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**ANNEX TO THE 2010 APEC BUSINESS
ADVISORY COUNCIL (ABAC) REPORT TO
THE APEC FINANCE MINISTERS**

**The Advisory Group on APEC Financial System
Capacity-Building**

**2010 REPORT ON CAPACITY-BUILDING
MEASURES TO STRENGTHEN AND DEVELOP
FINANCIAL SYSTEMS**

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THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

2010 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS

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THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

2010 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS

Summary of Recommendations

This year, the Advisory Group on APEC Financial System Capacity-Building focused on enabling the financial sector to play its crucial role in the successful pursuit of APEC's new growth strategy. This work builds on continuing efforts since the Advisory Group's establishment in 2003 to identify collaborative capacity-building initiatives that the public and private sectors could undertake under the APEC framework. Working closely with the APEC Business Advisory Council (ABAC), the Advisory Group undertook discussions with various key institutions and organizations this year. The results of these discussions are reflected in the following conclusions and recommendations.

Promoting inclusive growth through an APEC Financial Inclusion Initiative.

Microfinance has emerged as a potent tool to promote financial inclusion, and its ability to do so has grown in recent years with the expanded use of technology and financial innovation, increasing sophistication of microfinance institutions, and policy reforms. There is very significant potential in regional cooperation to assist economies in providing a favorable environment for promoting financial inclusion through microfinance. In last year's Report, the Advisory Group recommended that APEC Finance Ministers undertake a financial inclusion initiative as part of the broader APEC agenda to promote inclusive growth. This year, several economies have expressed their desire to sponsor a financial inclusion initiative under the APEC Finance Ministers' Process.

- *The Advisory Group welcomes the launch of an APEC financial inclusion initiative under the APEC Finance Ministers' Process and calls on APEC member economies, multilateral institutions and the private sector to collaborate in the successful implementation of this initiative.*

Improving small, micro and medium enterprises' access to finance. Small, micro and medium enterprises (SMMEs) form a key component of any effort to promote inclusive growth. Lack of access to finance is a major obstacle to the growth of SMMEs, and inadequate information and legal environments are the most serious problems in this regard. Regional collaboration focused on improving the information and legal environments in APEC member economies, with active participation of the private sector and international financial and development institutions, would greatly contribute to expanding SMMEs' access to finance throughout the region.

- *The Advisory Group urges APEC to undertake an SMME Finance Initiative that focuses on developing properly structured credit sharing information systems and improving legal infrastructure to promote SMME finance.*

Expanding private investment in infrastructure through an Asia-Pacific Infrastructure Partnership. There is a huge potential for public-private partnership (PPP) to contribute to the development of infrastructure in a way that will benefit governments, the private sector

and the public at large. APEC could play an important role in providing a model for regional cooperation through an initiative to be undertaken by interested member economies and later evaluated and considered for adoption on a wider scale. Activities under such a pathfinder initiative could include initial discussions among interested member economies focused on strategic and policy issues. These would need to involve a high-level panel of private sector advisors and multilateral institution participation, and followed at a later date by discussions focused on practical issues.

- *The Advisory Group recommends that APEC undertake a pathfinder initiative in cooperation with ABAC and the Advisory Group and involving interested member economies, to promote an Asia-Pacific Infrastructure Partnership (APIP), bringing together public and private sectors and multilateral institutions.*

Taking Asia-Pacific capital market development to the next stage. Bond market development in the region has reached a significant stage, owing to various regional cooperation efforts. Key weaknesses still need to be addressed, including supply constraints arising from inadequate market depth and liquidity, market infrastructure and architecture and legal and regulatory frameworks. There is wide scope for the introduction of new initiatives, building on current achievements, to bring capital market development and integration in the region to the next higher level. In addition to continued efforts to address key issues in the development of government and corporate bond markets, innovative solutions can be pursued on a regional basis under the APEC framework.

- *The Advisory Group recommends that APEC Finance Ministers and Senior Finance Officials undertake discussions with a view to compiling a package of measures to bring the development of the region's capital markets to the next level. We recommend that these discussions focus on (a) development of wholesale securities markets exclusively for professional investors; (b) regional public-private sector collaboration mechanisms to reduce barriers to cross-border settlement; (c) use of foreign securities as eligible collateral throughout the region; (d) ways to accelerate the region-wide convergence of accounting standards, disclosure regimes and corporate governance practices; and (e) establishment of a pathfinder initiative to introduce a regional funds passport scheme.*

Building capacities for regulatory reform in Asia-Pacific emerging markets. In addition to active involvement in public private partnerships in financial institutional capacity building, the Advisory Group coordinated the program and preparations of the 6th SEACEN-ABAC-ABA-PECC Public-Private Dialogue for the Asia-Pacific Region, which was held on 15-16 June 2010 in Manila, Philippines. This year's dialogue dealt with the theme *The Role of the Financial Sector in Sustaining Economic Growth and Stability*, and discussed current global financial regulatory reform processes in the context of ongoing regional efforts to strengthen and develop the region's financial markets. The conclusions of the dialogue helped shape the Advisory Group's views on the situation of financial systems in the region and its recommendations on how they may be strengthened.

- *The Advisory Group recommends that APEC Finance Ministers support capacity-building measures to help emerging markets in the region improve financial supervisory capacity, calibrate local conditions to global standards, promote the adoption of proven tools such as scorecards to strengthen corporate governance, and strengthen financial sector safety nets (including frameworks for liquidity support, sound crisis management policies and procedures and deposit insurance firms' governance and strategies).*

- *The Advisory Group proposes that APEC Finance Ministers support the development of a robust regional financial architecture, including a regional forum of financial regulatory authorities and the financial industry to address regulatory issues in light of the region's needs, review the relevance and impact of global reforms on the region, and ensure that development of global standards take into account market practices and market infrastructure in the region.*

THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

2010 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS

Since the completion of the Advisory Group's previous Report in 2009, the global economy has recovered from the deepest financial and economic crisis of the postwar period, on the back of unprecedented and globally coordinated fiscal stimulus measures and monetary policy accommodation. Robust growth in emerging markets, particularly China, provided additional support to the global economy, softening the impact of diminished private consumption and investment in developed markets.

At the time of this current Report's completion, however, the sustainability of the recovery remains uncertain. In advanced economies directly impacted by the crisis, unemployment remains high, soundness of banking systems have yet to be restored, and sovereign risks have emerged as the new focus of financial market turbulence, severely limiting the scope for future public stimulus measures. Clear signs are yet to emerge of a sustained recovery of private demand, in the absence of which these economies will enter another difficult period, once the effects of current stimulus packages have run their course.

A major issue for the region is how to revive demand to preserve huge productive capacities that have been built up prior to the crisis and prevent the economic and financial dislocations that would arise with the scaling down of such capacities. Unprecedented global economic growth prior to the crisis, driven to a large extent by US consumption and Asian exports, was made possible by huge internal and external imbalances, with the accumulation of current account deficits and household and financial sector debt in developed markets. These were mirrored by corresponding accruals of surpluses and savings in export-oriented and resource-rich economies, large parts of which were reinvested in developed markets, perpetuating conditions for the continued build-up of imbalances until the very onset of the present crisis.

Given that a return to such unsustainable pre-crisis patterns of production and trade now appears unlikely, mitigating painful adjustments will require efforts to further expand the world economy's growth potential, particularly through increased consumption in emerging markets. Accordingly, policymakers have announced intentions to promote a transition to a more balanced pattern of global growth that should at the same time be stronger and more sustainable, inclusive, innovative and secure. A major part of this transition would have to occur in developing APEC member economies, through the promotion of conditions to accelerate the movement of labor from low-productivity to high-productivity sectors and to spur the rapid growth of domestic private demand, paving the way for the emergence of a new engine for global economic growth.

Last year's Report cited the considerable potential for domestic demand-led growth in developing economies, particularly in emerging Asia, with its large population, rapidly growing middle class, considerable pool of savings, and relatively healthy financial systems. The Report also made a reference to factors that constrain growth of domestic consumption and investment. These include, among others, the lack of access to finance of small

enterprises and of the large number of people at the bottom of the economic pyramid, policy environments that hinder expanded private investment in infrastructure, and underdeveloped financial markets, especially those for long-term local currency financing. Underpinning these are financial regulatory systems and policies that need to be improved and updated through capacity-building.

This year, the Advisory Group on APEC Financial System Capacity-Building focused on financial sector solutions to these issues. In undertaking this work, the Advisory Group continues to build on previous efforts since its establishment in 2003 to identify capacity-building initiatives that the public and private sectors could undertake in cooperation with each other under the APEC framework. Working closely with the APEC Business Advisory Council (ABAC), the Advisory Group has developed various ideas during discussions with key internationally active institutions and organizations. These ideas are reflected in the proposals contained in this Report.

This report is divided into five major sections. These deal with (a) promoting inclusive growth through an APEC Financial Inclusion Initiative; (b) improving small, micro and medium enterprises' access to finance through an initiative focused on credit information and legal infrastructure; (c) expanding private investment in infrastructure through an Asia-Pacific Infrastructure Partnership; (d) taking Asia-Pacific capital market development to the next stage through a proposed package of measures; and (e) building capacities for regulatory reform in Asia-Pacific emerging markets.

I. PROMOTING INCLUSIVE GROWTH THROUGH AN APEC FINANCIAL INCLUSION INITIATIVE

As noted in the Advisory Group's 2008 Report, a majority of the adult population in many developing economies remain without access to financial services. Microfinance has emerged as a potent tool to address this issue, and its ability to do so has grown in recent years with the expanded use of technology and financial innovation, increasing sophistication of microfinance institutions, and policy reforms. The development of microfinance remains uneven across the region, and there is very significant potential in regional cooperation to assist economies in providing a favorable environment for promoting financial inclusion through microfinance.

In last year's Report, the Advisory Group recommended that APEC Finance Ministers undertake a financial inclusion initiative as part of the broader APEC agenda to promote inclusive growth. We suggested that such an initiative focus on promoting legal, policy and regulatory reforms that will provide an enabling environment for microfinance and sharing best practices in undertaking these reforms, particularly in (a) agent banking, (b) mobile phone banking, (c) diversity of microfinance service providers, (d) governance and management of state-owned banks with microfinance operations, (e) financial identity and (f) consumer protection.

This year, the Advisory Group collaborated with ABAC and Japan's Ministry of Finance together with APEC Senior Finance Officials to convene the APEC Public-Private Sector Forum on the Development of Bond Markets and Financial Inclusion. The Forum was held in Sapporo, Japan on 31 May 2010 back-to-back with this year's Senior Officials' Meeting – Senior Finance Officials' Meeting (SOM-SFOM) Dialogue. Discussions in this Forum provided deeper insights into financial inclusion and how an APEC financial inclusion initiative can add value to current activities being undertaken in the G20 and elsewhere. Following are key points arising from these discussions:

- With the growing commercial viability of microfinance, there is increasing interest among investors and great potential for channeling commercial investment into the sector. Public-private partnership with IFIs and bilateral institutions playing key roles could facilitate the expansion of such commercial investments. Nevertheless, while promoting and facilitating private sector investment is important, the major issue is not the lack of funds or investors, but rather the still limited number of top-tier MFIs.
- To broaden investment opportunities, it is important to accelerate the process of upgrading existing MFIs, as well as to promote wider participation of financial institutions. The most difficult challenge, however, is how to broaden the base of the financial inclusion pyramid, by expanding the coverage and penetration of microfinance. This reinforces the recommendation put forward by ABAC in 2009 that policy makers and regulators consider undertaking measures in six areas identified in a recent ground-breaking study where policies can have the most impact. These are mobile phone banking, agent banking, channel and product diversification, public bank reform, financial identity and consumer protection.
- An area where APEC can play a constructive role in promoting financial inclusion is the development of properly structured credit sharing information systems. This could involve the promotion of reforms to enable full-file and comprehensive credit reporting in member economies to private credit bureaus, which should be accompanied by measures to develop appropriate legal and regulatory frameworks defining key procedures, including types of information that can be collected, rights of data subjects, acceptable uses of information, data security requirements and obligations of credit bureaus, data furnishers and data users.
- There are already many existing best practices in providing an enabling environment for the introduction and use of new technologies and innovations. Many of these can be easily made available through various institutions. There is also a need to recognize the potential of the public sector, especially government banks, in promoting financial inclusion, especially given the magnitude of the challenges to expand coverage of microfinance. Capacity-building measures to assist developing economies in effectively harnessing public sector resources and in promoting public-private sector partnerships are needed.
- There is a lot of commonality between the G20's approach and the approaches currently being discussed in APEC and there is great potential for APEC to undertake an initiative that complements the work of the G20. Finally, there are ample resources, including expertise, funding and networks that private, international and bilateral institutions are willing to share in support of an APEC financial inclusion initiative.

In response to the growing interest in financial inclusion that has been generated by the work of various institutions including ABAC and its various collaborators in the Advisory Group in previous years, several economies have expressed their desire to sponsor a financial inclusion initiative under the APEC Finance Ministers' Process. The launch of such an initiative this year at the forthcoming APEC Finance Ministers' Meeting in Kyoto will be an important milestone for regional cooperation that will significantly contribute to achieving more inclusive growth.

The Advisory Group welcomes the launch of an APEC financial inclusion initiative under the APEC Finance Ministers' Process and calls on APEC member economies, multilateral institutions and the private sector to collaborate in the successful implementation of this initiative.

II. IMPROVING SMALL, MICRO AND MEDIUM ENTERPRISES' ACCESS TO FINANCE

Small, micro and medium enterprises (SMMEs) form a key component of any effort to promote inclusive growth, as they play important roles in the economy, and particularly in providing employment opportunities. The following examples illustrate this reality:

- In Japan, SMEs (not yet counting micro-enterprises) contribute around 51% to sales and 70% to employment, and represent 99.7% of all companies.
- In Thailand, SMEs account for 38% of GDP, 76% of employment and 99.6% of all enterprises.
- In China, SMEs are responsible for 56% of GDP, 62% of exports, 75% of employment in urban areas, 43% of tax revenues and 99% of companies.

The Advisory Group discussed a framework developed by World Bank staff for analyzing factors that affect the availability of credit to SMEs,¹ which explains how policies affect the availability of credit, through their impact on lending infrastructure and the structure of the financial industry, and how these two factors determine the feasibility and profitability with which different lending technologies are deployed.

The lending infrastructure, which refers to the rules and conditions affecting the ability of these institutions to lend, include (a) the information environment; (b) legal, judicial and bankruptcy environment; (c) social environment; and (d) tax and regulatory environment, including capital regulation and bank supervision. Along with the financial industry structure, the lending infrastructure has a profound impact on lending technologies.² Discussions undertaken by Advisory Group participants have identified the *information and legal environments* as the key areas where reforms could help expand SMMEs' access to finance within the region.

A survey of business sector organizations in APEC economies conducted by the Japan Chamber of Commerce and Industry on SMEs³ also reached similar conclusions. A key finding of the survey is that overall inadequacies in the information and legal environments (particularly related to collateral) are the most serious problems affecting SMME finance, with the former cited by many respondents in developing economies and the latter by respondents in the more advanced economies. In addition, regulatory and tax issues are also seen as significant issues in more advanced economies, while the lack of government schemes to support SME finance are considered as another important issue in developing economies.

These findings suggest that regional collaboration focused on improving the information and legal environments in APEC member economies, with active participation of the private sector and international financial and development institutions, would greatly contribute to expanding SMMEs' access to finance throughout the region. Transparency and reliability of lien registration and perfection systems is one area where improvement and harmonization have a potential to incentivize additional financing for worthy borrowers, particularly among SMME's who use asset-based financing to a high degree. Accordingly, an APEC SMME

¹ Allen Berger and Gregory Udell, *A More Complete Conceptual Framework for Financing of Small and Medium Enterprises*, World Bank Policy Research Working Paper 3795, December 2005.

² Lending technologies refer to the combination of primary information source, screening and underwriting policies and procedures, loan contract structure and monitoring mechanisms. They play a key role, in that they are the conduit through which government policies and financial structures affect the availability of credit to SMEs. Lending technologies can be divided into transactions lending technologies, which are based on hard data, and relationship lending, which is based on soft data. A third category, trade credit, involves both hard data and soft information. Berger and Udell (2005).

³ A Survey on Actual SME Business Conditions in the APEC Region, Japan Chamber of Commerce and Industry 2010.

Finance Initiative could be undertaken under the APEC Finance Ministers' Process with two essential components: (a) developing properly structured credit sharing information systems and (b) improving legal infrastructure to promote SMME finance.

Developing properly structured credit sharing information systems. Credit information sharing systems are key elements of modern financial sector infrastructure. Credit bureaus have assumed a core role within such systems by helping lenders acquire a more precise knowledge of a borrower's likelihood of repaying. However, the extent to which this result is achieved depends on the structure of credit reporting, bureau ownership and the type of information reported. In this context, distinctions between the following need to be made:

- Negative-only reporting versus full-file reporting. Negative-only reporting is the reporting of only negative data. Full-file reporting is the reporting of both negative and positive data (which may include information on the timeliness of payments, account type, lender, date opened, inquiries, credit utilization rates, credit limits and account balances).
- Segmented versus comprehensive reporting. Segmented reporting is a system in which only data from one sector or a limited number of sectors, e.g., retail or banking, are contained in reports. Comprehensive reporting is a system in which payment and account information contains information from multiple sectors, e.g., utilities payments.
- Public versus private credit bureaus. Public bureaus have been set up largely for supervisory purposes, to monitor the safety and soundness of the financial sector and determine whether reserves are sufficient. Private bureaus, by contrast, are set up to ease lending, and collect data primarily to reduce information asymmetries and improve risk assessment in lending. By this account, private bureaus are complements rather than substitutes to public bureaus.

A number of studies summarized in surveys undertaken by the Political and Economic Research Council (PERC)⁴ and in the Advisory Group's report of the APEC Public-Private Sector Forum on the Development of Bond Markets and Financial Inclusion (*see Annex A*) underscore the benefits of credit reporting regimes with full-file and comprehensive reporting to private credit bureaus. Under such regimes, broader-based lending and wider access to capital improve economic growth, growth in the capital stock and productivity, while contributing to lower income inequality.

The development of full-file and comprehensive credit reporting systems requires robust legal and regulatory frameworks governing important procedures, including the type of information that can be collected, the rights of data subjects (access, notification, dispute resolution and redress), acceptable uses of information, data security requirements and obligations of credit bureaus, data furnishers and data users. The Organization for Economic Co-operation and Development (OECD) Fair Information Practice Principles provide a useful reference point in developing legal and regulatory framework.

Properly structured credit sharing information systems can be developed by observing key principles: (a) Positive and negative payment data should be reported to private credit bureaus. (b) Bank, non-bank and non-financial payment data should be reported and data should not be segmented by sector. (c) Consumer rights and protections are paramount, as spelled out in the OECD Fair Information Principles. (d) Private credit bureaus and public credit registries are

⁴ Michael Turner, Robin Varghese and Patrick Walker, *Financial Inclusion through Credit Reporting: Hurdles and Solutions* (A PERC Briefing Paper for The Asia-Pacific Credit Coalition), April 2010. See also Michael Turner, Robin Varghese and Patrick Walker, *The Structure of Information Sharing and Credit Access: Lessons for APEC Policy* (A PERC Briefing Paper for The Asia-Pacific Credit Coalition), July 2008.

complementary, with private bureaus focused on making lending efficient. (e) Reporting of payment data should be voluntary. (f) Data use should be limited to well-defined permissible purposes.

APEC member economies can also benefit from the sharing of actual experiences in developing credit information systems. The Advisory Group considered the Japanese SME credit information database as an example of an existing system that can provide useful lessons for other economies. Under this system, over 200 participating institutions (including financial institutions, credit guarantee corporations and rating agencies) provide financial and non-financial data as well as default information to the Credit Risk Database (CRD) Data Center, which stores the data in anonymous form and consolidates them for use by members in credit risk scoring, data sampling and statistical information.

Japan's experience highlights a number of issues that can be discussed under an APEC initiative to help member economies design robust credit information systems. These include incentives for SMMEs to disclose accurate information; confidentiality and trustworthiness of data; types of data to be collected; financial sustainability; and enhancing the value of the system for participating institutions.

An APEC initiative could also discuss the regional dimension of credit information systems to support cross-border business activities involving SMMEs. Such discussions could include subjects such as collection of SME data across the region and developing an accurate data base to facilitate securitization of SME loans and strengthen SMMEs' ability to raise funds from capital markets.

Improving legal infrastructure to promote SMME finance. In general, security enforcement regimes in most APEC jurisdictions are intended to encourage provision of credit to commercial borrowers by recognizing and protecting the expectations of senior-secured lenders and providing legal certainty in the event of borrower insolvency. However, a number of important gaps remain. The absence of clear legal frameworks to enforce rights of secured lenders is an impediment to credit availability, disproportionately affecting SMMEs and other businesses that have historically had difficulty accessing bank credit. Systems for creating and perfecting valid security interests in the first instance are often not exclusive, universal and accessible to prospective lenders. Legal rules often do not clearly contemplate various forms of structured finance that are useful to providing SMMEs with operating liquidity.

Key issues related to the legal infrastructure for secured lending that need to be addressed in various member economies are the following:

- Absence of exclusive security interest registry, giving rise to the "hidden lien" problem
- Voidable conversion/preference
- Unclear perfection rules for certain types of collateral, such as movables, receivables and goodwill
- Absence of blocked account security precedence
- Untested debtor-in-possession process
- Treatment of floating charges or absence of such concepts
- Lack of broad licensing authority for commercial lending.

An APEC initiative to improve and harmonize standards for perfection and enforcement of security interests in collateral, as part of a system for developing a robust commercial finance market, would promote innovative financial products, enhance overall liquidity for the SMME sector, and advance the goal of financial sector inclusion and sustainable growth. In addition to facilitating financing for SMMEs, a harmonized approach would promote regional

investment and trade in financial services in the APEC region. Such an initiative could focus on the following activities:

- A survey of key enablers of financing availability
- Developing model elements of an APEC or region-wide code of security interest creation, perfection and enforcement, which could include clear perfection rules, broad coverage of collateral types, exclusivity to eliminate the “hidden lien” problem, and provisions for debtor-in-possession financing.
- A model treatment of floating charges/accounts receivable financing
- Establishment of a public-private dialogue to validate improvements
- An APEC checklist for statutory/regulatory implementation
- Promoting broad licensing authority for commercial finance, such as non-bank financial company charters.

The Advisory Group urges APEC to undertake an SMME Finance Initiative that focuses on developing properly structured credit sharing information systems and improving legal infrastructure to promote SMME finance.

