospitals. The problem here is that many private sector investors have yet to acquire the skills and capabilities that would facilitate such acceptance by communities. Without these skills and capabilities, investors are confronted with considerable political risk.

- Fourth, there is a real need for capacity-building in the public sector. In particular, developing economies lack sufficient expertise in identifying infrastructure needs and evaluating economic and social payoffs. In addition, it is important for public sector sponsors to have the capacity to negotiate terms with concession holders based on the best information. Otherwise they risk a public backlash if they are seen to have provided concessions too cheaply. In building capacity, there is no need to start from scratch, because the characteristics of infrastructure PPP have already been clearly identified and there is already a wealth of experience and expertise that can be harnessed.
- Fifth, there are two very important roles for multilateral institutions in this process. They can provide advice to governments. e.g., how to improve the way officials measure, budget and account for guarantees they provide, how to improve the environment for risk allocation and how to ensure that governments are able to increase benefits by assuming risks while providing strong incentives for investors to select projects carefully and to run them efficiently. In addition, in most emerging markets, infrastructure development requires institutions that can provide funds with long-term maturity and in local currency. Multilateral institutions have the credit standing to raise long-term debt and the ability to develop a long-term swap market to eliminate currency mismatch, given that infrastructure revenues are in local currency.

Noting that there is already considerable activity within and outside the region on infrastructure PPP, the Advisory Group has come to the conclusion that establishing a regional infrastructure dialogue would be beneficial for the region. Such a dialogue would be useful in building confidence and mandate for governments to invest in infrastructure, and in championing a pragmatic agenda for genuine partnership among government, business and communities.

The fourth area of concern is regional financial stability. There has been a lot of work done by ABAC and PECC in this area since the Asian crisis. This work has focused on concerns about the impact of short-term capital flows on financial stability, particularly in relation to highly-leveraged institutions and the growing use of derivatives. A study commissioned by ABAC in 2006 pointed out the lack of available data to assist governments and regulatory authorities, as well as market participants, in ensuring that volatile short-term capital movements do not destabilize financial institutions and systems.

The study concluded that there is a need to improve the quality of information on international capital flows, in order to support early warning systems and ameliorate the impact of volatility on financial systems. The current situation of financial markets today underscores the continued importance of improved data collection and market dissemination. It also highlights the need for better coordination of information on cross-border financial flows between major capital market regulators and international agencies.

The Advisory Group recognized that there is already a lot of work being done by the public sector and international institutions, including reviews of financial regulations and steps being taken by the FSF, IMF and standard-setting organizations. In Asia, the introduction of enhanced banking regulatory arrangements is a key factor that has helped provide the region with a degree of resilience in the face of current problems affecting global financial systems. Other factors are the region's relatively limited degree of integration with global capital markets, large current account surpluses and greater exchange rate flexibility.

However, several challenges to financial stability remain to be addressed.

First, notwithstanding the work of the FSF, IMF and other bodies, it is clear from the present crisis that no single organization has all the insights into financial innovation and its impact on regulatory arrangements.

Second, the rapid pace of financial market development is a challenge to regulators and market players, who need to update their understanding of how financial markets are evolving. This was demonstrated by the failure of regulators and market players to anticipate the degree of turbulence arising from the subprime crisis, where lack of data was a major contributing factor.

The third challenge is, in responding to this situation, how to achieve a healthy balance between regulation on one hand, and fostering efficiency and innovation, which are also important to the strengthening and development of financial markets, on the other.

What the Advisory Group is doing in response to these challenges is to look at ways of developing better data systems with respect to private financial sector activities. The Advisory Group is also exploring the issue of how to improve data dissemination, as well as collaborating with the IMF and the ADB Institute on these issues. The success of these public-private collaborative efforts depends on the quality of public sector involvement, and so the Advisory Group is seeking the support of central banks, finance ministries and financial regulators.

The fifth issue is improving credit reporting systems, which has been discussed in a previous section. On this issue, the Advisory Group recommended in its report the undertaking of measures to promote full-file comprehensive reporting to private credit bureaus.