III. EXPANDING PRIVATE INVESTMENT IN INFRASTRUCTURE THROUGH AN ASIA-PACIFIC INFRASTRUCTURE PARTNERSHIP

Financing infrastructure, a key ingredient of economic growth, is a major challenge for the region’s developing economies. A recent study⁵ has concluded that on average, Asia would need to invest about US\$750 billion annually to meet domestic and regional infrastructure needs over the period 2010-2020. In its 2009 report, the Advisory Group noted the important role of private investment in the development of infrastructure and the huge potential for public-private partnership (PPP) to contribute to this objective in a way that will benefit governments, the private sector and the public at large. A number of underlying issues remain to be addressed.

- The first is the information asymmetry between the public and private sectors. Given the private sector’s considerable information advantage, the public sector has been reluctant to engage more broadly in infrastructure partnerships. An environment for constructive and confidential dialogue, where industry can provide input and perspective without risk of loss of financial benefit or intellectual property, would be helpful in addressing this issue.
- The second is the need to develop broader and deeper capital markets for infrastructure projects, which are generally long-life assets earning revenues in local currencies. Deeper and more liquid bond markets and the formation of a yield curve with coverage and depth going beyond short- and medium-term government bonds will entail the development of a broad issuer base.
- The third is how to promote a more active role for IFIs in the provision of long-term funds in local currencies, for example by combining their robust credit standing to raise long-term debt and by promoting long-term swap markets to help refresh local balance sheets and eliminate currency mismatch of infrastructure revenues generated in local currencies.

While there are ongoing bilateral efforts to address infrastructure issues, there is a need to move toward a multilateral approach to provide effective ways of bringing skills and financial resources to developing economies. APEC could play an important role in promoting

⁵ Asian Development Bank and ADB Institute, *Infrastructure for a Seamless Asia*, 2009.

initiatives that could provide models for regional cooperation to be undertaken by interested member economies and later evaluated and considered for adoption on a wider scale. The Advisory Group recommended that APEC launch a regional infrastructure partnership for this purpose.

The Advisory Group convened a Public-Private Partnerships Forum in Melbourne on 9 February 2010 to discuss these issues and consider the idea of an Asia-Pacific Infrastructure Partnership (APIP) that would bring together public and private sector interests, multilateral agencies, academic institutions and professional groups. The Partnership would assemble knowledge and information, address issues of information asymmetry and support and promote capacity-building. (*See Annex B for the complete Forum Report.*)

Forum participants, who included representatives of business, public sector institutions, the ADB, academia and professional groups involved in PPP design, administration, finance and management, supported the idea of establishing the private sector component of APIP. Participants also welcomed the offer of RMIT University to provide financial support for its Australian APEC Study Centre in playing a coordinating role during the initial period of efforts to bring about the formation of APIP. The Advisory Group endorsed suggestions on the structure, governance and operation of a secretariat for APIP developed by the Australian APEC Study Centre, which provided for transitional arrangements to support the development of APIP, leaving open the prospect of an appropriate institution taking on the role if the concept gains broad support over the next few years.

The Advisory Group sees the role of APIP as twofold.

- At a strategic level, it would provide unbiased and objective advice to governments in the region on identifying and evaluating critical PPP development objectives and priorities, by helping ministers and senior officials develop a strategic approach to PPPs, consider PPPs in a holistic way and help in making appropriate policy choices.
- At a practical level, it would help officials deal with specific issues related to design, contracts, implementation and management of PPPs, making use of private sector expertise and experience in these areas, including related legal and financial issues and risk management.

The Advisory Group believes that the value of APIP can be demonstrated through an APEC pathfinder initiative involving a number of interested developing member economies and multilateral development institutions. Activities under this pathfinder initiative could include initial discussions with a small set of interested developing economies focused on strategic and policy issues with a high-level panel of private sector advisors and multilateral institution participation, to be followed at a later date by discussions focused on practical issues.

The Advisory Group recommends that APEC undertake a pathfinder initiative in cooperation with ABAC and the Advisory Group and involving interested member economies, to promote an Asia-Pacific Infrastructure Partnership (APIP), bringing together public and private sectors and multilateral institutions.

IV. TAKING ASIA-PACIFIC CAPITAL MARKET DEVELOPMENT TO THE NEXT STAGE: A PROPOSED PACKAGE OF MEASURES

Bond market development in the region has reached a significant stage, owing to various regional cooperation efforts, especially the Asian Bond Market Initiative (ABMI), which continues to undertake important initiatives. Nevertheless, discussions held during the past three years under the APEC Public-Private Sector Forum on Bond Market Development have

revealed key weaknesses that still need to be addressed. In particular, supply constraints arising from inadequate market depth and liquidity, market infrastructure and architecture and legal and regulatory frameworks represent the key obstacle to market development.

These discussions highlight the importance of continued and focused capacity-building efforts and collaboration among government and regulatory agencies, investors, issuers, credit rating agencies, private sector experts and international agencies. On 31 May 2010, the Advisory Group and ABAC, in cooperation with Japan's Ministry of Finance, convened the APEC Public-Private Sector on the Development of Bond Markets and Financial Inclusion in Sapporo, Japan. (*See Annex A for the full report.*)

The great diversity within the region has been highlighted by the discussions of the local currency bond markets in China, Korea and Japan, which are at different levels of development and facing different sets of challenges. The experiences of these three economies and the progress they have achieved over the past several years underscore the tremendous impact that reforms can have on market development. Going forward, each of these economies needs to focus on particular issues in order to sustain the momentum of market development.

- For China, the focus will be on optimizing the financing structure, improving the diversity of products and the issuer base, promoting globalization through increased foreign issuer participation and increased overseas issuance of domestic entities, more closely integrating the bond and banking markets, and the development of derivatives markets.
- For Korea, the key issue is ensuring that regulatory changes being undertaken as part of global regulatory trends in response to the recent crisis are in line with the objectives of market development, particularly with respect to their impact on liquidity and the demand for bonds and other safe assets.
- For Japan, the major issues revolve around improving the efficiency, transparency and liquidity of primary and secondary markets, the development of a robust market infrastructure and the diversification of the investor and issuer base, particularly through increased participation of foreign investors and issuers in the market.

There is wide scope for the introduction of new initiatives, building on current achievements, to bring capital market development and integration in the region to the next higher level. In addition to continued efforts to address key issues in the development of government and corporate bond markets, innovative solutions that can be pursued on a regional basis under the APEC framework include the following:

- Development of wholesale securities markets open only to professional investors (exempt from strict disclosure rules designed to protect retail investors), to encourage the expansion of the issuer base, including foreign issuers, and to promote more issuance by current issuers. Individual economies could establish such arrangements and eventually collaborate to develop regional arrangements for securities settlement, removing barriers to entry and undertaking further steps to create an integrated regional professional securities market.
- Collaboration between government and regulatory officials and market players to reduce barriers to cross-border settlement. The public sector should take the lead in addressing barriers related to tax, foreign exchange controls, investor registration, omnibus accounts and quotas. The private sector should lead efforts to address barriers related to messaging formats and pre-matching. Both public and private sectors should collaborate in

addressing barriers related to cash controls, physical certificates, securities numbering and settlement cycle.

- Promoting the use of foreign securities as eligible collateral throughout the region to enable major domestic and foreign financial institutions and investors to participate in cross-border collateral markets. In these markets, bonds can be actively used as collateral in money market transactions or traded in repurchase agreements, contributing toward more liquid bond markets. Existing arrangements can be considered as starting points in developing new bilateral arrangements, with a view toward a region-wide system.
- Continued collaborative efforts among governments, regulatory agencies, credit rating agencies and market players to promote region-wide convergence of accounting standards, disclosure regimes and corporate governance practices toward robust global standards.
- Establishment of a pathfinder initiative to introduce a funds passport scheme. Such a scheme is intended to facilitate the distribution of collective investment funds complying with a widely agreed common set of fund investment guidelines across participating jurisdictions. It should be designed to provide superior standards of retail investor protection and regulation compared to non-qualifying funds. Development of the common set of guidelines under which funds can apply for distribution across participating economies will need to be accompanied by efforts to address related regulatory and tax barriers as well as currency issues.

The Advisory Group recommends that APEC Finance Ministers and Senior Finance Officials undertake discussions with a view to compiling a package of measures to bring the development of the region's capital markets to the next level. We recommend that these discussions focus on (a) development of wholesale securities markets exclusively for professional investors; (b) regional public-private sector collaboration mechanisms to reduce barriers to cross-border settlement; (c) use of foreign securities as eligible collateral throughout the region; (d) ways to accelerate the region-wide convergence of accounting standards, disclosure regimes and corporate governance practices; and (e) establishment of a pathfinder initiative to introduce a regional funds passport scheme.

V. BUILDING CAPACITIES FOR REGULATORY REFORM IN ASIA-PACIFIC EMERGING MARKETS

Continuing its ongoing collaboration with the South East Asian Central Banks (SEACEN) Research and Training Centre and financial regulators in the region to strengthen financial systems, the Advisory Group coordinated the program and preparations of the 6th SEACEN-ABAC-ABA-PECC Public-Private Dialogue for the Asia-Pacific Region, which was held on 15-16 June 2010 in Manila, Philippines. This year's dialogue dealt with the theme *The Role of the Financial Sector in Sustaining Economic Growth and Stability*, and discussed current global financial regulatory reform processes in the context of ongoing regional efforts to strengthen and develop the region's financial markets.

As in previous years, the dialogue helped shape the Advisory Group's views on the situation of financial systems in the region and how they may be strengthened. Key messages from the discussions were as follows:

- *Risks to financial markets are growing again.* Risks to global financial markets are increasing with banks in developed economies coming under stress due to rising sovereign risks and continued weakness of capital buffers for smaller banks in developed markets. Funding market strains are reappearing and banks are not lending to each other, increasing the need for renewed liquidity support from central banks. In developed

economies, downside risks are rising due to growing fiscal vulnerabilities. Asian emerging markets will be impacted with respect to both funding and capital flows and asset prices.

- *Asian banks and regulators face increased economic, financial and regulatory challenges.* Asian banks are negatively affected by uncertain global recovery prospects, regulatory overreaction to the crisis and the tightening of capital requirements. Asian central bankers are confronted by challenges related to large capital inflows, currency appreciation, heightened exchange rate volatility, distortion of asset prices as a result of capital inflows, the low interest rate environment, implications of new financial stability mandates and international policy coordination and resolution mechanisms.
- *Growing fiscal imbalances present serious new risks and must be addressed.* The growing risk arises from the low interest rate environment that can encourage fiscal imbalances. Events in Europe indicate that markets are not very tolerant of high public debt levels that are seen as unsustainable.
- *Regulatory reforms must be handled with care.* While there is support for regulatory reforms within the region, three key principles need to be kept in mind. (a) Regulators should guard against financial fragmentation and protectionism. (b) The aggregate impact of global reform measures should be adequately assessed. (c) Reforms should be undertaken with regulatory transparency through extensive consultation with industry, full impact analysis, allowing a transition period for implementation, appropriate grandfathering terms and consistent compliance and enforcement.
- *Conditions in the region are not adequately reflected in current reform initiatives.* There is significant concern within the financial industry about the value to the region of certain reform initiatives currently being considered. Negative impact of certain reforms in Asia would include significant reduction of liquidity in markets; putting Asian banks at a competitive disadvantage due to the lack of deep long-term capital markets to tap in beefing up capital; slowing the recapitalization of the banking sector; and extraterritorial impact of North Atlantic legislation.
- *Divergence between G20 and regional financial market development goals must be avoided.* There is concern that strong domestic political pressures in some economies striving to shape the G20's agenda poses significant potential for divergence between the G20's direction and the direction of Asian regional efforts to promote liquid and efficient financial markets, which may also end up damaging regional cohesion and solidarity. G20 member economies from within the region have a serious responsibility to ensure that the outcomes of this process are consistent with regional financial market development goals, and need to play an active role in shaping the G20's agenda.
- *Synergy between G20 and East Asian regional processes can be achieved.* The G20 is focusing on macro-economic policies and structural reforms to promote recovery and long-term growth, as well as on international financial regulatory reform. East Asian regional cooperation has focused on the development of a multilateral swap arrangement and local-currency bond markets. Synergies between these parallel global and regional processes could be achieved if members from the region ensure their voice is reflected in the development of policies at the global level and regional institutions work closely with their global counterparts.
- *Basel reform proposals still need substantial improvement.* Responses to the package of proposals contained in the 2009 BCBS consultative document indicate that there is need for substantial improvement. Following are key issues regulators and policy makers

should keep in mind: (a) Implementation of reforms should be coordinated globally and be internationally consistent, while taking into account economic conditions, business models and tax and accounting systems particular to each economy. (b) The impact of new regulations on the cost of doing business and on capital markets should be reviewed and evaluated. (c) There should be close consultations and dialogue with the private sector to determine what constitutes an appropriate level of capital and liquidity in financial systems.

- *Basel reform could increase costs but will provide long-term benefits.* It is expected that implementation of the new standards will result in a more stable banking system, lower risk premia and more efficient allocation of resources. However, it is also expected to increase the costs of funding, e.g., as a result of excessive capital-raising affecting banks' profitability and the costs being eventually passed on to the consumer. Basel reforms can lead to a more robust global banking system, but only if it is implemented at the right pace and time.
- *Need to minimize the use of top-down one-size-fits-all approaches.* In the context of Asian banking systems, it is still unclear whether Basel reform proposals would enhance financial stability. The new leverage ratio could penalize banks for taking excess deposits over loans. The net stable funding ratio would encourage banks to seek long-term funding from the market rather than through demand deposits. In Japan, a balanced reform package helped prevent major banking failures despite relatively low capital levels with lower quality capital components. These considerations indicate that some issues may be better dealt with through Pillar 2 (e.g., leverage ratio and net stable funding ratio) or through a balanced package of measures rather than through Pillar 1 and regulation of equity capital. It must also be kept in mind that more regulations will raise compliance costs and discriminate against regulated institutions vis-à-vis unregulated institutions, and encourage more regulatory arbitrage.
- *Focus on supervisory capacity is badly needed.* It is important that regulatory reforms are coordinated (to ensure level playing fields and avoid regulatory arbitrage). However, finding a proper balance between individual jurisdictions' discretion (amply needed) and consistency in implementation is a very difficult challenge. Implementation of agreed rules will also be meaningless unless complemented by strong supervision. There is therefore a real need to ensure that supervisors have adequate resources and authority as well as appropriate organizational frameworks and constructive relations with other agencies.
- *The Asia-Pacific region needs a regional architecture to effectively deal with regulatory reforms.* The crisis has led to major efforts at regulatory reform at the global level and in North America and Europe. Regulators in the region need to carefully assess the value of various proposals, including higher taxes for the financial industry, and determine costs and benefits of adoption. It is important for Asia-Pacific economies to review the relevance and potential impact of such reforms on the region, and to develop an architecture for this purpose.
- *Further develop the Chiang Mai Initiative Multilateralization facility.* To strengthen the region's emerging markets against volatile short-term capital flows that can lead to capital account crises, policymakers should begin studies on converting the standby CMIM facility into a well-endowed and effectively managed international financial institution, such as an Asian Monetary Fund when the time is ripe. An AMF that complements the existing global financial architecture could add value through its deeper

understanding of Asian economies and avoid repeating mistakes committed before and during the Asian financial crisis.

- *The Asia-Pacific region needs a regional financial forum of regulators and the financial industry.* Given the highly fragmented situation of the region's financial market infrastructure, compared for example to Europe, it is important to complement regional surveillance with parallel regional efforts to ensure that global standards are developed taking into account market practices and market infrastructure in the region. There is a need for a regional financial forum to address regulatory issues in the light of the region's needs, involving collaboration among regulators and the financial industry. Private sector input that can take into account both local and global perspectives should also be solicited in the process of designing regional structures.
- *There is a continuing need to develop financial sector safety nets in the region's emerging markets.* With the increasing complexity of financial products and growing inter-linkages among financial markets, maintaining domestic financial stability has become a shared responsibility among various institutions, thereby requiring a coordinated approach among regulators domestically and internationally and cooperation with the private sector. Efforts should focus on basic components, building robust frameworks for liquidity support, sound crisis management policies and procedures and good governance and sound strategies for deposit insurance.
- *Good corporate governance is crucial for stable growth.* In the face of globalization and an uncertain future of the global economy, the public sector has expanded its intervention and regulatory scope. However, the great diversity of economies precludes the success of a one-size-fits-all approach. Success in managing a return to prudent growth will require good corporate governance. Identifying milestones can help economies make steady progress in reforming corporate governance practices. Corporate governance scorecards, which have proven very effective, should be considered as a useful tool for checking on commitments.
- *The challenge to regulators: calibrating local conditions to global standards.* International standards should be recognized as the minimum threshold rather than the limits of regulation. There should be ample room above the threshold to allow for local conditions to be calibrated into the governance standards. As financial markets gain their strength in the diversity they offer, which provide options to the public, the key is in managing the duality of a minimum threshold and accounting for localized conditions. This can be achieved by allowing idiosyncratic differences in the governance of the markets while ensuring consistency with the broad intentions of the minimum standards.
- *Balanced regulatory response to crisis is needed.* In responding to the dislocations caused by the crisis, stakeholders must work toward responsible change, balancing key objectives and interests. For the real economy to thrive, it must ensure businesses' continued access to capital. For financial institutions, it should ensure sufficient leeway to create viable markets out of mobilized funds. For regulators, it must define regulatory boundaries that enable them to take immediate and decisive action without micro-managing financial institutions. For the public, it must restore faith in financial markets, protecting savings within responsible limits while enabling people to take risks when the capacity to do so is in place.

APEC can play an important role in promoting capacity-building to assist emerging market regulators in the region in dealing with many of these issues. An example of such an initiative is the training program "Implementing Financial System Regulatory Reforms in the Region

following the global financial crisis,” funded by the APEC Support Fund and the Melbourne APEC Finance Centre at RMIT University, undertaken jointly with the Asia-Pacific Finance and Development Centre and endorsed by the Advisory Group. Benefiting regulators from 11 APEC economies and 17 non-APEC economies and involving representatives from the region’s financial industry and regulatory agencies and international institutions, this program provided a constructive example of a public private partnership in financial institutional capacity building.

The Advisory Group recommends that APEC Finance Ministers support capacity-building measures involving public-private sector collaboration to help emerging markets in the region improve financial supervisory capacity, calibrate local conditions to global standards, promote the adoption of proven tools such as scorecards to strengthen corporate governance, and strengthen financial sector safety nets (including frameworks for liquidity support, sound crisis management policies and procedures and deposit insurance firms’ governance and strategies).

The Advisory Group proposes that APEC Finance Ministers support the development of a robust regional financial architecture, including a regional forum of financial regulatory authorities and the financial industry to address regulatory issues in light of the region’s needs, review the relevance and impact of global reforms on the region, and ensure that development of global standards take into account market practices and market infrastructure in the region.

ATTACHMENT A
**APEC Public-Private Sector Forum on the Development of Bond
Markets and Financial Inclusion**
CONFERENCE REPORT

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APEC Public-Private Sector Forum on the Development of Bond Markets and Financial Inclusion

CONFERENCE REPORT

EXECUTIVE SUMMARY

The Advisory Group on APEC Financial System Capacity-Building and the APEC Business Advisory Council (ABAC), in cooperation with Japan's Ministry of Finance, convened the APEC Public-Private Sector on the Development of Bond Markets and Financial Inclusion in Sapporo, Japan on 31 May 2010. The Forum was attended by 80 participants from government, international organizations, private sector and academe.

The first part of the Forum focused on the development of capital markets, building on the results of the previous three bond market development forums organized by the Advisory Group and ABAC since 2007. The first three sessions, which dealt with this subject, included overviews of the region's bond markets and capacity-building efforts and discussions on the Chinese, Korean and Japanese bond markets. They also included discussions on innovative ways to bring the development of capital markets in the region to the next higher level. The second part focused on financial inclusion.

This forum represents a significant milestone in the work of the Advisory Group and ABAC on these two issues. As bond market development in the region has reached a significant stage of development owing to various regional cooperation efforts, an undertaking aimed at further progress in the broader context of capital markets has become desirable. With increased interest by APEC economies in the idea of a regional initiative, a discussion of financial inclusion has also become timely. Both initiatives require significant capacity-building efforts as well as active collaboration between public and private sectors.

Bond Market Development

Bond market development in the region has reached a significant stage, owing to various regional cooperation efforts, especially the Asian Bond Market Initiative (ABMI), which continues to undertake important initiatives. Nevertheless, discussions held during the past three years under the APEC Public-Private Sector Forum on Bond Market Development have revealed key weaknesses that still need to be addressed. In particular, supply constraints arising from inadequate market depth and liquidity, market infrastructure and architecture and legal and regulatory frameworks represent the key obstacle to market development. These discussions highlight the importance of continued and focused capacity-building efforts and collaboration among government and regulatory agencies, investors, issuers, credit rating agencies, private sector experts and international agencies.

The great diversity within the region has been highlighted by the discussions of the local currency bond markets in China, Korea and Japan, which are at different levels of development and facing different sets of challenges. The experiences of these three economies and the progress they have achieved over the past several years underscore the tremendous impact that reforms can have on market development. Going forward, each of these economies needs to focus on particular issues in order to sustain the momentum of market development.

- For China, the focus will be on optimizing the financing structure, improving the diversity of products and the issuer base, promoting globalization through increased foreign issuer participation and increased overseas issuance of domestic entities, more closely integrating the bond and banking markets, and the development of derivatives markets.

- For Korea, the key issue is ensuring that regulatory changes being undertaken as part of global regulatory trends in response to the recent crisis are in line with the objectives of market development, particularly with respect to their impact on liquidity and the demand for bonds and other safe assets.
- For Japan, the major issues revolve around improving the efficiency, transparency and liquidity of primary and secondary markets, the development of a robust market infrastructure and the diversification of the investor and issuer base, particularly through increased participation of foreign investors and issuers in the market.