Finally, the sixth area of concern is risk management and governance in banking systems, and this is where collaboration with SEACEN, financial regulators and central banks has been the major source of ideas and recommendations to regional officials. Ever since the first dialogue in 2005, the results of the discussions have been published and circulated these to relevant policy makers and opinion leaders in the region.

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, especially in financial institutions, through strengthening guidelines, voluntarily moving towards a principles-based regulatory framework, greater self- and market-based regulation, and ongoing training and development of directors.***
  - ***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.***

APPENDIX A: PROGRAMME OF THE DIALOGUE

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

18-19 August 2008
The Westin Hotel
Kuala Lumpur, Malaysia

Theme: ***Basel II Implementation and the Development of Asia's Financial Systems: Experiences, Challenges and Regional Cooperation***

Monday, 18 August

09:00 – 09:30 **OPENING CEREMONY AND INTRODUCTION**

Opening Remarks
Dr A. G. Karunasena, Executive Director
The SEACEN Centre

Welcome Remarks on behalf of ABAC
YBhg Tan Sri Dato' Azman Hashim, Chairman
AmBank Group

Keynote Address by Bank Negara Malaysia
YBhg Tan Sri Dato' Dr. Zeti Akhtar Aziz, Governor
Bank Negara Malaysia

09:30 – 09:45 **GROUP PHOTOGRAPH SESSION**

09:45 – 10:00 **TEA BREAK**

10:00 – 11:30 **SESSION 1:**

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

- Broad review of the robustness of regional banking systems in handling the current liquidity and credit constraints now facing global banking systems.
- 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.

Session chair:
Dr Twatchai Yongkittikul, Secretary General, Thai Bankers' Association

Speakers:

- *Ms Delora Jee, Deputy Comptroller, International Banking Supervision, Office of the Comptroller of the Currency*
- *Mr Cheung Tai Hui, Regional Head of Economic Research, SE Asia, Standard Chartered Bank*

Open Forum

Closing remarks by Session Chair

11:30 – 13:00 **SESSION 2:**

Toward international best practices in implementing Basel II

- Frameworks for prudential supervisory policy in developing economies.
- Approaches to self-assessment of objectives and performance by banking regulatory agencies.
- The economic capital concept, its application and challenges.

Session chair:
Mr Rajendra Theagarajah, Managing Director and Chief Executive Officer, Hatton National Bank

Speakers:

- *Mr Hideaki Tanaka, Chief Manager, Basel 2 Implementation Office, Corporate Risk Management Division, Mitsubishi UFJ Financial Group*
- *Mr Eric Kuo, Credit Portfolio Manager, Credit Risk Management Group, Chinatrust Commercial Bank*
- *Mr Steve Lau, Division Head of Banking Supervision, Hong Kong Monetary Authority*

Open Forum

Closing remarks by session chair

13:00 – 14:00 **LUNCH**

14:00 – 15:30 **SESSION 3:**

Enhancing regulatory coordination and response to cross-border challenges in implementing Basel II.

- Promoting regulatory coordination in implementing Basel II in the region.
- The robustness of the cross-border banking frameworks and principles.

Session chair:
Mr Steve Lau, Division Head of Banking Supervision, Hong Kong Monetary Authority

Speakers:

- *Mr Hideaki Tanaka, Chief Manager, Basel 2 Implementation Office, Corporate Risk Management Division, Mitsubishi UFJ Financial Group*
- *Mr Eckart Koerner, Director, Financial Risk Management, KPMG Business Advisory Services Sdn Bhd*

Open Forum

Closing remarks by session chair

15:30 – 16:00 **TEA BREAK**

16:00 – 17:30 **SESSION 4:**

Basel II Pillar 3 and IFRS.

- Sharing of disclosure standards.
- Improving financial information; transparency, disclosure and convergence of data requirements and reporting standards, including standards that would help convergence of credit rating practices and credit assessment.
- Privacy laws and information flows.
- Supervisory implications of the implementation of IFRS 7 and IAS 32, 39.