There is wide scope for the introduction of new initiatives, building on current achievements, to bring capital market development and integration in the region to the next higher level. In addition to continued efforts to address key issues in the development of government and corporate bond markets, innovative solutions that can be pursued on a regional basis under the APEC framework include the following:

- Development of wholesale securities markets open only to professional investors (exempt from strict disclosure rules designed to protect retail investors), to encourage the expansion of the issuer base, including foreign issuers, and to promote more issuance by current issuers. Individual economies could establish such arrangements and eventually collaborate to develop regional arrangements for securities settlement, removing barriers to entry and undertaking further steps to create an integrated regional professional securities market.
- Collaboration between government and regulatory officials and market players to reduce barriers to cross-border settlement. The public sector should take the lead in addressing barriers related to tax, foreign exchange controls, cash controls, investor registration, omnibus accounts and quotas. The private sector should lead efforts to address barriers related to messaging formats and pre-matching. Both public and private sectors should collaborate in addressing barriers related to physical certificates, securities numbering and settlement cycle.
- Promoting the use of foreign securities as eligible collateral throughout the region to enable major domestic and foreign financial institutions and investors to participate in cross-border collateral markets. In these markets, bonds can be actively used as collateral in money market transactions or traded in repurchase agreements, contributing toward more liquid bond markets. Existing arrangements can be considered as starting points in developing new bilateral arrangements, with a view toward a region-wide system.
- Continued collaborative efforts among governments, regulatory agencies, credit rating agencies and market players to promote region-wide convergence of accounting standards, disclosure regimes and corporate governance practices toward robust global standards.
- Establishment of a pathfinder initiative to introduce a funds passport scheme. Such a scheme is intended to facilitate the distribution of collective investment funds complying with a widely agreed common set of fund investment guidelines across participating jurisdictions. It should be designed to provide superior standards of retail investor protection and regulation compared to non-qualifying funds. Development of the common set of guidelines under which funds can apply for distribution across participating economies will need to be accompanied by efforts to address related regulatory and tax barriers as well as currency issues.

Financial Inclusion

In recent years, microfinance has grown to become a potentially powerful tool for promoting financial inclusion, with the growing profitability of microfinance institutions (MFIs) and the

expanding scope of their operations. Microfinance is attracting increasing interest from financial institutions and investors all over the world. The key factor has been the introduction of technology and innovation, such as mobile banking, point-of-sale technology and biometrics, among others, and microfinance has taken off in economies where policies and regulations have been put in place to enable the use of these technologies.

With the growing commercial viability of microfinance, there is increasing interest among investors and great potential for channeling commercial investment into the sector. Public-private partnership with international financial institutions (IFIs) and bilateral institutions playing key roles could facilitate the expansion of such commercial investments. Nevertheless, while promoting and facilitating private sector investment is important, the major issue is not the lack of funds or investors, but rather the still limited number of top-tier MFIs.

To broaden investment opportunities, it is important to accelerate the process of upgrading existing MFIs, as well as to promote wider participation of financial institutions. The most difficult challenge, however, is how to broaden the base of the financial inclusion pyramid, by expanding the coverage and penetration of microfinance. In its 2009 report, ABAC recommended that policy makers and regulators consider undertaking measures in six areas identified in a recent ground-breaking study⁶ where policies can have the most impact. These are mobile phone banking, agent banking, channel and product diversification, public bank reform, financial identity and consumer protection.

An area where APEC can play a constructive role in promoting financial inclusion is the development of properly structured credit sharing information systems. This could involve the promotion of reforms to enable full-file and comprehensive credit reporting in member economies to private credit bureaus, which should be accompanied by measures to develop appropriate legal and regulatory frameworks defining key procedures, including types of information that can be collected, rights of data subjects, acceptable uses of information, data security requirements and obligations of credit bureaus, data furnishers and data users.

There are already many existing best practices in providing an enabling environment for the introduction and use of new technologies and innovations. Many of these can be easily made available through various institutions. There is also a need to recognize the potential of the public sector, especially government banks, in promoting financial inclusion, especially given the magnitude of the challenges to expand coverage of microfinance. Capacity-building measures to assist developing economies in effectively harnessing public sector resources and in promoting public-private sector partnerships are needed.

There is a lot of commonality between the G-20's approach and the approaches currently being discussed in APEC and there is great potential for APEC to undertake an initiative that complements the work of the G-20. Finally, there are ample resources, including expertise, funding and networks that private, international and bilateral institutions are willing to share in support of an APEC financial inclusion initiative.

Implementing APEC's Growth Strategy

Post-crisis recovery is proceeding at varying speeds across regions and economies. Many of the Asia-Pacific region's economies are leading efforts toward a quick recovery and more balanced growth, offering hope for the emergence of a new engine that will help sustain global economic growth in the years ahead. While the economic rebound that came immediately on the heels of the crisis was driven mainly by government stimulus, downside risks remain that have been highlighted by recent developments in Europe. In this context,

⁶ Alfred Hannig and Stefan Jansen: *Inclusive Financial System Reforms: What works, what doesn't, and why?* Synthesis Report, GTZ 2008.

the private sector must begin to play a more important role if the economic recovery is to be sustained.

A healthy and well-developed financial market is vital in enabling the private sector to play this role. In the region's developing economies, efforts are needed to focus on ways to accelerate the development of bond markets. While much has been accomplished through policy and regulatory reforms to stimulate the growth of these markets, particularly in Asia, innovative solutions are needed to bring capital market development and integration in the region to the next higher level. Greater financial inclusion, which will broaden the base of economic growth and help deepen financial systems, is another issue that needs to be addressed.

This year, an APEC growth strategy is being introduced to complement the pillars of trade and investment liberalization, facilitation and technical and economic cooperation that have guided APEC's development since the Osaka Summit in 1995. Bond market development and financial inclusion are both central to the success of efforts to promote balanced, inclusive and sustainable growth. It is hoped that policymakers will seriously consider the ideas presented in this report in designing concrete initiatives that can be undertaken within the framework of this new growth strategy, in collaboration with the private sector.

APEC Public-Private Sector Forum on the Development of Bond Markets and Financial Inclusion

CONFERENCE REPORT

INTRODUCTION

The Advisory Group on APEC Financial System Capacity-Building and the APEC Business Advisory Council (ABAC), in cooperation with Japan's Ministry of Finance, convened the APEC Public-Private Sector on the Development of Bond Markets and Financial Inclusion in Sapporo, Japan on 31 May 2010. The Forum was attended by 80 participants from government, international organizations, private sector and academe.

The first part of the Forum focused on the development of capital markets, building on the results of the previous three bond market development forums organized by the Advisory Group and ABAC since 2007. The first three sessions, which dealt with this subject, included overviews of the region's bond markets and capacity-building efforts and discussions on the Chinese, Korean and Japanese bond markets. They also included discussions on innovative ways to bring the development of capital markets in the region to the next higher level. The second part focused on financial inclusion.

This forum represents a significant milestone in the work of the Advisory Group and ABAC on these two issues. As bond market development in the region has reached a significant stage of development owing to various regional cooperation efforts, an undertaking aimed at further progress in the broader context of capital markets has become desirable. With increased interest by APEC economies in the idea of a regional initiative, a discussion of financial inclusion has also become timely. Both initiatives require significant capacity-building efforts as well as active collaboration between public and private sectors. Through this forum, the Advisory Group and ABAC aimed to bring together experts from both sectors.

APEC senior finance officials welcomed the initiative from the private sector to hold these discussions, noting the importance of their collaboration with ABAC for the whole APEC Finance Ministers' Process (FMP) and the fruitful outcomes that have resulted from continuous private sector advice to APEC Economic Leaders, Ministers and Senior Finance Officials and Senior Officials that has become a specific characteristic of the APEC process. The holding of the fourth in the series of discussions on bond markets in this year's Forum demonstrates the importance given by APEC Finance Ministers to the views of the financial industry. The incorporation of financial inclusion in these discussions highlights the growing interest of APEC in this issue.

PART I: BOND MARKET DEVELOPMENT

A. OVERVIEW OF CURRENT TRENDS IN THE REGION'S BOND MARKETS

Asian Bond Markets: Overview of Current Trends and Regional Initiatives

The Asian Bond Market Initiative (ABMI) was endorsed by the ASEAN+3 Finance Ministers' Meeting in August 2003 in Manila. It was established for the purpose of helping develop efficient and liquid bond markets in the region and fostering a high degree of financial independence in Asia. Since then, it has made significant contributions and has become an important symbol of regional cooperation.

The ABMI Framework has evolved over the years. Today, undertakings within this framework are done by four task forces (focused on promoting issuance of local currency denominated bonds, facilitating demand for these bonds, improving the regulatory framework and improving related market infrastructure) and a technical assistance coordination team. These work under the supervision of a steering group, which monitors progress and coordinates future plans, and which in turn reports to the ASEAN+3 Deputy Finance Ministers, who meet semi-annually and to the grouping's Finance Ministers, who meet annually.

As a result of efforts undertaken by governments individually and within the framework of regional cooperation, Asia ex-Japan local currency bond markets have achieved historical growth since the start of the new century. The resilience of these markets has been demonstrated by continued strong issuance and growth in the face of difficult global economic and financial conditions since 2008. In 2009, the value of emerging Asian local currency bonds outstanding increased by 16.5% year on year. Their share of the world total of bonds outstanding has increased from 2.1% at the end of 1996 to 7.8% by the third quarter of 2009. Performance of Asian local currency bonds has remained robust throughout the current downturn. The iBoxx Pan-Asian Index returned (in unhedged US dollar terms) 4.14% in 2008, 5% in 2009 and 4.09% in the first quarter of 2010.

At the 13th ASEAN+3 Finance Ministers' Meeting in Tashkent, Uzbekistan in May 2010, the ministers agreed together with ADB to support the issuance of local currency corporate bonds in the region through a Credit Guarantee and Investment Facility (CGIF). The CGIF was established as an ADB trust fund with an initial capital of US\$700 million, which will be operational before the end of 2010.

Another important development relates to the work of the Group of Experts (GoE) The GoE was an independent group under the ASEAN+3 framework, made up of representatives of private sector entities, including central securities depositories (CSDs), local custodians, global custodians and international central securities depositories (ICSDs) with expertise in cross-border bond or foreign exchange transaction and settlement issues nominated by governments of member economies.

The GoE has submitted to ASEAN+3 a report discussing key issues related to cross-border bond transactions and settlements. The report by the GoE consists of three parts.

- The first part contains survey results of estimated cross-border transaction costs in ASEAN+3, focusing on custodian fees. The survey results show that cross-border bond transaction costs in the ASEAN+3 region are generally higher than those of the US or the EU. Even within the ASEAN+3 markets, considerable variation is found across countries.
- The second part discusses the feasibility of two options for developing a regional settlement intermediary (RSI), namely, through an Asian ICSD and through a CSD Linkage in Asia, and presents recommendations for the next step. The study provides necessary legal and financial conditions if the RSIs need to be established.
- The third part presents a list of major barriers to cross-border bond investment and settlement and a set of recommendations to address them. The study also identifies perception gaps as significant impediments that arise from lack of market participants' awareness of progress made by authorities in reforming or removing impediments.

In response, the ministers endorsed the establishment of an ASEAN+3 Bond Market Forum (ABMF) as a common platform to foster standardization of market practices and harmonization of regulations relating to cross-border bond transactions in the region. ABMF is expected to provide a framework to support a regional dialogue between the public and private sectors.

In addition, the ministers also welcomed the establishment of the technical working group on a Regional Settlement Intermediary (RSI) to further evaluate the policy recommendations by the GoE.

A Review of Findings from Previous APEC Public-Private Sector Forums on Bond Market Development

The idea of a public-private sector dialogue on bond markets was presented by ABAC in 2006 to the Finance Ministers, who endorsed the proposal. Australia came to host the first forum in Melbourne the following year, Peru hosted the second in Cusco in 2008, and Singapore hosted the third in 2009. The first forum focused on Indonesia, the Philippines and Vietnam; the second on Chile, Mexico and Peru; and the third on Malaysia and Thailand. The following are the major conclusions of these three forums.

In general, there has been very significant development of bond markets in the region as a result of policy and regulatory reforms following the Asian crisis, but key challenges remain.

- Most emerging bond markets remain relatively small and underdeveloped.
- There is great diversity in bond market development within the region. Disparities include the quality of the policy environment and the size of local currency bond markets relative to GDP.
- In Asia, governments have actively promoted financial integration through such initiatives as the ABMI and the Asian Bond Fund (ABF). In Latin America, the process has been driven by cross-border investment and issuance related to foreign investment.
- Supply constraints represent the key obstacle to market development. They fall broadly into three major categories – depth and liquidity; market infrastructure and architecture; and the legal, policy and regulatory framework.
- Liquidity and depth are critical for bond market development.
 - ✧ Promoting liquidity of corporate bond markets would require diversification of financial instruments and maturities and the development of secondary markets. Key obstacles to the development of secondary markets include the generally limited size of issuances; the buy-and-hold attitude of investors; the lack of price signals in the market and the lack of repo markets.
 - ✧ Enhancing depth requires addressing issues of concentration in both the issuer and investor base. Diversity of issuers in most economies is limited, and bond issuance in general is highly concentrated in the public sector. Key obstacles include underdeveloped market infrastructure; inadequate corporate governance, disclosure and financial information; high costs of issuance through charges and taxation; and uncoordinated regulatory and supervisory frameworks.
 - ✧ In most bond markets, the investor base is concentrated, with majority of bonds held by banks and hedge funds. This concentration limits the resilience of markets. There are a number of obstacles. (a) First, the insurance and pension fund sectors tend to be small. In emerging markets, institutional investors tend to be conservative in their asset structure, compared to developed economies, where their counterparts are large-scale buyers of government bonds. (b) Second, capital and market restrictions limit foreign investor participation. (c) Third, underlying monetary policy objectives of some economies need greater clarity. (d) Finally, there is a need to address regulatory disparities that result in different rules for different market participants.
- With respect to corporate bond market infrastructure, constraints on market making and price discovery are the primary impediments. Key issues include building benchmark yield curves; strengthening disclosure laws, listing requirements, and accounting

standards; improving transparency; building post-trading information structures, and providing a clearance and settlement infrastructure that is free, transparent and involves minimal administration costs. The role of credit rating agencies is vital. Effective comparison of ratings across economies requires consistency in application of methodologies. Associated derivatives markets remain underdeveloped in many developing economies. In the absence of those markets, investors' ability to reduce risk is diminished.

- Investors and issuers in the region are confronted with challenges related to the regulatory, supervisory, legal, and taxation environment.
 - ✧ The first is creating a level playing field, where rules and obligations are clear and applied in a non-discriminatory manner. This would require greater coordination and collaboration of regulatory agencies, clear, transparent and harmonized rules, proper enforcement, and innovation-friendly regulations.
 - ✧ The second is improving legal protection and legal infrastructure. Inconsistent interpretation of rules is detrimental to confidence and the willingness of firms to enter markets. Key issues include enforcement of contracts; creditor rights protection and enforcement; effective and efficient settlement systems; and insolvency and bankruptcy laws supported by informal work-out arrangements within and across jurisdictions.
 - ✧ The third is taxation. Withholding taxes have an important impact on corporate bond markets. Taxes also affect cross-border investment and issuance. Among steps that could be considered are a survey of individual member economies; regular reviews of relevant taxes within a regional context; and regional discussions to address adverse impacts of taxes on market development.
 - ✧ The fourth is the need for coordination and collaboration among domestic regulatory agencies to avoid confusion in supervisory arrangements and the arbitrary application of rules, as well as to reduce excessive and burdensome compliance costs such as those arising from multiple reporting requirements.
 - ✧ The fifth is further liberalization of capital markets and the development of derivatives markets. Restrictions on capital flows, inability to manage foreign exchange and interest rate risks, and barriers to entry to both issuance and investment are key impediments that limit the growth of the investor base.
 - ✧ The sixth is exchange rate policy, which has a significant impact on the development of bond markets. Fixed rates impede market diversity and limit the ability of taking foreign exchange positions onshore, usually resulting in investors having to hold underlying assets to protect against currency moves. As such, foreign investor participation tends to be limited. In an environment of exchange rate flexibility, investors see more investible opportunities on a regional basis.
 - ✧ The seventh is the development of derivatives and repo markets that enable investors to hedge, such as through interest rate and currency swaps. These are important developments yet to take place in some markets, but are necessary for investors to manage underlying risks in their portfolios.

Discussions during the third forum reinforced the importance of a number of key issues.

- First is the need to prioritize corporate bond market development and how governments could facilitate this process. Governments should have clear strategies for creating a benchmark yield curve, promoting secondary market liquidity and risk management instruments, widening the issuer and investor base, and establishing new products.

- Second, legal and regulatory systems need to be strengthened to attract investors. This means working toward securities and corporation laws that foster and enforce transparency and fair play, provide adequate creditor protection and recovery processes, market regulations that allow efficient bond transactions, and standardized custodial and settlement practices designed to reduce operational risks.
- Third, taxation is a key issue, as investors look at total return. Tax and other incentives should be considered in expanding the investor base, and the impact of various taxes should be re-examined.
- Fourth, investors should be assured of the quality of requirements for issuance and adequate disclosure, and should have sufficient access to market information.
- Adequate market surveillance is needed to ensure compliance of market players and intermediaries with relevant guidelines and should cover primary and secondary markets to detect abuses and deter misconduct.
- Markets that enable investors to hedge, such as through interest rate and currency swaps, are necessary to manage underlying risks in portfolios.
- Credit guarantee institutions could help facilitate access of local companies to long-term capital.
- Investor education is important to develop a credit culture, which is key to greater market activity, and the role of institutional investors should be promoted.
- Incentives are useful in promoting local demand for new assets, such as savings bonds or Islamic financial instruments. The investor base should be diversified by mobilizing the onshore individual savings pool in addition to existing public and corporate asset pools and providing the right conditions for foreign investors to enter the market.
- Finally, further steps are needed to provide investors with useful and comparable credit ratings for bonds across the region's emerging markets, as well as efficient bond settlement systems.

Looking ahead, continued capacity-building is important. Regional cooperation and integration is a key element of capacity-building. There is a need for institutional arrangements to ensure continued reforms and improvements on a long-term basis and spanning political cycles. Importance needs to be given to capacity-building in certain priority areas. Such efforts should focus on the issues previously mentioned to address supply constraints.

Developed economies can play an important role in promoting policies that lead to market development in developing economies. Consideration could be given to how the synergy of such programs with other regional efforts may be enhanced. International institutions play a very useful role in bringing onto the table the experiences not just of APEC economies, but also of non-member economies. APEC should consider how programs undertaken by these institutions can be more effectively deployed in conjunction with each other and with other capacity-building efforts in the region.

Considering Asia's experience, regional financial integration in Latin America could be facilitated through closer collaboration among regulators and policy makers with more active support from international institutions such as the Inter-American Development Bank. Experiences in Asia and Latin America underscore the positive contributions of closer collaboration between the public and private sectors to the success of efforts to develop domestic financial markets. There is much scope for expanding this collaboration, such as through exchanges of information on best practices, implementing mechanisms for public-private partnership and regular roundtables.

Within APEC, there is a need to deepen connectivity between international initiatives and the actual implementation of reforms in member economies. The APEC Finance Ministers could consider APEC policy reviews on connectivity, focused on how regional and international capacity-building activities can more effectively support individual economies in developing their markets.

Development of Local Currency Bond Markets in the Region and the Role of Rating Agencies

Asian local currency bonds are emerging as an asset class, attracting domestic and foreign investors with a view to yield and portfolio diversification. While until the mid-1990s, Asian issuers were using mainly the short-term dollar debt markets as a funding source, they have since turned to medium- and long-term borrowing in local currencies. Examples are San Miguel's PHP38 billion issue in 2009 and a number of Korean, Indian, Australian and Gulf-based banks that became unable to issue in global markets raising funds in Malaysia in 2008.

Despite the dynamic growth of South and Southeast Asian bond markets, there remain several areas for improvement. The investor base, which has not changed significantly, except for fixed income mutual funds which have grown in some countries, needs to be expanded. Settlement systems need to be improved. In a number of markets, an artificial rating benchmark exists where investors buy paper carrying a rating of single A and above. The ability to price non-investment grade credit risk is not as developed, as markets still operate based on absolute yield. Longer dated maturities are also needed to help further develop the market.

Following are observations on some individual emerging Asian markets:

- Indonesia's local currency bond markets have posted strong growth with an increasing presence of local corporate borrowers accounting for over 50 % of total corporate bonds outstanding. This has led to greater diversity of the issuer base. Among the fixed income investors: mutual funds, insurance companies and foreign holders account for 40 % of the investor base, bringing them on a par with banks. In line with the growth of local currency bond markets, the two local rating agencies, PT Fitch Ratings Indonesia and the government-backed Pefindo, have assisted in the development of the local currency bond markets by increasing their coverage of ratings. However, liquidity, transparency and investors establishing correlations between ratings and pricing are some issues that require attention.
- Malaysia has a relatively robust local bond market with a broad range of market participants and a wide diversity of tenors and financial instruments. Private sector bonds make up half of the market. The market is the largest in the ASEAN region and has provided a robust platform for Sukuk (Islamic Finance) issuance. Despite the size and development of this market, issuers have generally preferred to obtain a single rating from either of the two local rating agencies, Rating Agency Malaysia (RAM) and Malaysian Rating Corporation (MARC). An overwhelming majority (98 %) of issuers have a single rating which suggests that market participants have a role to play by assisting in evolving this market to a dual rating market, with a view to establishing better corporate governance standards. However, with 334 ratings, Malaysia is the most developed ratings market in the region.
- Ten years ago the Philippine local currency bond market was largely one of government bonds. At present the top 20 corporate bond issuers outstanding as of December 2009 consist of large corporations and banks that account for over 80% of the market. In recent years the local currency bond market has become an attractive source of funding for firms. Banks remain the primary investors and the market continues to be illiquid. There is only one local rating agency (PhilRatings) that assigns ratings to local currency bonds, although Fitch Ratings assigns ratings to local currency bank bonds.

- Singapore's bond markets have grown rapidly since 1998. The market is liquid, diverse (several offshore names have issued in the market) and sophisticated in terms of the structured products offered. The market is hampered by low yields and the lack of ratings for the top 50 issuers in the market. Investors have a role to play by encouraging issuers to obtain ratings.
- Thailand's bond market provides a good alternate source of funding to corporations. The top ten issuers are mainly government-linked corporations that account for almost 50% of the amount outstanding. The investor base is reasonably diversified with banks dominating the investor profile (25%). There has been growing diversity in sector issuance with companies in the oil and gas, property, food production, telecommunications, auto leasing and health care sectors issuing in the market. Two rating agencies serve the local market in Thailand – Fitch Ratings Thailand and TRIS Rating Co, Ltd. Both agencies have a track record in developing the local financial institution and corporate ratings for local currency bonds. Insurance, bond funds and structured finance products are also rated by FitchRatings.
- The markets in Vietnam are in a stage of infancy with no rating agency present in the local markets.

Rating agencies play a constructive role in the development of local currency bond markets, but more work needs to be done in terms of promoting greater transparency and improving corporate governance standards by encouraging multiple ratings (at least a dual rated universe), expansion of the investor base, removal of artificial investment benchmarks for investment (e.g. Single A rating ceilings), development of local high yield markets, and issuance of longer dated maturities.