Session chair:

Mr Eckart Koerner, Director, Financial Risk Management, KPMG Business Advisory Services Sdn Bhd

Speakers:

- *Mr Rajendra Theagarajah, Managing Director and Chief Executive Officer, Hatton National Bank*
- *Ms Claudia Kuan, Manager, Enterprise-wide Risk Management Division, Chinatrust Commercial Bank*
- *Mr Walter Yao, Senior Manager, Country Analysis Unit, Banking Supervision and Regulation, Federal Reserve Bank of San Francisco*

Open Forum

Closing remarks by Session chair

18:00 – 20:00 **Welcome Reception Hosted by The SEACEN Centre**

Tuesday, 19 August

09:00 – 10:30 **SESSION 5:**

Corporate Governance.

- The role of corporate governance in bank safety and financial stability.

- Improving governance in banking and making boards and regulatory agencies more responsive and effective.
- Facilitating culture change in banking organizations.
- Corporate social responsibility.

Session chair:
Mrs Juliet McKee, Company Director and Advisor on Corporate Governance; member of New Zealand PECC

Speakers:
- *Mr Saifuddien Hasan, Director of Indonesian Banking Development Institute*
- *Dato' Muhammad Ibrahim*, *Assistant Governor*, *Bank Negara Malaysia*
- *Mr JP Sabourin, Chief Executive Officer, Malaysia Deposit Insurance Corporation*

Open Forum

Closing comments by session chair

10:30 – 11:00 **TEA BREAK**

11:00 – 13:00 **SESSION 6:**

Promoting robust credit reporting standards.
- The role of credit bureaus.
- Privacy issues.
- Capacity-building to develop best practices.
- Toward an Asia-Pacific regional framework.

Session chair:
Dr JC Parrenas, Senior Advisor to the Chairman Chinatrust Financial Holding Company Ltd.

Speakers:
- *Dr Michael Turner, President, Political Economic Research Council*
- *Mr Anthony Hadley, Vice President, Government Affairs, Experian*
- *Dr Twatchai Yongkittikul, Secretary General, Thai Bankers' Association*

Open Forum

Closing comments by session chair

13:00 – 14:00 **LUNCH**

14:00 – 15:30 **SESSION 7**

Financial Inclusion/Microfinance

- Promoting a conducive legal, policy and regulatory framework.
- Regional cooperation.

Session chair:
Dr J.C. Parrenas, Senior Advisor to the Chairman Chinatrust Financial Holding Company Ltd.

Speakers
- *Mr Chandula Abeywickrema, Deputy General Manager, Hatton National Bank*
- *Dr John Conroy, Special Consultant, Foundation for Development Cooperation.*
- *Mrs Leny I. Silvestre, Managing Director, Supervision and Examination I and Microfinance Committee Member, Bangko Sentral ng Pilipinas*

Open Forum

Closing comments by session chair

15:30 – 15:45 **TEA BREAK**

15:45 – 17:00 **SESSION 8:**

Capacity building and public-private partnership:
- Strengthening and developing corporate bond markets.
- Promoting creditor rights, informal work-outs.
- Protection of consumer interests.
- Infrastructure public-private partnership.

Session chair:
Mr Eduardo Pedrosa, Secretary-General,
Pacific Economic Cooperation Council

Speakers:
- *Dr J.C. Parrenas, Senior Advisor to the Chairman Chinatrust Financial Holding Company Ltd*.
- *Ms Susan Hopkins, Senior International Advisor, Large Bank Supervision, Office of the Comptroller of the Currency*

Open Forum

Closing comments by session chair

17:00 – 17:30 **CLOSING COMMENTS**

On behalf of ABAC
Dr Twatchai Yongkittikul, Vice Chairman

ABAC Finance Working Group; Executive Director of Thai Bankers' Association

On behalf of ABA
Mr Henry Hwang, Chairman, ABA Policy Advocacy Committee and Executive Vice President, Mega International Commercial Bank Co., Ltd.

On behalf of PECC
Mr Eduardo Pedrosa, Secretary-General, Pacific Economic Cooperation Council

CONCLUSION OF DIALOGUE
Dr A. G. Karunasena, Executive Director, The SEACEN Centre

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