B. THE DEVELOPMENT OF APEC ECONOMIES' BOND MARKETS: EXPERIENCES FROM CHINA, KOREA AND JAPAN

The Chinese Bond Market: Current Development and Prospects

In spite of its relatively short history, China's bond market has been growing rapidly. As in many other developing economies, China's bond market was launched only recently; hence its currently limited market depth and liquidity. However, with the Chinese government giving priority to the development of a multi-level capital market, the bond market entered a period of rapid growth characterized by four major features.

- First is the expansion of the market's size. By end-2009, bonds outstanding reached RMB 17.53 trillion, 3.4 times of that at the end of 2004. Trading volume also grew rapidly. In the inter-bank bond market, the trading volume of spot security increased 18 times during the same period of time, and that for pledge-style repo and buy-out style repo expanded 6.5 times. The number of participants in the inter-bank market climbed to 9,427, forming a multi-level market structure with market makers as core, financial institutions as main investors and other institutional investors as participants.
- Second is the diversification of products. In the early stage, trading involved mostly treasury and enterprise bonds. Today, China's bond products include policy financial bonds, central bank bills, commercial bank sub-bonds, common financial bonds, financial company bonds, panda bonds, hybrid capital debt, asset-backed securities, short-term financing bill, medium-term notes and corporate debt, among others. In the first quarter of 2010, issuance by small and medium enterprises exceeded those of state firms for the first time.
- Third is the improvement of market facilities. Efforts to develop an efficient, integrated bond trading system, a bond tendering and bidding system as well as a custody and clearing system have been accelerated. Recent years have witnessed a continuous improvement in the market-making mechanism and hence remarkable growth of market

liquidity. In 2009, regulators allowed commercial banks to enter the exchange market, in order to lessen market segmentation between the exchange and over-the-counter markets. The management of issuance and circulation has also been improved, and information disclosure and credit ratings systems were established, with a clear direction toward market-oriented operations.

- The fourth is enhancement of financing functions. The ratio of bond market financing to bank loans has increased 21-fold from 0.7% in 1999 to 16.4% in 2009. Today, China's inter-bank credit debt market is the largest in Asia. The yield curve has developed with the establishment of benchmark interest rate for pricing of financial products. The bond market now supports the implementation of monetary and fiscal policies. In recent years, the People's Bank of China (PBoC) has introduced new instruments for open market operations including the central bank bills and short-term repos, which now serve as important channels for implementing monetary policy. In 2009, treasury bond issuance reached RMB 1.62 trillion, up 91% year-on-year, providing a powerful support in implementing proactive fiscal policies.

However, China's bond market still has a long way to develop, with the following as key issues:

- The financing structure needs to be optimized. In spite of government efforts to develop direct financing, it still has a long way to go. In 2009, new bank loans amounted to RMB 9.6 trillion, while new issuance of enterprise bonds stood at only RMB 1.6 trillion. Banking loans still remain the most important source of financing for supporting economic growth and social development.
- There is need for greater diversity of products and the issuer base, as well as an improved credit rating system. Products are currently dominated by low-risk bonds such as treasury bonds, central bank bills and policy bank bonds, which accounted for 82.3% of the total market in 2009. The credit rating industry has a relatively short history and faces a number of challenges.
- Globalization needs to be accelerated. Although the government is encouraging more foreign issuers in the market, without full convertibility of the local currency, bond issuance by foreign entities has been limited. As of end-2009, there were only four such issuances amounting to only RMB 4 billion. Overseas issuance by domestic entities is also at a very early stage.
- Markets need to be more closely integrated. Wider participation of more commercial banks in the exchange market is needed, in order to promote integration through arbitrage across markets.
- Markets for derivatives need to be developed. With the rapid growth of the bond market and innovative products, the ability of China's financial system to deal with credit and interest needs to be enhanced. In the absence of risk-mitigating and diversifying derivative instruments, market players find it difficult to hedge against systemic risk.

These challenges reflect the fact that China is still at an early stage of developing its bond market. Nevertheless, there is much potential for its future development, and the prospects for entering a new stage in this process that can significantly expand opportunities stand to be enhanced by the deepening and acceleration of economic, financial and structural reforms.

- Acceleration of economic structural adjustment will provide a favorable environment for further development of China's bond market. In the post-crisis era, China's credit policies will be more focused on differentiation strategies, while ensuring stable economic growth. It is expected that new bank loans, which grew rapidly in 2009, will grow more modestly

in the future, while direct financing will play an increasing role in meeting the demands of a growing economy.

- The emergence of a multi-level capital market promises to provide an historical opportunity for China's bond market. In recent years, governments at all levels have placed emphasis on bond market development. The Central Conference on Financial Affairs convened in 2007 put forward the objective of "enlarging the scale of enterprise bond issuance, sparing no effort to develop the corporate bond market and improving the bond management system." In January 2009, the PBoC lifted limits on bond issuance in the inter-bank market to facilitate direct financing of SMEs, more fluid circulation and smoother trading.
- China has learned valuable lessons and experiences from the financial crisis, particularly with respect to proper risk management on the part of both regulators and bond-issuers.
- The continued development of the institutional investor base will contribute to enhanced market stability. Institutional investors ranging from commercial banks and insurance companies to securities corporations and trust companies will be playing an indispensable role in activating and stabilizing China's bond market.

Regarding prospects for the future, current policy directions are seen resulting in a number of positive outcomes that will help create a wide and deep bond market that will offer tremendous opportunities and promote overall development:

- First, easier access and a more diversified issuer base can be achieved through increased issuance of various types of instruments, including short-term bonds and asset-backed securities issued by agriculture sector firms, collective bonds issued by small and medium enterprises, financial bonds issued by qualified auto finance companies and corporate bonds and pilot property investment trust funds issued by qualified real estate firms.
- Second, it is expected that improved market infrastructure, increased capacity-building and prudent financial innovation will result from various measures. These measures include improvements to the information disclosure mechanism, the credit rating system and services provided by intermediary agencies, as well as the development of debt and asset-backed securities and structured products.
- Third, phased moves toward capital account convertibility are expected to promote the gradual internationalization of the bond market. These moves include the step-by-step loosening of restrictions on cross-border capital flows and expansion of channels for overseas investment in RMB by qualified domestic institutional investors (QDII), the accelerated development of the RMB offshore financial market, greater foreign investment in China's financial markets and increased issuance of RMB bonds by foreign financial institutions. These developments will help bring about a multi-level capital market with a higher level of internationalization and improved transactions, pricing and information disclosure.

The Korean Bond Market: Current Development and Prospects

The Korean bond market has steadily developed since the Asian financial crisis, when total bonds outstanding was worth Won 235 trillion, equivalent to 46% of GDP. By the end of 2009, the value of total bonds outstanding has grown to Won 1,208 trillion and 114% of GDP. The secondary market has grown dramatically, with 2009 trading volume being 20 times that of 1997. Online trading has been a key factor, as 99% of bonds are now traded online.

Since the first issuance of guaranteed corporate bonds in 1972, the Korean corporate bond market has developed in response to several major events. The second milestone was the establishment of the first domestic credit rating agency in 1986, followed by the introduction of shelf registration in 1992. Immediately after the Asian crisis, changes were made to the

Deposit Protection Act removing the legal protection for bonds guaranteed by guarantee insurance companies in 1998, while the Asset-Backed Securities (ABS) Act was enacted into law in the same year. The next phase of development came with the introduction of the Well-Known Seasoned Issuer (WKSI) program in 2009.

These major changes had a profound effect on the development of the market. After the policy changes introduced in 1998, the ratio of guaranteed corporate bonds to total corporate bonds dramatically fell from a level above 70% in 1997 to less than 30% in 1998 and to less than 10% in 1999. Since then, almost all corporate bonds issued have been non-guaranteed. ABS issuance also rose sharply in the years following the enactment of the ABS Act, particularly during the years 2000-2001 and almost equaled total corporate bond issuance in 2002-2003 as the latter experienced a brief reduction. As corporate bond issuance experienced a recovery and steadily expanded after 2004, however, ABS issuance lagged behind.

Another important development has been the tremendous growth of the secondary market. As with the corporate bond market, this was spurred by several changes introduced by the government in the wake of the Asian crisis. These included the introduction of mark-to-market rules for bonds in collective investment schemes in 1998, the replacement of syndication with the Primary Dealer System and the listing of Korean Government Bond futures in 1999 and the deregulation of short sales of bonds and improvements in the market for repo and securities borrowing and lending in 2000. These changes have resulted in the dramatic rise of trading volume in government bonds since 1998. Securities firms currently account for more than half (50.4% in 2009) of total trading volume among all investors, followed by mutual funds (16.9%) and banks (16.7%).

Latest developments, particularly regulatory changes being undertaken as part of the global response to the recent crisis, are beginning to have an impact on the Korean bond market. Major regulatory changes introduced in Korea include the launch of an integrated multi-level oversight council, restrictions on business areas and operation size of financial institutions and a stronger investor protection framework. Financial institutions are also closely watching whether Korean regulatory authorities will follow the current global regulatory trend, in particular with respect to regulation of over-the-counter derivatives and establishment of processes and institutions to deal with bankruptcy of financial institutions and prevent future bailouts.

While it is feared that new regulations could reduce liquidity in the market, there is also an opportunity for reforms having salutary effects on the bond market. With the introduction of new regulations to promote safety and soundness as well as decreased risks in financial markets, demand for bonds and other safe assets is expected to increase.

- New regulations directing banks toward safe assets and requiring large institutions to separate safe and risky businesses are resulting in Korean banks shunning investment in risk assets and moving toward government bonds. The impact of these regulations on low-rated and less liquid corporate bonds is expected to be negative. Banks are expected to increase their bond investments if a slowdown in the property and securities markets leads to an expansion of bank deposits.
- For insurers, following the bailout of AIG, market participants expect more restrictions on investment in risk assets and derivatives, as well as mergers. Insurers are expected to increase their investment in safe assets such as bonds, especially in view of the impending adoption of risk-based capital in 2011 and reinvestment of funds raised from initial public offerings. Bonds are expected to take up a larger portion of managed assets under the low interest rate environment.

- For securities and asset management companies, it is expected that regulations on management of short-term products and derivatives, as well as quality standards for money market funds, will be strengthened.
- In view of the European fiscal crisis and the fall in yield of US treasury bonds, it is expected that overseas investors will increasingly prefer Asian local currency bonds and provide a stable base for supply and demand in the Korean bond market. However, the bond market could be negatively affected by any increased regulation on Korean branches of overseas banks.

The Japanese Bond Market: Expanding Foreign Issuance and Investment

Since the 1990s, various reforms have been undertaken to develop the Japanese corporate bond market, including deregulation of limitations and improvements in guidelines governing corporate bond issuances. In 2006, electronic registration of corporate bonds was introduced. These reforms have stimulated the growth of the market. In 2009 alone, corporate bond issuance grew by 29%. Nevertheless, compared to the US corporate bond market, where the total worth of bonds outstanding is equivalent to 48% of GDP, the Japanese market is still small, amounting to only 11% of GDP.

Corporate bonds account for only 0.1% of total household financial assets in Japan, as compared to 5% in the US. An important factor is the continued preference of Japanese households for cash deposits, which make up 55% of their financial assets, with insurance and pension reserves comprising another 27%. Compared to Japan, financial assets of US households are more evenly distributed among various types of assets including cash deposits (14%), insurance and pension reserves (29%), stocks, investment trusts and other equities (44%) and bonds (9%).

Consequently, the investor base for corporate bonds in Japan is also much less diverse compared to the US. Banks (with 48% of total worth of bonds outstanding) and insurers and pension funds (29%) are the largest holders, followed by government (12%). In the US, the investor base is more evenly composed, with the largest portion (27%) held by insurers and pension funds. Banks only hold 8% of corporate bonds. Individual investors hold 19% of corporate bonds in the US, compared to only 2% in Japan. Notably, foreigners hold 21% of corporate bonds in the US, compared to only 1% in Japan.

The high-yield market is much less developed in Japan compared to the US, with very few corporations issuing bonds rated below investment grade. In 2009, investment-grade issues comprised 95% of the total in Japan, compared to 84% in the US. Turnover in the Japanese corporate bond market is also much more limited than in the US.

One important factor affecting Japan's corporate bond market is the structure of sectoral money flows, with large deficits in the public sector and surpluses in the private sector (financial firms, private non-financial firms and households). Companies being cautious in making investment decisions under the current post-crisis circumstances, there is low demand for investment. When needed, it is also attractive to raise capital through bank loans. Issuance of yen-denominated bonds issued by non-residents, more widely known as samurai bonds, fluctuates widely, reflecting trends in exchange rates, real economic growth and other factors.

In view of these challenges, Japan is continuing efforts to promote the steady development of the market, in collaboration with market participants. The focus of these efforts has been the improvement of the primary and secondary markets. With respect to the primary market, key objectives include enhancing flexibility, improving underwriting practices and establishing a robust system for default risk management. With respect to the secondary market, efforts are aimed at establishing a system for price information, the development of repo markets and strengthening of the clearing system.

Tax reforms are also being undertaken through the new Japanese Bond Income Tax Scheme. Effective June 2010, non-resident investors will be exempt from tax on interest on corporate bonds issued before the end of March 2013. It is hoped that this tax change will be made a permanent arrangement. Current procedures for tax exemption for interests on bond investments are also being simplified.

These reforms are aimed at key objectives, which include greater efficiency, transparency and liquidity of the corporate bond market, as well as the development of a robust infrastructure, particularly in the area of information on transaction prices, clearing and settlement systems.

From the standpoint of issuers, it is expected that financial reforms being undertaken in various economies in response to the crisis will limit the scope of banking activities, while changes in the Basel Accord may additionally lead to more restrained lending activities of commercial banks. In this context, companies are expected to increasingly turn to capital markets. Consequently, expanded issuance and investment in Japan's bond market, including by foreign issuers and investors, is seen as a positive development due to its impact on market liquidity.

Major Japanese corporate issuers also face a growing demand for fund raising in other Asian economies, and are increasingly looking at opportunities for their subsidiaries to issue local currency bonds in these markets. For this reason, efforts to develop local currency bond markets in emerging Asian markets are viewed very favorably. The proposal to create bond markets for market professionals with less stringent requirements is also expected to enhance the accessibility of Japan's bond markets for foreign issuers and investors.

From the standpoint of investors, in addition to market and economic fundamentals, market access and the management of growth are two key issues that could be addressed to promote foreign investment in local currency bond markets.

- Global custodians provide tools to allow clients to manage entry into new markets, which include market profiles with detailed information on trading and settlement practices, taxation and investment regulations, pre-investment documentation required of foreign investors prior to trading in some markets and reference guides for documentation for settlement, among others. As all trades require the certainty of settlement, investors need to have timely information about changes in relevant laws and regulations. Governments and regulators can benefit from collaboration with global investment specialists in designing reforms to reduce cross-border and behind-the-border barriers to enable increased market access as well as increased visibility.
- In order to enhance market liquidity in a diverse region, it is important to address the fragmentation of markets before it takes place. The development of efficient local markets in the region can be promoted by region-wide recognition of new and more efficient practices by both regulators and the industry. The benefits of such an approach have been demonstrated in Europe, where the European Union has collaborated with industry during the past few years to develop and monitor coherent market practices alongside interoperable standards and promoted the alignment of interests. Markets in the region would be well served by the establishment of a regional public-private sector forum that includes both domestic and regional initiatives in its scope, fosters industry focus through convergence of concrete goals on regional bond market development, and leads to endorsement by the public sector of private sector efforts to develop coherent market practice.

C. CAPACITY-BUILDING FOR CAPITAL MARKET DEVELOPMENT AFTER THE FINANCIAL CRISIS

Regional integration continues to be an important aspiration of the business sector for the Asia-Pacific region. In the area of capital market development, the lack of market integration has hampered the development of local markets. Much of the accomplishment achieved thus

far in this area has occurred within the framework of ASEAN and ASEAN+3. However, there is still a long way to go, both in terms of the development of individual markets, as well as in terms of regional financial integration.

There is wide scope for the introduction of new initiatives, building on current accomplishments, to bring capital market development and integration in the region to the next higher level. Innovative solutions that can promote a more active private sector role in these efforts are needed, and given its strong links to the private sector, APEC can play an important part. This section discusses a number of new proposals, in addition to various considerations on how improvements in the market can be achieved.

A Passport Scheme for Cross-Border Recognition of Fund Management Products as a Vehicle for Financial Integration

Funds passporting and its benefits. One innovative way of promoting financial integration is the introduction of a passport scheme that facilitates the distribution of collective investment funds complying with a widely agreed set of regulations across participating jurisdictions. Benefits stand to arise from greater market depth and liquidity, lower product manufacture and investment costs, greater investment choice and potential returns and improved investor protection. Such a scheme can significantly improve the ability of participating jurisdictions to tap into the global pool of assets under management that is estimated to increase to US\$156 trillion over the next decade.

In addition, the region can benefit from the development of talent and knowledge-intensive activities and generation of employment in key sectors. These include, for example, fund management, accounting and administration; transfer agency and shareholder services; custody; trustee; client relationship and business development management; compliance; legal services; tax, human resources; finance and marketing.

The UCITS experience. The experience of Europe offers a way to better understand the workings of a funds passporting scheme. First proposed in 1976, the Undertakings for Collective Investment in Transferable Securities (UCITS) became a reality through the first UCITS Directive (UCITS I) of the European Commission in 1985. The Directive had two broad objectives. The first was to enable the sale of fund management products among member economies, which came to be called “passporting”. The second is to outline a set of principles by which UCITS funds must manage their assets. The scope of these rules includes risk management, counterparty and concentration limits, eligible assets, disclosure and regulation, among others. Once authorized as UCITS qualified by one participating economy under the harmonized legislative framework, a product can then be sold to retail investors in all participating economies without need for further authorization.

Considered unsatisfactory in the beginning, UCITS has developed in stages. Since 1985, the European Commission has amended the scheme by issuing several directives: a draft UCITS II directive (eventually abandoned during the 1990s), UCITS III (2003) and UCITS IV (for adoption in 2011). With the improvements introduced by UCITS III, UCITS funds achieved tremendous growth and expanded their geographical coverage. From 2001 to 2009, the total number of cross-border funds grew from 3,200 to 7,500. The current pool of UCITS funds, which includes equity-linked, balanced, bond, money market and alternative funds, is worth more than five times the global hedge fund industry at its height.

UCITS funds continued to grow in popularity relative to non-UCITS funds, and by the end of 2009 already accounted for 75% of the total European fund market. While UCITS was originally intended to facilitate intra-European distribution of funds, it has become a popular product in other parts of the world, including the Middle East and in Asian economies such as Japan, Hong Kong, Singapore and Chinese Taipei. In 2009, 30% of UCITS sales were already being made outside Europe, with Chinese Taipei becoming the second largest market globally.

UCITS' growing global reach has especially benefited Luxembourg and Ireland, which have become leaders in the passporting of UCITS funds across borders owing to regulatory and tax settings that encourage global administration and distribution. To compensate for the decline of its heavy industries, Luxembourg successfully targeted the funds industry by offering low taxes. Foregone taxes on revenues of domiciled funds were more than compensated for by the growth of the industry and its impact on employment and the economy. Ireland made use of its network of double tax treaties with various jurisdictions to compete with Luxembourg for leadership in UCITS.

Key to the expansion of UCITS were significant improvements made to the original directive by UCITS III. The Product Directive – one of its two major elements – successfully expanded product coverage, allowing investments other than transferable securities, UCITS funds of funds, greater use of cash deposits, financial derivatives instruments and financial indices. It also clarified the use of permissible money market instruments and rules on counterparty exposure. UCITS III also contained a Management Company Directive, which covered cross-border management companies and the use of simplified prospectus. Considered by market participants as much less successful than the Product Directive, it is being improved through UCITS IV, which is due for adoption in 2011.

Widely recognized as a success story, UCITS provides an example of a scheme that, through a process of continued refinement, has evolved into a sophisticated structure that has also fostered closer regulatory cooperation, expanded product choice, economies of scale, expanded opportunities for economic development and improved standards of investor protection and regulation in participating jurisdictions. It provides an attractive model for consideration in the Asia-Pacific region, where the preservation of retail investors' savings is acquiring greater importance as a consequence of recent demographic and economic trends.

Funds passporting as a step toward regional financial development and integration.

Successful penetration by UCITS of a number of key markets in Asia indicates that funds passporting is a feasible option for the region. Given the significant development of capital markets, increasing cooperation among regulators and the substantial growth of funds generated in the region, many key prerequisites for a successful funds passporting regime are already in place in several economies.

The role that funds passporting can play in the region is better understood by referring to two key policy objectives behind regional financial cooperation efforts: the recycling of savings into capital markets within the region and the development of emerging capital markets and the requisite financial expertise. The achievement of these objectives requires three elements: (a) large and broad capital markets to absorb savings; (b) efficient trading, settlement and clearing structures to reduce overall costs and risk; and (c) efficient intermediation between the region's asset markets on one hand and the region's investors on the other. Significant progress has been achieved in putting the first two elements in place, through such efforts as the ABMI and ABF and other ongoing work.

With respect to the third element (efficient intermediation), an important weakness still needs to be addressed. Two factors that drive efficient financial intermediation are (a) product innovation (i.e., creating attractive products for Asian investors) and (b) fund jurisdiction (i.e., local products that are easily accessible across the region). There has been significant progress in product innovation in recent years, particularly with the introduction of real estate investment trusts, exchange traded funds and structured products.

With regard to jurisdictional issues, however, there has been little progress in allowing funds domiciled within the region to be more broadly available. This challenge is illustrated by the example of the ABF Pan-Asia Bond Index Fund (PAIF), an exchange traded fund invested in eight Asian local currency bond markets launched under the auspices of several central banks under the Executives Meeting of East Asia and Pacific Central Banks (EMEAP), and which is currently domiciled in Singapore and listed in Japan and Hong Kong, China. PAIF is

currently the only major Asian domiciled large fund offering available to investors across a wide range of jurisdictions.

The process of listing PAIF in some markets required detailed discussions with local regulators, and even eventual changes to local regulations. It required efforts to manage ever increasing burdens associated with meeting multiple compliance needs of different jurisdictions, including setting up additional business units to meet local regulatory requirements. These processes entail significant business costs, which stand in the way of making local products more accessible across the region.

Ironically, while regionally domiciled funds face these challenges, funds domiciled outside the region (including UCITS funds from Luxembourg and Ireland, as well as other offshore funds from such jurisdictions as Bermuda, Cayman and Virgin Islands) can be easily registered in many jurisdictions within the region. Consequently, the region's funds market has evolved in a way where offshore funds have established dominant or significant positions (91% in Hong Kong, China; 79% in Singapore; 59% in Chinese Taipei; and 37% in Australia). In practical terms, and as an example that illustrates the consequences of the current regulatory framework, this means that an investor based in Hong Kong who wishes to buy a Hong Kong equity fund is likely to be offered a UCITS fund from the distributor.

This situation results in leakages in financial intermediation know-how out of the region, which will continue to escalate with the growth of Asian savings that is being driven by demographics (ageing populations) and economics (growing affluence). In addition, as foreign domiciled funds like UCITS are designed to conform to regulations set outside the region (and driven by specific considerations in these jurisdictions), they do not necessarily incorporate the needs of investors and regulators in the region, such as those for derivatives or alternative investments.

These are challenges to which a funds passporting initiative within the region can provide a solution that could give regulators the comfort they need to increase cross-border recognition of products, particularly unlisted funds, from within the region. However, the goal of a common set of fund investment guidelines under which funds can apply for region-wide distribution would be in itself a challenging one. Key issues that will need to be addressed for the success of regional funds passporting are the following:

- Regulatory barriers: Overcoming differences in regulations among participating jurisdictions would require agreements on such issues as licensing, compliance, monitoring, disclosure, dispute resolution, appropriateness of products, investor protection and legal recourse.
- Tax: There is a need to develop common approaches to treatment of foreign investors vis-à-vis local investors as well as to the issues of withholding tax and the review and harmonization of existing tax treaty arrangements to remove tax arbitrage opportunities.
- Currency issues: Issues related to increased costs arising from foreign exchange conversions involving the use of the US dollar as a settlement currency and the lack of free convertibility of currencies in the region need to be addressed.

Given the diversity in levels of market development within the region, a funds passporting scheme would be best established through a pathfinder initiative that can evolve over time. In the beginning, the initiative could examine the possibility of a system of mutual recognition of fund products, perhaps initially through a smaller group of economies that already have established infrastructure for selling, managing and regulating fund products. Products could also be made available to sophisticated investors first and to retail investors later. Once the scheme becomes more established, other member economies could be encouraged to join. Eventually over the longer term, the possibility of establishing a link between the regional passporting scheme and UCITS could also be examined.

A Regional Professional Securities Market

Focusing on wholesale financial services, a proposal for the establishment of an Asian Inter-Regional Professional Securities Market (AIR-PSM) provides useful ideas.⁷ The development of a regional professional securities market that can efficiently bridge the cross-border needs of issuers and investors in the region would be in line with the trend of closer regional integration, following the rapid growth of regional supply chains and intra-regional trade over the last few decades. It is also seen as a possible next stage of development on top of the development of local currency bond markets.

In their current stage of development, most domestic bond markets in the region are not able to fully capitalize on innovations in the international capital market for professionals. Although many institutional investors from the region are keenly interested in local currency bonds and equities, particularly in Asia, where currencies are expected to appreciate over the medium and long term, the available financial instruments are limited. This underscores the need to develop the infrastructure for cross-border financial and capital market transactions.

In Japan, the development of the corporate bond market has been limited due to stringent disclosure requirements for public offerings imposed on issuers to protect Japanese retail investors, although the majority of these bonds are purchased by professional investors. Existing private placement markets in Japan, which do not anticipate the emergence of a secondary market from the outset, are also not easy to use for both issuers and investors. Such restrictions have significantly limited the ability of issuers to issue bonds in a quick and timely manner.

Japan offers tremendous potential to provide funds for the region, given its sizable savings, the presence of major corporate groups with significant operations in the region and the existence of a well-developed domestic bond market infrastructure. It is well-placed to play a role in the development of a regional professional securities market and the requisite systems for disclosure and the provision of traded-price information for eligible financial instruments, and in promoting a high-quality market environment that can help increase the supply of such instruments.

The AIR-PSM proposal aims to enable the efficient circulation of savings within the region in a way that adds high value. It also aims to help develop and accumulate financial expertise in the region by creating a marketplace that will encourage companies and financial institutions in the region to become innovative principal and professional users of the market. Eventually, it is envisioned to develop into markets for Asian currency denominated regional bonds that will free issuers in the region from foreign exchange risk.

The proposal offers to develop the AIR-PSM in three stages:

- In the first stage, Japan could establish a public offering bond market under the rules of one of the existing Japanese exchanges. This market would be open only to professional investors and exempt from disclosure rules that were designed to protect retail investors. Yen-denominated bonds may be issued in this market by either Japanese or non-Japanese issuers, and can substitute for samurai bonds and the existing Japanese shelf registration system, providing minimum disclosure requirements in English for foreign issuers. A Japanese version of the eurobond market (Euro Asia Offering Market) could be established, with eurobonds or medium-term notes with an eligible option of being listed on the Japanese exchange and offered to professional investors in Japan. This market would be based on principles similar to Rule 144A (providing a safe harbor from

⁷ For a full discussion of the AIR-PSM proposal, refer to Shigehito Inukai, *Grand Design for an Asian Inter-Regional Professional Securities Market* (Tokyo, LexisNexis Japan Co., Ltd. 2008) and Waseda GCOE website in Japanese (<http://www.globalcoe-waseda-law-commerce.org/>).

the registration requirements of the US Securities Act of 1933 for private resale of restricted securities to qualified institutional buyers) option of the eurobond.

- In the second stage, other interested economies in the region could establish similar arrangements in their own domestic markets.
- In the third stage, interested economies and Japan would collaborate in developing regional arrangements for securities settlement, removing barriers to entry and undertaking further steps to create a cross-border professional securities market: i.e., AIR-PSM.

Toward a Regional Clearing and Settlement System: Addressing Barriers to Cross-Border Settlement

Work within ABMI on improving bond market infrastructure has recently focused on the development of infrastructure for securities settlement. This work was undertaken by the Group of Experts (GoE) under Task Force 4 of ABMI from institutions including domestic and international central securities depositories as well as local and global custodians. The GoE has taken a two-pronged approach. One is an evaluation of options for a regional settlement intermediary. The other is examining barriers to cross-border settlement, including legal and regulatory settlement-related barriers. This section focuses on the latter, which has been undertaken through an extensive market survey of over 58 financial institutions and experts in the region and 30 meetings in key financial centers in the region.

Areas identified by institutional investors, asset managers, banks, brokers, custodians and NCSDs/ICSDs where barriers are most serious are the following:

- Currency convertibility
- Taxes
- Securities numbering
- Cash remittance

Other areas where significant barriers exist are:

- Corporate events
- Physical certificates
- Investor registration
- Settlement cycles
- Omnibus accounts
- Legal jurisdiction
- Message formats
- Issuer disclosure
- Trade matching

The study reveals that important barriers to cross-border investment and settlement exist in many of the economies in East and Southeast Asia. Some markets have made significant and rapid progress in recent years toward reducing barriers. However, perception gaps remain, where market participants are not aware of the progress that has been achieved. Gaining and retaining cross-border investors' confidence in a market is critical, as negative perceptions about a market tend to persist.

Reducing barriers requires a combination of regulatory and private sector initiatives. Areas where the public sector will need to play the central role in addressing barriers are taxes, foreign exchange controls (conversion, repatriation), cash controls (credit balances, overdrafts), investor registration, omnibus accounts and quotas. Areas where the public and private sectors will need to collaborate in introducing reforms are physical certificates, securities numbering and settlement cycle. The private sector will have to play the central role in addressing barriers related to messaging formats and pre-matching.

A key issue that economies need to address is improving information flows in the market. This includes timeliness of information, uniform disclosure, price transparency, market statistics, information on corporate actions and legal information such as bankruptcy and insolvency laws.

To facilitate reforms, the ABMI study recommends the establishment of a coordinating body with a mandate to set realistic goals and timelines for reducing barriers to cross-border bond investment across the region. This body should liaise with regulators and industry representatives while monitoring and reporting on progress. It should work with individual market authorities and encourage them to improve the transparency of regulations and to establish best practices and standards. While the main focus would be regulatory barriers, private sector initiatives should also be encouraged. Individual economies are encouraged to develop medium-term roadmaps for reducing barriers.

Promoting Cross-Border Securities Collateral Management

Liquidity is a major issue that needs to be addressed for the region's bond markets to develop to the next stage. In this context, it is useful to examine the prospects for promoting the wider use of securities in cross-border collateral management within the region. For the financial industry, it is currently an important issue that stems from the need to improve risk management to cope with unstable prices and liquidity risks that have arisen with the increasing frequency of global crises, as illustrated by the Lehman Shock and the Greek Debt Crisis.

Globally active financial institutions managing their positions on an integrated basis around the world are aware that pressures originating in one market tend to be quickly transmitted elsewhere. With expansion of client activities in the region, especially in Asia, as a result of growing activities of corporate clients, the introduction of new financial products and services for clients and the rapid growth of markets, the ability to provide stable financial services to clients has become ever more important to financial institutions. This has led to a greater appreciation of tools for managing liquidity risks in contingency cases, which also contribute positively to market stability.

The use of bonds as collateral is an important element of managing liquidity risks. Most financial authorities in Asia have liquidity providing facilities backed by bond collaterals. Most financial institutions in the region use government bonds as collateral for repos and loans from financial authorities. A number of central banks all over the world, such as Federal Reserve Bank, the Bank of England, the Swiss National Bank and the Bank of Japan, accept foreign securities as collaterals in the context of cross-border collateral management.

The basic scheme for the use of cross-border collateral for local liquidity enhancement is as follows:

- In the home economy, a bank opens an account with a custodian, where eligible bonds are deposited.
- In the host economy, the central bank also opens an account with the custodian for receiving the eligible bonds as collateral or in repo agreement.
- In cases of contingency, the central bank of the host economy provides local currency loans against delivery of the collateral by the custodian.

Currently, the use of foreign securities as eligible collateral is not yet accepted in most emerging markets in the region, where there is an overwhelming preference for cash, although there are already initial efforts to introduce the practice. Financial institutions with operations in several markets are keen to benefit from a more flexible pool of collateral that also provides a means to meet any unforeseen sudden need for liquidity, as well as to better manage their risks and liquidity profiles in serving corporate clients. Where it is being

practiced, the use of securities for cross-border collateral management has contributed to market stability during the recent crisis.

In the context of efforts to promote the development of bond markets, the use of foreign securities as eligible collateral will promote the development of local currency balance sheet business and enhance the attractiveness of bonds for financial institutions. It will enable major domestic and foreign financial institutions and investors to participate in cross-border collateral markets, and lead to development of markets in the region where bonds are actively used as collateral in money market transactions or traded in repurchase agreements. Eventually, expanded use of bonds in cross-border collateral management will help increase investor demand.

Given these benefits, emerging markets in the region should consider promoting the use of securities in cross-border collateral management. Cooperation among authorities, particularly central banks, is a key ingredient for success. The role of the custodian, which needs to be credible and at the same time flexible in times of emergency, is of central importance. Existing arrangements, particularly those involving emerging markets, provide a good starting point for consideration in developing new bilateral arrangements, which can eventually lead to a region-wide system. The participation of financial institutions, particularly those that have been involved in current arrangements, in designing these systems will be helpful.

Enhancing the Quality and Usefulness to Regional Investors of Domestic Credit Ratings

While international bond markets are well-served by existing global credit rating agencies, domestic credit ratings remain important for the development of emerging local currency bond markets in the region, due to their usefulness to investors in differentiating among various levels of risk in most of these markets. As domestic credit ratings provide *relative* rankings of creditworthiness within a single market (where financial commitments issued or guaranteed by the government are normally assigned the highest rating and others are rated in relation to this benchmark) over a wider scale, as opposed to global credit ratings, which assign ratings based on a globally comparable scale, they are most useful to investors in less developed economies where global ratings tend to be normally compressed within a narrow range and do not allow sufficient differentiation among credits.

However, because domestic ratings are not intended to be internationally comparable (nor comparable over time, if the creditworthiness of the benchmark entity changes significantly), their usefulness to regional investors wishing to use ratings to compare bonds in different emerging markets is very limited. Regional investors are now able to use information provided by global rating agencies that also issue domestic ratings to make such comparisons, but still very few markets in the region are covered in this way.

Due to these limitations, efforts are being undertaken to improve the comparability of domestic credit ratings across the region, to facilitate cross-border investment. These efforts focus on promoting convergence of practices among domestic credit rating agencies in the region. The Association of Credit Rating Agencies in Asia (ACRAA), which was established with this objective in mind (in addition to ensuring high quality of domestic ratings), has played an important role through its cooperation with ADB and its undertakings within the framework of ABMI, which include best practice dialogues, workshops and the development of a handbook on international best practice in credit ratings.

The success of these efforts, however, will also depend on governments and regulators providing a healthy environment for the development of the credit rating industry. In the context of current discussions on regulatory reforms, two issues need to be addressed.

- First, credit rating agencies in the region operate within the context of specific corporate cultures that are characterized in many economies, although to varying degrees, by

close relationships among members of the same corporate grouping, main bank relations and strong ties to government. In response to criticisms of the role that credit rating agencies played in recent crises that occurred in the US and Europe, the urge to regulate the industry has increased. It is therefore important for governments and regulators in the region to keep in mind the regional context and the dangers of overregulation, particularly its potential impact on liquidity and the already deteriorating credit environment.

- Second, credit ratings are based on information made available to agencies within the context of existing accounting standards, disclosure regimes and corporate governance practices in each market, which currently vary across the region. Enhancing the quality of credit ratings will require continued efforts by governments and regulators to promote improvements in these areas. Promoting comparability of ratings across markets in the region will require efforts toward region-wide convergence of these standards, regimes and practices. This will also require greater collaboration between the industry and governments, especially in the context of regional organizations.

Future Directions for Regional Cooperation in Bond Market Development

Recent developments have highlighted the importance of bond markets for the region. As problems in the global financial system in the wake of the recent crisis led to the tightening of credit and drastic reduction of bank lending to the corporate sector, firms were able to continue funding their operations through the region's local currency bond markets. This stood in stark contrast to the situation during the Asian financial crisis before governments undertook efforts to develop their bond markets. In this sense, these efforts have succeeded in meeting one of the most important objectives of bond market development in the region, which is to help ensure firms' continued access to finance in times of turmoil and thus strengthen financial stability.

Nevertheless, the region will benefit from further reforms that will introduce greater efficiency in financial intermediation. Liquidity, market infrastructure and hedging markets remain key issues that require focus to achieve continued progress. An important element in this process is financial integration, which can be advanced through efforts to improve settlement systems, reduce transaction costs and facilitate cross-border transactions. As Asian bond markets further develop and become more integrated among each other, APEC can play a key role in helping these markets benefit from global integration, which is important to reduce the risks of market volatility and to help these markets maximize the efficiency benefits from increased foreign investment, particularly in government bond markets.

Within this context, financial institutions see the following as key steps toward further progress. With respect to government bond markets, efforts should focus on:

- Regular, predictable issuance programs for government bonds, including through the retiring and reissuing of bonds so as to create liquid benchmark issues.
- Robust, reliable and efficient OTC trading infrastructure such as price discovery, trade execution, clearing and settlement platforms. Elimination of barriers to trading such as transaction taxes.
- Establishment of a Primary Dealer Network evaluated and rewarded on the basis of their contribution to liquidity.
- Effective government bond repurchase markets (without such barriers as the prohibition on shorting and the punitive treatment of failed trades but with supporting legislation such as netting of financial transactions in bankruptcy).
- Liquid Government bond futures markets through the establishment of efficient futures platforms and well designed futures contracts

- A broad domestic investor base through promoting the institutional savings sector (life and health insurance, pension, mutual and hedge funds).
- A larger and more diversified foreign investor base through the removal of withholding tax, complex investment registration processes and capital controls
- The elimination over time of exchange controls and the development of a freely convertible currency.

With respect to corporate bond markets, following are key issues:

- The development of a liquid government bond market (see above).
- Increased transparency and better corporate governance in the issuers and intermediaries through legislation, enforcement and promoting a culture of compliance and adherence to international accounting standards.
- Adherence to international norms in the credit rating process and standards for corporate bonds
- A fair, efficient and predictable process for resolving disputes relating to corporate bonds (including bankruptcies) and protection of creditors' rights.

D. BOND MARKET DEVELOPMENT: SUMMARY OF KEY ISSUES

Bond market development in the region has reached a significant stage, owing to various regional cooperation efforts, especially ABMI, which continues to undertake important initiatives. Nevertheless, discussions held during the past three years under the APEC Public-Private Sector Forum on Bond Market Development have revealed key weaknesses that still need to be addressed. In particular, supply constraints arising from inadequate market depth and liquidity, market infrastructure and architecture and legal and regulatory frameworks represent the key obstacle to market development. These discussions highlight the importance of continued and focused capacity-building efforts and collaboration among government and regulatory agencies, investors, issuers, credit rating agencies, private sector experts and international agencies.

The great diversity within the region has been highlighted by the discussions of the local currency bond markets in China, Korea and Japan, which are at different levels of development and facing different sets of challenges. The experiences of these three economies and the progress they have achieved over the past several years underscore the tremendous impact that reforms can have on market development. Going forward, each of these economies needs to focus on particular issues in order to sustain the momentum of market development.

- For China, the focus will be on optimizing the financing structure, improving the diversity of products and the issuer base, promoting globalization through increased foreign issuer participation and increased overseas issuance of domestic entities, more closely integrating the bond and banking markets, and the development of derivatives markets.
- For Korea, the key issue is ensuring that regulatory changes being undertaken as part of global regulatory trends in response to the recent crisis are in line with the objectives of market development, particularly with respect to their impact on liquidity and the demand for bonds and other safe assets.
- For Japan, the major issues revolve around improving the efficiency, transparency and liquidity of primary and secondary markets, the development of a robust market infrastructure and the diversification of the investor and issuer base, particularly through increased participation of foreign investors and issuers in the market.

There is wide scope for the introduction of new initiatives, building on current achievements, to bring capital market development and integration in the region to the next higher level. In

addition to continued efforts to address key issues in the development of government and corporate bond markets, innovative solutions that can be pursued on a regional basis under the APEC framework include the following:

- Development of wholesale securities markets open only to professional investors (exempt from strict disclosure rules designed to protect retail investors), to encourage the expansion of the issuer base, including foreign issuers, and to promote more issuance by current issuers. Individual economies could establish such arrangements and eventually collaborate to develop regional arrangements for securities settlement, removing barriers to entry and undertaking further steps to create an integrated regional professional securities market.
- Collaboration between government and regulatory officials and market players to reduce barriers to cross-border settlement. The public sector should take the lead in addressing barriers related to tax, foreign exchange controls, cash controls, investor registration, omnibus accounts and quotas. The private sector should lead efforts to address barriers related to messaging formats and pre-matching. Both public and private sectors should collaborate in addressing barriers related to physical certificates, securities numbering and settlement cycle.
- Promoting the use of foreign securities as eligible collateral throughout the region to enable major domestic and foreign financial institutions and investors to participate in cross-border collateral markets. In these markets, bonds can be actively used as collateral in money market transactions or traded in repurchase agreements, contributing toward more liquid bond markets. Existing arrangements can be considered as starting points in developing new bilateral arrangements, with a view toward a region-wide system.
- Continued collaborative efforts among governments, regulatory agencies, credit rating agencies and market players to promote region-wide convergence of accounting standards, disclosure regimes and corporate governance practices toward robust global standards.
- Establishment of a pathfinder initiative to introduce a funds passport scheme. Such a scheme is intended to facilitate the distribution of collective investment funds complying with a widely agreed common set of fund investment guidelines across participating jurisdictions. It should be designed to provide superior standards of retail investor protection and regulation compared to non-qualifying funds. Development of the common set of guidelines under which funds can apply for distribution across participating economies will need to be accompanied by efforts to address related regulatory and tax barriers as well as currency issues.

PART II: FINANCIAL INCLUSION

A. THE EMERGENCE OF MICROFINANCE AS AN EFFECTIVE TOOL FOR PROMOTING FINANCIAL INCLUSION

An Overview of New Developments in Financial Inclusion

Microfinance has been around for quite some time, but it really has taken off during the previous decade. While there are no global comprehensive figures, available data all point to strong double-digit growth of microfinance. Profitability of microfinance institutions (MFIs) is growing. Compared to commercial banks in the same economy, MFIs tend to be more profitable, and this is particularly the case in East Asia and Latin America. A study by JP

Morgan and CGAP comparing indices of major MFIs listed in stock exchanges with MSCI indices of financial institutions also indicate that MFIs are outperforming banks over the long run.⁸

A number of MFIs have grown in size and sophistication, and the scope of services being offered has expanded. Some MFIs have become full-fledged commercial banks offering a wide range of services including housing and consumer loans, savings, life and health insurance, utilities payments and remittances. For these reasons, it is not surprising that microfinance is now attracting much interest from financial institutions and investors all over the world. Traditional banks can now choose from a wide array of options to engage in microfinance, from providing front and back office functions to MFIs, up to directly providing microfinance services.

Foreign funding, which used to account for only about 15% of funding for microfinance a few years ago, is rapidly growing. In the beginning, it has been dominated by non-profits institutions, which were joined by socially-responsible investors in the mid-1990s and later by commercial investors. Commercial investments have been growing rapidly in recent years, with international financial institutions (IFIs) in the beginning playing a catalytic role by proving the feasibility of business models and attracting private capital, especially microfinance investment vehicles (MIVs). The rapid growth of MIVs owes in large part to the emergence of a top tier of MFIs and demonstrates the potential of microfinance as a commercially viable activity.

In the context of APEC's growth agenda, microfinance offers a potentially powerful tool to channel private capital to promote inclusive growth. But to effectively harness this tool, it is necessary to identify the factors that account for the rapid growth of microfinance. The key factor has been the introduction of technology and innovation, such as mobile banking, point-of-sale technology and biometrics, among others, which have brought down the costs of microfinance.

The biggest problem of MFIs in the past has been the high administrative costs of providing very small loans to a very large number of clients. Technology and innovation have provided solutions that have cut down these costs, and microfinance has taken off in economies where policies and regulations have been put in place to enable the use of these technologies. A good example is the Philippines, which has succeeded in putting in place an innovative regulatory framework for mobile phone banking. This underscores the importance of assisting developing economies in designing such policies and regulations, and this is where APEC could play an important role.

The Asia-Pacific region can derive significant benefits from promoting microfinance, as in many developing member economies, only a limited portion of the adult population have access to finance. Promoting and facilitating private sector investment is important, and IFIs can play a role by working together with private financial institutions. In this context, the major issue is not the lack of funds or investors, but rather the still limited number of top-tier MFIs that are the principal targets of these investments. To broaden investment opportunities, it is important to accelerate the process of upgrading existing MFIs, as well as to promote wider participation of financial institutions, including commercial banks.

Finally, it is important to broaden the base of the financial inclusion pyramid, by expanding the coverage and penetration of microfinance. In its 2009 report, ABAC recommended that policy makers and regulators consider undertaking measures in six areas identified in a recent ground-breaking study⁹ where policies can have the most impact. These are mobile

⁸ CGAP/J.P.Morgan: *Microfinance Global Valuation Survey 2010*.

⁹ Alfred Hannig and Stefan Jansen: *Inclusive Financial System Reforms: What works, what doesn't, and why?* Synthesis Report. GTZ 2008.

phone banking, agent banking, diversifying service providers, making use of state-owned banks, creating financial identities and consumer protection.

Opening a New Frontier: Microfinance's Growing Access to Capital Markets

According to MIXMarket,¹⁰ a World Bank initiative that has become the industry standard database, a survey conducted by self-reporting MFIs has shown that the number of MFIs has grown at a rapid rate in recent years, with overall number of clients rising from around 5 million in 2005 to over 8 million in 2007. The total gross loan portfolio of MFIs has more than tripled from slightly less than \$10 million to just under \$44 million. The potential for growth remains large, with an estimated 1.5 billion working poor still currently in need of financial services, of which less than 10% have been reached by MFIs to date.¹¹

Sources of capital for MFIs now range from donations and grants to commercial capital. MIVs, usually managed by professional investment managers, have grown to supply a significant portion of MFIs' funding needs,¹² comprising US\$2 billion out of the total US\$3.9 billion of foreign capital invested in MFIs as of 2006.¹³ By 2008, there were already 68 MIVs with total assets under management reaching US\$5 billion. MIVs provide structures through which investors can invest in MFIs that lend to low-income clients. MIVs provide capital to MFIs in a variety of forms, including debt, equity and guarantees, assisting their growth and sustainability.

Returning steady cumulative returns across the board, MIVs have performed consistently and attracted investors.¹⁴ Credit quality is high due to the low credit risk of the underlying business, where credit officers know their customers well, who are typically low-income people (with women comprising the majority) who value the opportunity to access credit, resulting in high repayment rates (default rates for microloans are typically under 2%, although these differ across regions). MIVs also attract investors by offering strong diversification opportunities. Investing in professionally-managed MIVs give investors the opportunity to access a wide range of MFIs in a large number of regions and economies that are screened and monitored for financial and social performance, as well as a wider universe of borrowers.¹⁵

¹⁰ <http://www.themix.org/>

¹¹ <http://www.cgap.org/p/site/c/>

¹² Taking Developing World Markets (DWM) as an example, it structured and placed the first collateralized loan obligation (CLO) in microfinance in 2004; structured, placed and managed the first rated CLO in 2006; managed the first and second major institution-only microfinance fund in 2007 and 2008, and arranged the first cross-border bond issue by an MFI (Access Bank Bond I) in 2008. It created the DWM Microfinance Equity Fund in 2009, which is open to taking controlling stakes in MFIs, and the DWM Microfinance Fund in 2010 offering local currency. It plans to create the first Asia-wide structured MF fund offering local currency in the course of the year. Other financial institutions such as Citi, Morgan Stanley and Deutsche Bank have also been active in securitizing microloans and creating CLOs.

¹³ CGAP Note, *Foreign Capital Investment in Microfinance: Balancing Social and Financial Returns*, February 2008, <http://www.cgap.org/gm/document-1.9.2584/FN44.pdf>

¹⁴ Examples are the BlueOrchard Microfinance Securities I (US\$87 million CLO, 7-year notes, USD senior tranche) with 6.33% p.a.; Microfinance Securities XXEB (US\$60 million CLO, 5-year notes, USD senior tranche) with 6.12% p.a.; and Azerbaijan's Access Bank (US\$25 million bond, 5-year notes, USD) with 8.5% p.a.

¹⁵ Using the example of DWM, its Benchmark Fund offers credit diversification by providing exposure to 82 MFIs in 32 economies. DWM offers geographic diversification by setting exposure limits on most of its MIVs spread across 38 economies, based on country risk analysis covering political stability, economic climate, regulatory environment and enforceability of contracts. These limits include 35% maximum regional exposure, 15-20% maximum exposure to an economy depending on credit ratings, 10% maximum single MFI exposure, 30% maximum exposure to eligible enterprises that are less than 3 years old, 50% maximum total local currency exposure and 10-15% maximum exposure in any one local currency depending on credit ratings. DWM also offers local currency diversification; foreign exchange exposure of its

Their expertise enables MIVs to help expand investment in a sector characterized by a number of specific institutional-level risks. MFI-level risks include those associated with small size and organization; operating in a small emerging market; uncollateralized microloans; lack of experience of MFIs in borrowing or receiving equity investment from international markets; limited experience on the part of senior management; being unregulated financial institutions, potential political, economic and regulatory risks in the domestic economy; natural disasters; inconsistent accounting standards; potential fraud at the senior officer and at the branch office level; and large variety of credit quality of microloans.

As a result, MIVs have attracted increasing interest from institutional investors. Over 71% of investors in MIVs are institutions that include pension funds, banks, foundations, fund of funds, NGOs, development finance institutions (DFIs) and government agencies.¹⁶ Of these institutions, DFIs and government agencies often play a significant role, working in tandem with MIVs to develop the microfinance landscape. DFIs and government agencies often take on catalytic roles in providing both funding directly or through MIVs and technical assistance to MFIs around the world. They often provide seed funding and management know-how in the establishment of new microfinance banks, microfinance holding companies and MIVs. Such public-private partnerships have enabled both investors and MFIs to achieve financial success and generate significant social impact.

Most MIVs are currently unregulated. MicroRate and the Consultative Group for Assisting the Poor (CGAP) conduct annual MIV surveys to increase transparency. Registered investment funds are open to retail investors, usually regulated by local market authorities and regularly publish information on net asset value (NAV). Unregistered investment funds, which are usually unregulated, include private investment funds (private companies open to qualified and accredited investors seeking a return but not to retail investors), structured investments such as collateralized obligations that offer investors two or more classes of investment, and not-for-profit investment funds (typically non-profit organizations like NGOs and cooperatives that reinvest most or all returns and are usually exempt from regulation).

As the MIV space has grown, the regulatory framework has also matured. Currently, the majority of MIVs are domiciled in Europe with 46% of the world's MIVs (based on assets) registered in Luxembourg, which as a leading investment fund center provides flexibility and choice of MIV structures and relevant technical expertise.¹⁷ While MIVs have, in the past, focused on other regions, investor interest in emerging Asia has been growing, offering wider opportunities for the future of microfinance in the region's developing economies.¹⁸

B. THE ROLE OF THE PUBLIC SECTOR IN PROMOTING FINANCIAL INCLUSION

Providing an Enabling Environment for Promoting Financial Inclusion

Six Key Policy Areas

Flagship Fund outside the US dollar and the Euro (which make up 76% of the total) include exposure to 12 other emerging market currencies.

¹⁶ CGAP Note, *Foreign Capital Investment in Microfinance: Balancing Social and Financial Returns*, February 2008, <http://www.cgap.org/gm/document-1.9.2584/FN44.pdf>

¹⁷ CGAP Focus Note *Microfinance in Luxembourg*, February 2010 <http://www.microfinancegateway.org/gm/document-1.9.43145/02.pdf>

¹⁸ DWM plans to launch an Asia-Focused Debt MIV in the first half of of 2011. Features include a structured approach comprising junior, mezzanine and senior tranches to attract a broad range of investors, public-partnership and technical assistance components, focused on Tier 2 and 3 MFIs, aim to reach Asian economies not yet served by MIVs and loans in local currencies. It has a target of US\$100 million to fund loans to between 30 and 50 MFIs in at least 10 Asian economies serving over 10 million clients.

An important role of the public sector is providing an enabling environment for financial inclusion. A key issue is what policy makers should focus on to achieve the greatest impact. Six key policy areas are currently the focus of various international efforts, including those of the Alliance for Financial Inclusion (AFI) and efforts within APEC, to promote innovative policies. These areas are: (a) agent banking (enabling non-bank agents to provide financial services); (b) mobile phone banking (increasing access to financial services through mobile technologies); (c) financial identity (facilitating the development and use of financial identities for low-income clients) ; (d) consumer protection (promoting policies that provide adequate consumer protection in financial services); and (e) public bank reforms (enabling regulation for more effective commercial provision of financial services); and (f) channel and product diversification (facilitating the adoption of small savings accounts and micro-insurance).

1. Agent banking

The agent banking model involves retail outlets including retail shops and post offices acting as agents for banks where banks and other financial institutions have insufficient capacity or incentive to establish formal branches. New communications technologies (e.g., bank cards, point-of-sale devices, mobile phones) are used to manage cash-in, cash-out services, linking transactions to a bank.

The agent banking model is attractive due to a number of advantages. First, agent banks are less costly to establish than traditional bank branches, as they require smaller investment in staff and infrastructure. Second, the agent banking model is more flexible, since agents have lower security requirements than traditional branches. Third, agent banking has significant potential to help banks expand outreach in remote areas, because it involves low travel costs for customers and is supported by communities benefiting from additional revenues arising from retailers' commissions.

Initially, the agent banking model focused on traditional payments of utility bills and taxes. Recently, it has developed further to provide a growing range of financial products and services. While payments and transfers still dominate the menu of agent banking services, these services now typically include withdrawals, deposits, pre-approved credit lines, simplified current accounts, remittances, conditional cash transfers and employees' salaries.

Successful development of agent banking requires addressing a number of key policy issues. These include the setting of regulatory boundaries, consumer protection and ensuring commercial viability.

- Setting regulatory boundaries involves defining eligibility criteria for agents, determining the types of financial services that agents are allowed to offer, setting disclosure requirements and adapting rules related to anti-money laundering (AML) and combating the financing of terrorism (CFT), as well as know-your-customer (KYC) procedures. Authorities are finding a variety of ways to deal with these issues. In Mexico, for example, agents are permitted to perform KYC verification for low-value transactions, while Brazil has adopted a risk-based approach, where any institution supervised by the central bank can establish an agent relationship but banks are responsible for supervising, setting standards and tracking the operations of their agents.
- Consumer protection issues include building consumer trust to promote the use of agents, ensuring transparency with respect to commissions, guaranteeing privacy and data protection, supporting complaints resolution, real-time settlement and inter-operability challenges.
- Commercial viability cannot be ensured through laws and regulations alone; it requires sufficient business incentives for agents and financial institutions to use the agent banking model. For instance, governments can use cash transfers to kick-start the model, but agents must also be able to offer other services. Maximizing the number of transactions per customer is one way to ensure the financial viability of the system.

Three economies provide examples of how governments have succeeded in expanding access to finance through agent banking.

- In Brazil, which is one of the pioneers in agent banking, more than 100,000 retail outlets have been converted into agent banks since 1999, in the process reaching over 13 million unbanked people. All of the economy's 5,600 municipalities now have access to banking services, with many of these depending solely on agents.
- In Indonesia, the post office (PT Pos Indonesia) provides payment services through a network that is composed of 3,500 branches, 300 mobile service vehicles and 11,000 village agents. As an agent for its 38 bank partners, PT Pos carries out 20 million money transfers per month.
- In Peru, the network of agents has nearly tripled the proportion of districts with access to bank services from 5% to 14% of the total. Key to the success of agent banking is cost – the estimated cost of setting up an agent bank is only US\$5,000 as compared to the US\$200,000 cost of establishing a bank branch.

2. Mobile phone banking

Mobile phone banking has benefited from the rapid growth of mobile phone penetration, with subscriptions, which now number over 4 billion globally, increasing more than four-fold since 2002. Over half of new mobile phone subscribers are living in developing economies. Given these developments, mobile phones offer a huge potential for expanding financial access at a much lower cost than through physical branches. They are able to help reach the unbanked by offering convenient and real-time transactions, dramatically reducing transaction costs, expanding points of access in remote areas, and enhancing security by reducing the need to carry cash.

Mobile phones can be used to deliver a wide range of financial services. These include money transfers, retail purchases, bills payments, welfare payments and other social services, savings, withdrawals and remittances. Mobile phone banking generates transaction data that can be used to develop customers' credit histories, which in turn can expand and deepen the scope of financial inclusion.

Policy-makers and regulators are currently grappling with a number of policy issues arising from the development of mobile banking.

- One set of issues revolves around AML-CFT rules, as well as KYC procedures. Traditional AML-CFT rules may need to be updated for virtual or outsourced relationships and transactions. Mobile phone transfers pose unique risks but also open new opportunities, as such transfers leave trails. The Financial Action Task Force (FATF) has advocated a risk-based approach that allows regulation to be tailored to perceived risk, although in practice, many economies face challenges in achieving compliance this way. The application of standard KYC procedures to low-income customers has been questioned, and some policymakers have opted for simplified procedures allowing the development of products with a low-risk profile.
- A second set of issues is related to inter-operability, which enables customers to gain access to a different operator's mobile banking platform. An important issue involves market structure and competition policy. While mandating inter-operability will serve to promote competition and benefit consumers, it will also inhibit early movers due to concerns about losing their competitive edge. The need of customers to convert e-money into cash, using bank branches, automatic teller machines or agents adds another layer to inter-operability, as sharing cash-in, cash-out infrastructure can lower the costs of expanding outreach.
- A third set of issues deals with consumer protection. Mobile phone banking presents new challenges. These include the large distances between providers and customers,

lack of clear incentives or liability of agents for transparency, fraud arising from cash-in, cash-out transactions by agents, and the need for technology-tailored solutions to data security and privacy, redress mechanisms and pricing transparency. Policy considerations include the introduction of technology in financial education efforts to help reduce information asymmetry and the expansion of the scope of central bank supervision to cover operators to provide more comfort to unfamiliar customers.

There is a growing body of practice in the developing world on the regulation of mobile phone banking. Examples can be found in Kenya, the Philippines and Mexico.

- Kenya launched M-PESA (M stands for mobile, while pesa is the Swahili word for money) in 2007, when only 23% of the population possessed bank accounts but 80% had access to mobile phones. This service has grown into one of the most successful in the world, reaching over 8.5 million customers through 12,000 agents by the end of 2009. In the M-PESA Mobile Network Operator (MNO)-based model, clients can cash-in and cash-out (e.g., transfer and receive funds, pay bills, withdraw or donate) with any of the thousands of M-PESA agents. M-PESA wallets are held by Safaricom (a major provider of converged communication solutions in Africa, including telephone, broadband internet and fax) and are not classified as deposits. M-PESA account funds are pooled and deposited by Safaricom into an account held in trust at a commercial bank; the pool is used to back e-money at a 1:1 ratio.
- In the Philippines, two mobile banking operators (Smart Communications and Globe Telecom/G-Cash) provide services to an estimated 71.2 million customers (almost 80% of the entire population). Mobile transactions have proven to be very popular, as they cost only around a fifth of those executed through bank branches.
- In Mexico, the mobile banking model limits the telecommunications company (Telco) to a banking agent role, as the banking law currently allows only banking institutions to accept deposits from customers. Basic banking services provided by Telco retailers to clients include deposits, withdrawals, bills payments and remittances, with deposits withheld and managed by the bank.

3. Financial identity

Efforts in this area are aimed at facilitating the creation and use of financial identities for low-income clients. There are a number of difficult challenges, which include incomplete population registration and lack of an economy-wide identification system, as well as the inadequacy of data protection regimes and heightened risks of identity theft or misuse of information. One unintended consequence of the implementation of AML and CFT rules and regulations to promote financial integrity and prevent crimes and terrorist finance is that low-income people are further discouraged from accessing the financial system and are pushed instead to the informal sector.

Innovative policies focus on the use of personal identification information for purposes of creating financial identities. Such information is available from official documents (e.g., passports, ID cards, drivers' licenses) as well as non-official documents (e.g., employee IDs, utility records, letters from community leaders). Personal identification information consists of a wide range of information, including personal identifiers (name, address, date and place of birth, citizenship), bank information (account information, savings, credit, investment), insurance information (account information, payments, claims) and other financial information (post-paid telecommunications services and otherservices), as well as ID numbers and biometric identifiers.

A variety of approaches are used by different authorities in dealing with this issue. In India, simplified KYC measures are applied to low-risk customers in opening "no-frills" accounts. The Philippines allows the use of a greater variety of identity cards. In South Africa, authorities use a system for simplified address verification using informal networks.

4. Consumer protection

Consumer protection is generally considered to be a regulatory response to a market failure. Consumer protection laws, which are designed to ensure fair competition and the free flow of truthful information in the marketplace, are a form of government regulation to protect the interest of consumers.

Consumer protection is central to financial inclusion for a number of reasons. Benefits of financial inclusion cannot be attained without adequate consumer protection. Consumers make better decisions if they are given the right information and they know what to do with it. Market discipline facilitates financial market expansion. Financial literacy forms an important part of consumer protection. It is best promoted through collaboration among consumers, non-government organizations, financial institutions and governments.

The microfinance industry has been active in promoting consumer protection through the setting out of principles of pro-consumer microfinance, while allowing for the legitimate needs of MFIs to be met. An example is the code of conduct developed by the ACCION Network, a network of leading microfinance institutions, to aid in the industry's global self-regulation. The Network seeks to promote the application of these principles among MFIs, to collaborate with regulatory authorities in promoting effective and non-burdensome policies and rules and to raise awareness among MFIs about the importance of consumer protection.

ACCION's Microfinance Pro-Consumer Pledge consists of nine principles:¹⁹

- Quality of service (treating every customer with dignity and respect and providing convenient and timely services)
- Transparent pricing (giving clients complete and understandable information about the costs of loans and transaction services and how much they are receiving for savings)
- Fair pricing (ensuring that rates do not provide excessive profits, but are sufficient to ensure the continued survival and effectiveness of the business)
- Avoiding over-indebtedness (not lending to any customer more than he/she can afford to repay)
- Appropriate debt collection practices (effective practices that also treat customers with dignity and avoid depriving customers of basic survival capacity as a result of loan repayment)
- Privacy of customer information (protecting private information of customers from being disclosed to those not legally authorized to see it)
- Ethical staff behavior (holding employees to a high standard with respect to conflicts of interest and unethical behavior and adopting effective sanctions against such behavior)
- Feedback mechanisms (providing formal channels of communication with customers through which customers can give feedback on service quality, including mechanisms for responding to specific customers regarding their personal complaints)
- Integrating pro-consumer policies into operations (promoting pro-consumer orientation in the conduct of business through staff training and incentives, financial education for customers and customer satisfaction programs, among others)

Measures to promote consumer protection for low-income clients have been undertaken in a number of economies. Examples are as follows:

¹⁹ ACCION Microfinance Pro-Consumer Pledge (<http://www.accion.org/Page.aspx?pid=846&srcid=739>)

- In the Philippines, the central bank conducts financial literacy campaigns among Philippine overseas workers in various cities in the world through road shows that aim to educate workers on planning, saving and investing.
- Peru introduced a holistic system of consumer protection in 2004 that reduced complaints received by the financial regulator (Superintendencia de Banca, Seguros y AFP or SBS) by 32% since its introduction. While SBS supervises policies and procedures, financial institutions are responsible for implementing these. In 2008, financial institutions themselves were handling 99% of about 400,000 consumer complaints.
- Peru also introduced a “Regulation of Transparency,” by which cost information associated with financial services are published in the daily news. Interest rates dropped 15% within the first six months of the law.

5. Public bank reforms

Reform of public banks can lead to more effective commercial provision of financial services by government-owned banks. A successful example of public bank reform is the case of Bank Rakyat Indonesia (BRI), which remodeled itself from a loss-making government bank to become the world’s largest and most profitable microfinance network. The process of restructuring started in 1983 in conjunction with the liberalization of interest rates and withdrawal of subsidies. BRI started to focus on achieving self-sustainability through savings mobilization and profitable operations. A key measure was the training provided by BRI to 16,000 employees, together with the provision of performance incentives and technology.

6. Channel and product diversification

Low-income households need a range of financial products beyond credit, such as payments, savings, micro-insurance and remittances. To help meet these needs, policy makers need to consider effective ways of reviewing, popularizing and promoting the adoption of relevant microfinance products (including micro-insurance and micro-savings).

Uganda provides an example of policies promoting channel and product diversification, through the enactment of the Microfinance Deposit-Taking Institution Act of 2003, which created a new tier of microfinance deposit-taking institutions (MDIs) supervised by the central bank and allowed to take deposits. As a result of this new law, the number of savers at licensed MDIs increased from below 100,000 in 2002 to around 250,000 in 2006. In this case, the government took the lead in promoting financial deepening without directly participating in market transactions.

A Closer Look at Financial Identity: Developing Properly Structured Credit Sharing Information Systems in APEC

Financial identity is a policy area where there is substantial room for reforms and where APEC could play an important role in facilitating the creation and use of financial identities in the region. It is a key issue, as inability to establish a financial identity limits the reach of the financial system, by keeping many financial institutions from the market due to the high costs of assessing risks and by limiting access to financial services for large segments of the population.

A variety of factors accounts for the lack of financial identities in many economies. These include the absence of an economy-wide identification card system, unreliable or inconsistent birth registration system, haphazard or partial registrations for marriages, municipal services and other public services, and the lack of a reliable address system. Even in economies where systems are in place, there may be uneven coverage for lower-income and rural segments of the population.

The KYC recommendations of the FATF currently specify that institutions should undertake customer due diligence measures when establishing business relations and carrying out occasional transactions that are above applicable designated thresholds or wire transfers. Customer due diligence measures are defined as involving “identifying the customer and verifying that customer’s identity using reliable, independent source documents, data or information.” This latter requirement can be constraining if interpreted in a narrow sense as limited to official identification cards, passports and other government-issued identity documents.

Flexible approaches are needed to address the challenges to promoting financial identity. These would require allowing access to broader data sets in establishing an individual’s identity. These data sets could include, aside from traditional official documents (e.g., passports, drivers’ licenses, voter identity cards), a wider range of identifiers such as utility accounts tied to an address as defined by the utility provider, biometric identifiers, digital photos, welfare basket allotment cards and account information from non-financial service providers such as mobile phone numbers. Credit bureaus and other information service firms can be harnessed to build solutions to establishing an identity based on the information topography of a society.

This approach would require two policy issues to be addressed. First, guidelines need to be developed to allow credit bureaus access to a wider set of information sources for establishing identities. Second, a data protection framework that guards individuals’ data by limiting its uses and access, based on OECD Fair Information Practices guidelines, would need to be adopted. In addition, policymakers and practitioners can benefit from the development of a body of case studies on how different economies are dealing with technical and regulatory issues in establishing individual identities for credit reports, which will be helpful in designing expanded information sharing systems.

Developing properly structured credit sharing information systems is an issue that APEC economies could consider as one of the objectives of regional policy initiative for promoting financial inclusion. Credit information sharing systems are key elements of modern financial sector infrastructure. Credit bureaus have assumed a core role within such systems by helping lenders acquire a more precise knowledge of a borrower’s likelihood of repaying. However, the extent to which this result is achieved depends on the structure of credit reporting, bureau ownership and the type of information reported. In this context, distinctions between the following need to be made:

- Negative-only reporting versus full-file reporting. Negative-only reporting is the reporting of only negative data (adverse payment data on a consumer, which consists of late payments of more than 60 days or more commonly 90 days past due, liens, collections and bankruptcies). Full-file reporting is the reporting of both negative and positive data. Positive data would encompass information on the timeliness of payments, including whether payment was on time or was moderately late. The payment information may contain the payment date relative to the due date. Positive information also includes data on account type, lender, date opened, inquiries, debt and can also include credit utilization rates, credit limits and account balances.
- Segmented versus comprehensive reporting. Segmented reporting is a system in which only data from one sector or a limited number of sectors, e.g., retail or banking, are contained in reports. Comprehensive reporting is a system in which payment and account information are not restricted by sector and contains information from multiple sectors, e.g., utilities payments.
- Public versus private credit bureaus. Although there is no theoretical reason why a public bureau cannot behave like a private one, there are practical reasons. Public bureaus have been set up largely and primarily for supervisory purposes, to monitor the safety and soundness of the financial sector and determine whether reserves are sufficient,

rather than primarily to facilitate greater and sustainable lending. Private bureaus, by contrast, are set up to ease lending, and the reasoning behind the data collection by private bureaus lies primarily in reducing information asymmetries and to improve risk assessment in lending. By this account, private bureaus are complements rather than substitutes to public bureaus.

A number of studies citing evidence from the USA, Canada, Brazil, Colombia and Argentina, among others, summarized in surveys undertaken by the Political and Economic Research Council (PERC)²⁰ presents the following conclusions:

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

²⁰ Michael Turner, Robin Varghese and Patrick Walker, *Financial Inclusion through Credit Reporting: Hurdles and Solutions* (A PERC Briefing Paper for The Asia-Pacific Credit Coalition), April 2010. See also Michael Turner, Robin Varghese and Patrick Walker, *The Structure of Information Sharing and Credit Access: Lessons for APEC Policy* (A PERC Briefing Paper for The Asia-Pacific Credit Coalition), July 2008.

- Using data from 129 economies, one study concluded that private bureaus increased lending by 21%. In lower-income economies, private bureaus increased lending by 14.5% compared with 10.3% for public bureaus. Another study found that private sector lending increased by more than 45% of GDP with a shift from 0% to 100% coverage of credit-eligible adults by a full-file private bureau. Using data from 170 banks across Latin America, an IDB study found that banks that loaned primarily to consumers and small businesses and that used private bureau data had nonperformance rates that were 7.75 percentage points lower than banks that did not, while no such effect of any magnitude for the impact of public bureaus were found.
- With reference to concerns arising from the recent credit crisis in the US, unlike a relaxation in lending rules, expansion of information in credit files can help prevent problems associated with consumer overextension, while allowing easier credit for consumers. This is because it also facilitates better credit decision by lenders, so that lenders' improved ability to identify good risks from bad is the factor leading to increased access to credit. It helps lenders identify good credit risks that otherwise would have been misidentified as bad risks and thus would have been denied credit. At the same time, bad risks that are previously given credit because they have been thought to be good risks will no longer be subsidized by lower-risk individuals.
- 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.

The legal and regulatory framework is important because a number of important procedures would need to be defined, including the type of information that can be collected, the rights of data subjects (access, notification, dispute resolution and redress), acceptable uses of information, data security requirements and obligations of credit bureaus, data furnishers and data users.

- An important element of an effective legal and regulatory framework is the specification of requirements regarding information contained in credit files. These requirements include (a) protection of consumer rights; (b) information privacy, referring to limitations and regulation of access to consumer information; (c) use of public record information; (d) the periodicity of reporting; (e) data expiration regulation; (f) provisions for the sharing of both positive and negative information; (g) noting disputed information or suspected fraudulent activity; and (h) equal treatment of reporting financial and non-financial industries. Given the wide diversity among APEC member economies, how each of these requirements is addressed will vary across the region.
- Another important element is the determination of data subject rights and protections and the obligations of data furnishers and credit bureaus. (a) Data subject rights and protections would involve such issues as control over third-party access to credit files, right to access the credit file, procedures for consumer disputes and re-verification, redress for harms and notification of adverse actions and dispute rights. (b) Data furnisher obligations would involve the regular reporting of accurate data, timely responses to consumer disputes, correcting and updating inaccurate information, reporting the status of accounts (whether open, closed or delinquent), and responding to suspected identity fraud. (c) Credit bureau obligations would involve maintaining data quality standards, disclosures to data subjects, dispute resolution procedures, data privacy and security (including in the case of third-party verification), and inclusion of financial, governance and security standards.
- The Organization for Economic Co-operation and Development (OECD) Fair Information Practice Principles provide a useful reference point in efforts to develop the legal and regulatory framework. The Principles cover a number of areas, including limitations related to data collection (what is collected, means of collection, source of data,

knowledge and consent of data subject and scope of application of the principle); data quality; permissible purposes or use limitation (control against original purposes, exceptions and disclosure mechanisms); security safeguards; openness; individual participation (the right of the subject to know about the existence of data, right to access data; right of challenge and provision of reasons for refusal; and subject challenge to data); and accountability.

- Dispute and grievance resolution mechanisms are important for safeguarding rights of data subjects, improving data quality and enhancing system legitimacy. An effective mechanism would address issues in each of the four basic phases of grievance resolution. (a) With respect to personal information, credit bureaus must be able to immediately release information to consumers and release all information in the consumer file. (b) With respect to the receipt of grievance (when a consumer contests the information), credit bureaus must provide consumers easy access to customer service and a clear framework for the resolution of each case should be in place. (c) Credit bureaus must have a system to verify data. (d) With respect to consumer rights in notice and follow up of grievance procedure, data subjects must be notified of the results of their case and a system of appeals should be in place in case the consumer refutes the resolution.

These considerations have led industry players to formulate six general principles that are being proposed to form the basis for improving credit reporting in the region:

- Positive and negative payment data should be reported to private credit bureaus.
- Bank, non-bank and non-financial payment data should be reported; data should not be segmented by sector.
- Consumer rights and protections are paramount, as spelt out in the OECD Fair Information Principles.
- Private credit bureaus and public credit registries are complementary; private bureaus focus on making lending efficient.
- Reporting of payment data should be voluntary.
- Data use should be limited to well-defined permissible purposes.

Demand- and Supply-Side Measures

Beyond providing an enabling environment, there is a broader role that the public sector can play in promoting financial inclusion. The role of public banks referred to in an earlier section is a case in point. In addition, the number of credit-worthy and mature MFIs that can attract sustained private funding is still very limited, and effectively mobilizing savings of low-income households remains a challenge. While improvements in the policy and regulatory environment to promote commercially sustainable microfinance are still under way, supplementary measures can be undertaken by the public sector to accelerate the process of expanding financial inclusion.

Demand-side interventions focus on making low-income and rural clients more bankable. These could include efforts by governments and public banks in the following areas:

- Financial literacy and education
- Empowering clients and organizing clients' groups
- Providing social safety nets in conjunction with or in preparation for the delivery of microfinance services
- Technical support for livelihood projects and micro-business

- Identifying and providing key rural infrastructure services, including transport, water and sanitation, energy and agricultural services
- Programs to meet basic needs, particularly health and sanitation

Supply side interventions can be undertaken by government and public banks. To support promising private MFIs that have not yet attained sufficient creditworthiness, the following measures could be considered:

- Policy-based wholesale lending by public banks playing the role of apex institutions to MFIs
- Linkage programs among private banks, MFIs, savings and credit cooperatives and self-help groups
- Technical and managerial support and training for MFIs in areas such as risk management in preparation for transition to regulated status

Public banks can also undertake policy-based retail banking for clients not served by private MFIs. Examples of institutions undertaking such activities are BRI in Indonesia, BAAC in Thailand and LandBank of the Philippines.

The success of policy-based lending and retail banking activities by public banks and apex institutions is dependent on fulfillment of a number of important conditions. These include:

- Management of these government-owned entities on a commercial basis
- Accordance with the government's policy priorities
- Avoidance of direct government subsidy
- Independence of operations, including due diligence with respect to clients
- Use of affordable funds from the market or donors (with implicit government guarantee)
- Avoidance of competition with private MFIs and a clear exit strategy
- Avoidance of discouraging savings mobilization by the private sector
- Setting industry standards

In playing these roles, governments and public banks can help nurture markets and a level playing field, while promoting the development of new MFIs. These actions should be geared toward eventually increasing private investment opportunities and realizing financial inclusion in an efficient and equitable manner. As the positive role that governments and public banks could play in promoting financial inclusion has not yet been given adequate attention, experiences in developed member economies in APEC of providing market-friendly interventions and policy-based finance should be studied and opportunities for adapting best practices discussed to support the promotion of financial inclusion in the region. An appropriate role of multilateral and bilateral institutions, such as JICA, could be considered in the development of such initiatives in APEC.

C. KEY ISSUES FOR AN APEC FINANCIAL INCLUSION INITIATIVE

Achieving Synergy between APEC and G-20 Initiatives

Recent developments, particularly in microfinance, have pushed financial inclusion to the forefront of the agenda for global development. The G-20 has included financial inclusion in its agenda. In their June 2010 Toronto Summit Declaration, the G-20 Leaders endorsed nine principles for innovative financial inclusion, which are intended to form the basis of an action plan (to be finalized in November 2010 at the Seoul G-20 Leaders' Summit) to help improve access to finance. These nine principles are as follows:²¹

²¹ G-20 Toronto Summit, *Principles for Innovative Financial Inclusion* (<http://g20.gc.ca/toronto-summit/summit-documents/principles-for-innovative-financial-inclusion/>)

- *Leadership*: Cultivate a broad-based government commitment to financial inclusion to help alleviate poverty.
- *Diversity*: Implement policy approaches that promote competition and provide market-based incentives for delivery of sustainable financial access and usage of a broad range of affordable services (savings, credit, payments and transfers, insurance) as well as a diversity of service providers.
- *Innovation*: Promote technological and institutional innovation as a means to expand financial system access and usage, including by addressing infrastructure weaknesses.
- *Protection*: Encourage a comprehensive approach to consumer protection that recognises the roles of government, providers and consumers.
- *Empowerment*: Develop financial literacy and financial capability.
- *Cooperation*: Create an institutional environment with clear lines of accountability and co-ordination within government; and also encourage partnerships and direct consultation across government, business and other stakeholders.
- *Knowledge*: Utilize improved data to make evidence based policy, measure progress, and consider an incremental “test and learn” approach acceptable to both regulator and service provider.
- *Proportionality*: Build a policy and regulatory framework that is proportionate with the risks and benefits involved in such innovative products and services and is based on an understanding of the gaps and barriers in existing regulation.
- *Framework*: Consider the following in the regulatory framework, reflecting international standards, national circumstances and support for a competitive landscape: an appropriate, flexible, risk-based Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) regime; conditions for the use of agents as a customer interface; a clear regulatory regime for electronically stored value; and market-based incentives to achieve the long-term goal of broad interoperability and interconnection.

In view of the commonality between the G-20 principles and ABAC proposals to APEC Finance Ministers and Leaders on financial inclusion, there is tremendous potential for APEC to leverage a shared vision of financial inclusion between APEC and the G-20 to enable APEC to become a global leader in promoting expanded access to finance while ensuring the safety and soundness of financial services provision.

The Asia-Pacific region presents daunting challenges in this regard. Among the many challenges are promoting strong regulatory frameworks and supervisory capacity, financial institution building, attracting expanded commercial banks’ engagement in microfinance, identifying consumer needs, ensuring financial viability of MFIs, promoting access of non-banks to payment systems and strengthening agents’ liquidity management capabilities. A comprehensive approach is needed to effectively address these challenges, and APEC, particularly the Finance Ministers’ Process, is uniquely suited to bring together governments, the private sector and multilateral agencies to coalesce and provide the needed solutions.

APEC and Other Regional Capacity-Building Efforts

Within the context of the current post-crisis global economic situation, an APEC initiative on financial inclusion can contribute significantly to ongoing efforts to put the global economy back on the path to growth. APEC has identified key aspects of a growth strategy that will form the basis for a comprehensive work program in the lead to the 2010 APEC Economic Leaders Meeting in Yokohama. Complementing the three pillars of trade and investment liberalization, facilitation and economic and technical cooperation enshrined in the Osaka Action Agenda when Japan chaired APEC in 1995, this strategy is aimed at achieving inclusive, balanced and sustainable economic growth.

Financial inclusion, using microfinance as a tool, has significant potential to contribute to successful outcomes within the framework of this growth strategy.

- Financial inclusion is a crucial element of any inclusive growth strategy. Microfinance is a potent tool for empowering enterprises at the bottom of the economic pyramid to more effectively participate in economic growth, as well as to expand opportunities for low-income households and individuals.
- Financial inclusion can support efforts to achieve more balanced growth by helping stimulate regional and domestic demand in developing economies. In the past few years, these economies, particularly in Asia, relied on exports to developed markets in America and Europe for growth. In the current post-crisis situation, they face the challenge of rebalancing growth away from exports toward greater reliance on domestic demand.
- Financial inclusion can contribute significantly to environmentally sustainable growth. For example, micro-insurance can play a role in mitigating the risks of environmental damage. Governments can also consider ways of partnering with MFIs to provide financing for projects such as local water supplies and introducing and expanding renewable energy and sustainable practices in agriculture and forestry.

There is much scope for achieving synergy between activities to promote financial inclusion under the APEC framework and those being undertaken by other international organizations and institutions in the region. Currently, a huge number of activities are being undertaken to promote financial inclusion. These activities, which aim to help develop market infrastructure, assist governments and market players, and promote funding, include the promotion of technology, credit information, financial identities, effective payment systems, transparency and innovative business models; establishment and dissemination of standards of good practice; training; policy advisory services; research, data analytics, publication and dissemination of information; funding and mobilizing capital and policy dialogues.

A wide variety of institutions are actively engaged in promoting financial inclusion. These include policy and research organizations supported by development agencies, privately-funded grant-making and knowledge-pooling bodies, international financial institutions, well-networked organizations serving as intermediaries to promote and maintain partnerships, networks and associations of market players and government agencies engaged in microfinance, and development agencies undertaking capacity-building and research activities. Although there are overlaps in their activities, there is very significant potential for complementation, given institutions' varying memberships, levels and nature of financial and technical resources and geographical reach.

D. FINANCIAL INCLUSION: SUMMARY OF KEY ISSUES

In recent years, microfinance has grown to become a potentially powerful tool for promoting financial inclusion, with the growing profitability of MFIs and the expanding scope of their operations. Microfinance is attracting increasing interest from financial institutions and investors all over the world. The key factor has been the introduction of technology and innovation, such as mobile banking, point-of-sale technology and biometrics, among others, and microfinance has taken off in economies where policies and regulations have been put in place to enable the use of these technologies.

With the growing commercial viability of microfinance, there is increasing interest among investors and great potential for channeling commercial investment into the sector. Public-private partnership with IFIs and bilateral institutions playing key roles could facilitate the expansion of such commercial investments. Nevertheless, while promoting and facilitating private sector investment is important, the major issue is not the lack of funds or investors, but rather the still limited number of top-tier MFIs.

To broaden investment opportunities, it is important to accelerate the process of upgrading existing MFIs, as well as to promote wider participation of financial institutions. The most difficult challenge, however, is how to broaden the base of the financial inclusion pyramid, by expanding the coverage and penetration of microfinance. In its 2009 report, ABAC recommended that policy makers and regulators consider undertaking measures in six areas identified in a recent ground-breaking study²² where policies can have the most impact. These are mobile phone banking, agent banking, channel and product diversification, public bank reform, financial identity and consumer protection.

An area where APEC can play a constructive role in promoting financial inclusion is the development of properly structured credit sharing information systems. This could involve the promotion of reforms to enable full-file and comprehensive credit reporting in member economies to private credit bureaus, which should be accompanied by measures to develop appropriate legal and regulatory frameworks defining key procedures, including types of information that can be collected, rights of data subjects, acceptable uses of information, data security requirements and obligations of credit bureaus, data furnishers and data users.

There are already many existing best practices in providing an enabling environment for the introduction and use of new technologies and innovations. Many of these can be easily made available through various institutions. There is also a need to recognize the potential of the public sector, especially government banks, in promoting financial inclusion, especially given the magnitude of the challenges to expand coverage of microfinance. Capacity-building measures to assist developing economies in effectively harnessing public sector resources and in promoting public-private sector partnerships are needed.

There is a lot of commonality between the G-20's approach and the approaches currently being discussed in APEC and there is great potential for APEC to undertake an initiative that complements the work of the G-20. Finally, there are ample resources, including expertise, funding and networks that private, international and bilateral institutions are willing to share in support of an APEC financial inclusion initiative.

CONCLUSION

Post-crisis recovery is proceeding at varying speeds across regions and economies. Many of the Asia-Pacific region's economies are leading efforts toward a quick recovery and more balanced growth, offering hope for the emergence of a new engine that will help sustain global economic growth in the years ahead. While the economic rebound that came immediately on the heels of the crisis was driven mainly by government stimulus, downside risks remain that have been highlighted by recent developments in Europe. In this context, the private sector must begin to play a more important role if the economic recovery is to be sustained.

A healthy and well-developed financial market is vital in enabling the private sector to play this role. In the region's developing economies, efforts are needed to focus on ways to accelerate the development of bond markets. While much has been accomplished through policy and regulatory reforms to stimulate the growth of these markets, particularly in Asia, innovative solutions are needed to bring capital market development and integration in the region to the next higher level. Greater financial inclusion, which will broaden the base of

²² Alfred Hannig and Stefan Jansen: *Inclusive Financial System Reforms: What works, what doesn't, and why?* Synthesis Report, GTZ 2008.

economic growth and help deepen financial systems, is another issue that needs to be addressed.

This year, an APEC growth strategy is being introduced to complement the pillars of trade and investment liberalization, facilitation and technical and economic cooperation that have guided APEC's development since the Osaka Summit in 1995. Bond market development and financial inclusion are both central to the success of efforts to promote balanced, inclusive and sustainable growth. It is hoped that policymakers will seriously consider the ideas presented in this report in designing concrete initiatives that can be undertaken within the framework of this new growth strategy, in collaboration with the private sector.

ANNEX

APEC PUBLIC-PRIVATE SECTOR FORUM ON THE DEVELOPMENT OF BOND MARKETS AND FINANCIAL INCLUSION

ORGANIZED BY
THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY BUILDING
THE APEC BUSINESS ADVISORY COUNCIL
IN COOPERATION WITH THE MINISTRY OF FINANCE, JAPAN

31 May 2010
ANA Hotel Sapporo, Ohtori Room
Sapporo, Japan

PROGRAM

08:30-09:00	REGISTRATION
09:00-09:15	OPENING SESSION
09:00-09:05	Welcome and Opening Remarks Mr. Yoshihiro Watanabe, Chair, Finance and Economics Working Group, APEC Business Advisory Council (ABAC) and Managing Director, Institute for International Monetary Affairs
09:05-09:10	Mr. Mark Johnson AO, Chair, Advisory Group on APEC Financial System Capacity-Building and Chairman, AGL Energy
09:10-09:15	Mr. Takeshi Kurihara, Chair, APEC Senior Finance Officials' Meeting and Director, Research Division, International Bureau, Ministry of Finance of Japan
	PART I: The 4th APEC Public-Private Sector Forum on Bond Market Development
	Chair: Mr. Mark Johnson AO, Chair, Advisory Group on APEC Financial System Capacity-Building and Chairman, AGL Energy
09:15-09:45	SESSION ONE OVERVIEW OF CURRENT TRENDS IN THE REGION'S BOND MARKETS
09:15-09:30	Asian Bond Markets: Overview of Current Trends and Regional Initiatives Mr. Satoru Yamadera, Economist, Office of Regional Economic Integration, ADB
09:30-09:40	Overview of Findings from Previous APEC Public-Private Sector Forums on Bond Market Development Dr. Julius Caesar Parreñas, Coordinator, Advisory Group on APEC Financial System Capacity-Building and Advisor on International Affairs, The Bank of Tokyo-Mitsubishi UFJ, Ltd.
09:40-09:45	Development of local currency bond markets in South and South East Asia and the role played by rating agencies in developing these markets) Mr. Vivek Goyal, Managing Director, Head of Business and Relationship Management Asia Pacific, Fitch Ratings
09:45-11:00	SESSION TWO THE DEVELOPMENT OF APEC ECONOMIES' BOND MARKETS: EXPERIENCES FROM CHINA, KOREA AND JAPAN
09:45-10:00	Presentation: The Chinese Bond Market: Current Developments and Prospects Madame Lili Wang, Co-Chair, ABAC Finance and Economics Working Group; and Executive Director and Senior Executive Vice President, Industrial & Commercial Bank of China (ICBC)
10:00-10:15	Presentation: The Korean Bond Market: Current Developments and Prospects Dr. Young-Hwan Byeon, Financial Economist, Capital Market Supervision Office, Financial Supervisory Service, Republic of Korea
10:15-10:30	Presentation: Expanding Foreign Issuance and Investment in the Japanese Bond Market Mr. Yoshio Okubo, Senior Managing Director, Japan Securities Dealers Association
10:30-10:35	Comments Mr. Moonsoo Kim, Head of the Rating Planning Team, Business Development Division, Korea Ratings
10:35-10:40	Comments Mr. Kunihiko Ogura, General Manager, Planning and Administration Department, Finance Division, Mitsui & Co., Ltd.

- 10:40-10:45 **Comments**
Mr. Masayuki Tagai, Executive Director, Global Market Infrastructures, Treasury and Securities Services, JP Morgan Chase Bank, N.A.
- 10:45-11:00 **Open Discussion and Q&A**
- 11:00-11:20 **COFFEE BREAK**
- 11:20-12:45 **SESSION THREE (PANEL DISCUSSION)**
CAPACITY-BUILDING FOR CAPITAL MARKET DEVELOPMENT AFTER THE FINANCIAL CRISIS
- 11:20-11:25 **Introduction by the Session Chair**
- 11:25-11:35 **Comments by Panelist: Passport Schemes for Cross-Border Recognition of Fund Management Products as a Vehicle for Financial Integration**
Mr. James R.F. Shipton, Managing Director, Executive Office, Head of Government Affairs, AEJ, Goldman Sachs
- 11:35-11:45 **Comments by Panelist: Toward a Regional Clearing and Settlement System – Addressing Barriers to Cross-Border Settlement**
Mr. Hiroshi Ikegami, Director, Fixed Income and Investment Trust Department, Japan Securities Depository Center, Inc.
- 11:45-11:55 **Comments by Panelist: Promoting Cross-Border Securities Collateral Management to Improve Bond Market Liquidity**
Mr. Hiroyoshi Nakamaru, Chief Manager, Risk Management Department, Global Operations Control Division, The Bank of Tokyo-Mitsubishi UFJ, Ltd. (TBC)
- 11:55-12:00 **Comments by Panelist**
Professor Shigehito Inukai, Executive President and Secretary General, Capital Markets Association for Asia; and Professor, Faculty of Law, Waseda University
- 12:00-12:05 **Comments by Panelist**
Mr. Hon Cheung, Regional Director – Asia, State Street Global Advisors
- 12:05-12:10 **Comments by Panelist**
Mr. Kazuo Imai, Chairman, Association of Credit Rating Agencies in Asia (ACRAA); and Advisor, International Business, Japan Credit Rating Agency, Ltd.
- 12:10-12:15 **Comments by Panelist**
Mr. Romuald Semblat, Senior Economist, International Monetary Fund (IMF)
- 12:15-12:45 **Open Discussion and Q&A**
- 12:45-14:15 **LUNCH**
- PART II: Financial Inclusion Forum**
- Chair:** Dr. Julius Caesar Parreñas, Coordinator, Advisory Group on APEC Financial System Capacity-Building and Advisor on International Affairs, The Bank of Tokyo-Mitsubishi UFJ, Ltd.
- 14:15-15:45 **SESSION FOUR (PANEL DISCUSSION)**
INNOVATIVE POLICIES TO PROMOTE FINANCIAL INCLUSION THROUGH MICROFINANCE
- 14:15-14:30 **Introduction by the Session Chair: New developments and the emergence of microfinance as an effective tool for promoting financial inclusion**
- 14:30-14:35 **Promoting investment in microfinance**
Mr. Hiroshi Amemiya, Advisor, Developing World Markets
- 14:35-14:50 **Key policy solutions for promoting financial inclusion**
Mr. Eduardo Jimenez, Regional Associate, Alliance for Financial Inclusion
- 14:50-15:00 **Promoting financial identity through credit reporting systems**
Dr. Robin Varghese, Asia-Pacific Credit Coalition (APCC) and Senior Fellow and Director of Research, PERC/Information Policy Institute
- 15:00-15:10 **The role of the public sector in promoting financial inclusion**
Mr. Kazuto Tsuji, Executive Technical Advisor to the Director General, Public Policy Department, Japan International Cooperation Agency (JICA)
- 15:10-15:20 **Promoting synergy between APEC and the G-20 in promoting financial inclusion**
Dr. Lois Quinn, Senior Economist & Financial Systems Advisor, Office of International Banking and Securities Markets, US Department of the Treasury
- 15:20-15:30 **Promoting synergy in regional cooperation for financial inclusion**
Mr. John West, Senior Consultant for Capacity Building and Training, Asian Development Bank Institute

15:30-15:45 **Open Discussion and Q&A**

15:45 **End of Session**

15:45-16:00 **CLOSING SESSION**

15:45-16:00- **Closing Remarks**

Madame Lili Wang, Co-Chair, ABAC Finance and Economics Working Group; and Executive Director and Senior Executive Vice President, Industrial & Commercial Bank of China (ICBC)

THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative



ATTACHMENT B

CONFERENCE REPORT OF THE PUBLIC PRIVATE PARTNERSHIPS FORUM AND THE WORKSHOP ON MEASURES TO PROMOTE AN INSTITUTIONAL FRAMEWORK FOR PUBLIC-PRIVATE PARTNERSHIPS

9-10 February 2010
Melbourne, Australia

PART I: PUBLIC PRIVATE PARTNERSHIPS FORUM

Introduction

The Forum and an associated workshop were convened to further APEC's work in promoting PPPs in infrastructure in the region and to consider the idea of an Asia Pacific Public-Private Infrastructure Partnership (APIP). The latter would bring together public and private sector interests, multilateral agencies, academics and professional groups. It would assemble knowledge and information, address issues of asymmetry of information and support and promote capacity building.

Invitations to both the Forum and to the workshop were distributed widely through ABAC and the Advisory Group connections and to groups known to the Australian APEC Study Centre at RMIT University. The Centre convened the events in cooperation with ABAC and the Advisory Group and with Corrs Chambers Westgarth, Lawyers, Melbourne, which hosted the Forum, a lunch and a reception.

The background to the Forum and workshop and the programs are attached to this report, together with a list of participants. A separate report on the workshop will be circulated.²³

The Forum

The forum was well attended; over 60 participants attended, drawn from business, public sectors, the Asian Development Bank, academia and professional groups

²³ This report was prepared by the Australian APEC Study Centre at RMIT University.

involved in PPP design, administration, financing and management. It was hosted by Mr. John Denton, ABAC member Australia, and senior managing partner at Corrs Chambers Westgarth.

Opening Session

Mr. Tony Canavan, Director, Partnerships Victoria gave the opening address. He noted that Australia was relatively well placed to manage the impact of the global financial crisis but that well before the crisis Australia invested heavily in infrastructure. Victoria has led the way in Australia in committing to developing its infrastructure through PPPs and the private sector is playing a crucial role in the process, including importantly in financing. He outlined the key processes in the development of guidelines and procedures and in knowledge sharing in the region. He responded to questions on managing the impact on the environment of PPPs and on work in developing a long-term pipeline of projects.

Session 2 considered prevailing market conditions for PPP contracts

In introducing the session, the Chairman, Mr. Mark Johnson noted that the Asia-Pacific Infrastructure Partnership was a model that the region could aspire to achieve. He observed that the Forum was designed to consider how best a model might be constructed, taking into account prevailing market issues confronting PPPs.

Presenters noted the need to look ahead beyond the global financial crisis. The appetite for risk is beginning to improve but the crisis heightened risk and there are long-term changes to the debt market. There is greater sensitivity to market disruption and a focus on which groups might guarantee against risk. In Australia, there is a push for a more comprehensive approach and a growing recognition of the need for PPPs to operate on an equity basis. There are limits to how much infrastructure can be built and a need to fit projects into broader planning. Taxation policy should focus on economic efficiency.

While the financial crisis did have an impact, governments have reacted and projects had been successfully transacted.

As regards developments in Japan, it was noted that in the past the public sector led the construction of infrastructure. Companies had experience in PPPs in the domestic market but were now focusing on operational aspects of PPPs. The new government is now focusing on growth frontiers and business involvement through technology and know-how. With a declining population, deeper investment in innovation and technology is a crucial aspect of Japan's development. There is considerable cooperation between Japan and India in a major transportation corridor. An Indian Minister had noted that this decade will be the "Infrastructure Decade".

Thailand is considering how to get out of an infrastructure mess. The country has the need, the will and the money but few PPPs are proceeding. There are political issues regarding concessions in PPPs to private operators. Changes in governments have tended to discourage private investment. There are limits on private equity in Thailand and on foreign ownership and all projects need to be at least 51% Thai owned. Thought is being given to establishing a private investment fund offshore in the hope that this would encourage private capital into the PPP space.

The Forum was advised that Colombia is involved in PECC and would like to be part of APEC and the dynamic Asia Pacific group. Opportunities to invest in Latin America should not be ignored. Brazil, Chile, Colombia, Peru and Mexico have infrastructure

needs. Companies in Australia and in Asia are well placed to support Latin American economic development.

Session 3 considered measures by regional and global financial institutions to address impediments to PPPs, particularly in risk bearing and financing

Japan's Bank for International Cooperation provides loans and guarantees. Its representative noted that risk sharing needed to be economically feasible and financially viable and that risks should be allocated to the party best suited to bearing risk. For any risk sharing, government commitment to a project is essential. Host governments needed to provide commitment, a stable policy, legal and regulatory framework and sound environmental and social policies. Currency convertibility is a prerequisite in attracting foreign capital, as is a right to remit funds. The tendency for host governments to push risk onto the private sector is to be avoided, as are overly optimistic assumptions for demand projections. Governments should allow for flexibility to adjust arrangements and mechanisms should be agreed with the private sector.

The Asian Development Bank takes an all round (top -down and bottoms- up) approach to PPPs. Sovereign risk is an issue in some economies even where a project might appear to be soundly constructed. Commercial banks support economies they know and have experience with. However, international banks and local commercial banks are coming back into PPP financing. The ADB 's AAA rating means that through associating with a project the ADB can provide confidence to private sector participants. However, the guarantees available from both the ADB and the World Bank are under- utilized. The ADB has provided guarantees on political risk; as an example the Bank has provided guarantees on projects in Afghanistan.

The ADB has the capacity to do a lot more in PPP infrastructure and finance is available. However, frameworks to transact PPPs need to be in place. Longer-term, it will be important to fund infrastructure from local savings. Self -assessments by economies on their capacity to undertake PPP projects suggests that a number have unrealistic expectations about their preparedness to implement projects. In these situations, the ADB will work, through its various facilities, to encourage private sector involvement in PPPs.

An Australian private sector specialist noted that not enough is being done to attract funding into PPPs. The idea of a perfect match between public and private interests is an unlikely scenario and much rigour and work is required to bring this decade into the decade of "infrastructure PPPs" There is a large pool of finance and expertise in the region but there is a case now to build the relationships between all concerned parties.

In discussions, it was noted that optimism in forecasting should be avoided and that facilities are available to manage risk. Capital pools are available to finance PPPs but work is needed to bring long-terms savings pools in the region into infrastructure financing. Money is available but capital market structures are under-developed. Investors are less interested in PPP financing and attracting them remains a challenge. It was also observed that political support is a critical factor. An issue was raised on the need to incorporate in contracts the concept of risk-bearing over the life of a project and whether the tender procurement mode is the only mode, or whether other practices were relevant to some economies. The ADB's willingness to discuss financing arrangements with the private sector was favourably commented on.

Session 4 discussed the establishment of an institutional framework for an Asia-Pacific Infrastructure Partnership and an offer to support activities in Melbourne through 2010

In introducing the session, the chairman noted the various efforts in place in promoting PPPs and that a partnership needed to relate to PPPs at national level, sub-national and national level and sub-regional level, and involve public and private parties. The ADB is promoting various financial arrangements and seeking to address asymmetry in information as well as long-term financing requirements through a Pan Asia Infrastructure Forum. There are presently no counterpart groups in the private sector to match those of governments. APEC includes the largest economies and it has a mechanism for involving the private sector and an objective through ABAC is to deepen government/private sector relationships. Japan as chair of ABAC is supportive of an institutional partnership.

The co-chair of the Senior Officials' Meeting noted that APEC promoted regional efforts to further PPPs in the region and that Japan wished to work with ABAC to achieve that objective. A desalination plant under construction in Victoria involved Japanese and other private sector investors. Transport infrastructure would promote supply chain connectivity – another important APEC objective. A regional group would encourage private sector financing and support an expanding growth agenda.

As regards an APIP, it would be important to recognize that on some projects there could be cooperation between various parties but that others might benefit from a competitive approach. There would be a need to look at the unique strengths of each project and of each economy. Capital market mechanisms needed to be developed to generate the enormous capital required to finance infrastructure and to cooperate with government funds in project financing. Matching financing opportunities for projects is the key objective and there are now some guidelines in place. We need mechanisms to create projects and to reduce risks. Also needed is a facility to share best practices. APIP could further promote PPPs and while there is sound technical knowledge available, generating political will and appreciation would be relevant. Capacity training and education would also be important, including in the private sector.

It was noted that various parties needed to come together to make a partnership effective and that an institutional framework should contribute to resolving some of the many challenges in PPP development. Partnership between governments, the private sector, academics and researchers is critical and with its wide reach into Asia and Australia, RMIT University is well placed to support educational efforts which are relevant to PPPs. Education is an infrastructure investment for the future and that is why RMIT University supports the APEC Study Centre and the initiative at the heart of the Forum.

The Victorian government has dual objectives in PPPs. These cover industry involvement in developing PPPs and a financial interest in getting best value for money in PPPs in the State. PPPs are a strength for Victoria as an exporter of financial services and the development of PPPs helps position Melbourne as a global centre of excellence – also a Government goal – for training in financial services in the APEC region. Government support for the Melbourne APEC Finance Centre, a facility at the Australian APEC Study Centre at RMIT University, fits well with these priorities. Partnerships Victoria is internationally recognized as a specialist in PPP development and for its expertise.

It was noted that a private Japanese owned bank in Australia supported many PPP projects both pre and post the global financial crisis, and would continue to do so through loans and credit facilities. Whether in Australia or in overseas markets, documentation and legal risk is a challenge but if a bank can build and deliver services then governments would participate with banks in implementing PPPs. One impact of the financial crisis has been that financing is available for shorter periods – 7/9 years – compared with the pre-crisis environment. Currency issues also pose challenges for banks and regional PPPs require regional solutions.

The chairman of the session noted the strong support for the concept of a partnership arising from the discussions. He pointed to the relevance of the research and training and data collections to support regional PPPs and the network of institutions in this field that were active. He welcomed the lead taken by RMIT University and the State Government of Victoria noting that Victoria was a good place on which to build the initiative. There is a rich experience in PPPs and cross-border interest in infrastructure. Japan is entering a period where business and the government are looking at the Asian region to sustain growth. There is an opportunity now to address the many issues in promoting PPPs.

In discussions, participants noted the need to pay greater attention to the politics of PPPs. Tackling technical issues was important but political sensitivities on pricing was a critical aspect of gaining aspect of regional PPP development. Emphasis was placed on enhancing PPP activities to generate political support. Education at various levels was discussed. Education needed to be both at the “high” political end and at the technical level. Different approaches would be required. Dislocation was noted as a real problem arising from PPPs in smaller economies where private sector managers of projects drew scarce labour from other economic sectors.

Concluding Session

In his summary conclusions of the Forum, Mr. Mark Johnson commended the engagement of participants and the high level of expertise that had been brought to the discussions. He observed that the Forum had discussed the big picture – PPPs as an APEC priority endorsed by Leaders, the massive funds involved and the fact that requirements are dynamic, reflecting changes arising from the impact of the global financial crisis and how these had impacted on models. He noted that dynamics of markets would cause further changes to models now being used.

The private sector is interested to participate in PPPs and looking for ways to mobilize funds, noting the risk profile of PPPs, the long-life and capital intensity and the fact that local currency revenue streams do not match private sector financing requirements. He observed that the role of the IFIs is pivotal. Structural adjustments were required to develop regional bond markets and ABAC and APEC are supporting those adjustments.

Harnessing the private sector knowledge and expertise was of concern to policy makers but the private sector would be responsive only if projects could be expected to make realistic returns. Ministers and public sector officials were attracted to PPPs only if they contributed to community growth and development. But resistance to engaging the private sector was an inhibiting factor in some economies.

The proposal for the APIP was useful. While the model is aspirational it would ultimately require solid commitments and financial and human resources. He asked whether participants saw a structure that fitted with a strategy and noted that a

partnership should not seek to be a substitute for the ADB or the World Bank and nor should it be captive to private sector interests. He welcomed the participation of educators and academics as part of the institutional structure.

PART II: WORKSHOP ON MEASURES TO PROMOTE AN INSTITUTIONAL FRAMEWORK FOR PUBLIC-PRIVATE PARTNERSHIPS

Introduction

The workshop was convened to further APEC's work in promoting PPPs in infrastructure in the region and to consider a proposal for an Asia Pacific Public-Private Infrastructure Partnership which would bring together public and private sector interests, multilateral agencies, academics and professional groups and which would assemble knowledge and information, address issues of asymmetry of information and support and promote capacity building.

The Workshop – 10th February, Park Hyatt

The workshop was well attended; invitations were extended to ABAC members and staffers and to PPP specialists. The purpose was to further define the objectives for the Asia Pacific Public-Private Infrastructure Partnership. The 15 participants were drawn from business, public sectors, the Asian Development Bank, the World Bank, academia and professional groups involved in PPP design, administration, financing and management. The workshop included representatives from Pacific Economic Cooperation Council, Partnership Victoria, and Infrastructure Australia.

Opening Session

Mr. Ken Waller opened the workshop. He gave an overview of the outcomes of the Forum held the day before and the goals for the workshop. He noted that the development of PPPs is a priority for APEC Leaders that Japan ABAC is very supportive of work to develop an Asia Pacific Infrastructure Partnership but required a clear picture of its objectives and how it would function. He outlined the purposes of the workshop: how to create a Partnership that would bring private sector knowledge and expertise to support public sector policy makers in making effective decisions on PPP projects and securing the involvement of the IFIs in a partnership. He noted that for it to succeed a partnership would require solid commitment and resources and some form of secretariat; the question to consider is how best to work toward those goals. He asked participants to provide guidance in a frank and open way and to help develop a strategy that might lead toward a structure, loosely defined.

Mr. Waller noted that the Victorian Government and RMIT University had agreed to utilise funding available to the Australian APEC Study Centre to promote initiatives in APEC in PPPs this year and that those initiatives should complement and support those of the Advisory Group on APEC financial system capacity building.

Session 2

Defining key components of a public private partnership and links with key regional and global agencies

Mr. Michael Barrow, ADB, discussed infrastructure demand and provided an overview of ADB activities. He quoted from the Jan 2009 'Infrastructure *for a Seamless Asia*' Report about the size of infrastructure need. Between 2010 and 2020, Asian economies need to invest approximately \$8 trillion in overall national infrastructure. Regional infrastructure development creates a win-win outcome for all participating countries. Improving connectivity in the region would bring Asia large welfare gains through increased market access, reduced trade costs, and more efficient energy production and use.

The goal for the ADB for 2020 is to "scale up private sector development and private sector operations in all operational areas, reaching 50% of annual operations by 2020". ADB has many initiatives around PPPs, including MPI3C, PPP Days, training and workshop, development of PPP resources, a countrywide approach for India, readiness for PS Engagement, project financing guarantees and joint agency efforts. He noted that a number of areas in the ADB were involved in PPPs and the Bank is presently revamping its internal strategy for PPPs.

There is countrywide, holistic approach with the Government of India. It emphasises the crucial importance of PPPs in addressing infrastructure gaps in India. India has been assisted by the ADB through its "Mainstreaming PPPs in India" technical assistance programs. With a view to improving infrastructure in the rural sector, the Government and ADB agreed on the objectives, scope, implementation arrangements, and financing plan for a capacity development technical assistance (CDTA) to be provided in support of a flagship Government program, the Provision of Urban Amenities in Rural Areas (PURA).

Mr. Kamran Khan, World Bank, noted that East Asia will need huge infrastructure investments, 70% for new capacity and 30% for maintenance and replacement. He focused on the factors that constrain successful implementation of PPPs, including inability to combine public and private finances for PPPs, pre-financial close risks/transaction costs, under-developed capital markets, and the lack of local currency debt financing. The WB partnership with ASEAN Infrastructure Finance Network is a regional platform providing a strategic perspective to policymakers, and public and private sector practitioners on raising and channeling private financing into infrastructure.

The complex nature of the challenge calls for government and the private sector to develop innovative, regional solutions. For example, the APEC Framework approaches to bidding procedures and concession agreements, creation of secondary market for infrastructure assets to attract institutional capital and Infrastructure Finance Marketplace led by the WB-Singapore Urban Hub. Transparent and consistent frameworks were needed across the region.

He commented on the need to for instruments that would bring Official Development Assistance Finance together with private sector capital to address financing viability gaps in funding. This required new thinking on doing business with the private and public sectors. Pension funds are not investing in PPP projects and there was a need to change the profile of projects to attract significant private savings into infrastructure development. He questioned the value at this stage of creating infrastructure funds. The overarching issue is to define ways of attracting private investment in public infrastructure and different ways would be needed to succeed.

Mr. Glenn Maguire, Partnerships Victoria, discussed the breadth of experience in Victoria and Australia with PPPs. He focused on the importance of a country using a tender selection process applicable to that country's way of doing business. He drew

on his experiences with some Asian economies and noted that a forum that shared experience in the region could be extremely valuable. Partnership Victoria would be pleased to be involved.

He noted the important role of capacity building, in securing good resources for public agencies to equip them with the knowledge and techniques of developing and implementing PPPs, and in the concurrent development of private sector capabilities in bidding and implementing PPPs.

He commented on the dangers of entertaining unsolicited bids and the reliance on use of their associated feasibility studies, which often underestimated costs and over-estimated revenues. Project selection and development processes were critical and international agencies could play a valuable role in assisting governments to develop robust feasibility studies.

He suggested that efforts to build capacities should be targeted and proposed that tender selection, avoidance of corruption in tender processes should be usefully pursued, and a menu of options developed. He thought it useful to build work on lessons learned, that more information would be helpful on developments in PPPs in the region and that any Forum that evolved be chaired by an Asian-based expert. He noted that Australian experience with an officer level intergovernmental PPP forum worked well in the early years of PPPs; it focused on addressing common priority issues (eg. tender processes, and discount rates) and sharing practical experiences. However, whilst an Australian Ministerial PPP forum was established it was not suitable. He was of the opinion that a one-off forum might be more practical.

Mr. Garry Bowditch representing PECC, expressed concern on the enormity of the geography. He thought there were strategic choices. Rather than address the region, he asked what specific processes should be the focus of attention. He noted the need to work with the ADB and the World Bank; a common issue was the absence of a pipe-line of bankable projects in the region. He observed that the hypothesis behind the proposal for a partnership was the prospect of early intervention by the private sector with government so that they could discuss what might be acceptable and appropriate ways in which to attract the private sector into PPPs. He thought it might be useful to think of working with 1 or 2 economies in providing impartial and frank advice. For a partnership to work it would need to capture the imagination and be successful.

The ensuing discussion focused on the importance of setting up a framework for governments to meet with the private sector early and often in any PPP process. The private sector can have a critical role and help build confidence. APEC might be well placed to propose a panel of private sector experts which could meet with the public sector specialists and investors. Such a grouping could create a useful platform. It would be advisable for this to convene in the region; the World Bank would be pleased to work on a joint basis with others. ADB gave the example of its water committee and its success in India. It is important to have "champions" and there is a need to show a successful model project. Examples where strong leadership pushed through reforms are the Phnom Penh Water Board and the New Delhi Metro.

It was noted that the ADB and the World Bank have high credibility in Thailand and it would be helpful if they could participate in an infrastructure funds; this would help mobilise local savings. It was observed that the delivery of services was a different issue to the question of ownership of a project. The concept of "trusted advisors" was considered and it may be useful to think in those terms in assembling a group of advisors. APEC and ABAC may well be considered as trusted advisors. Any model of

a partnership would need to define outputs for the long-term. In many economies there are constituencies against change. They can be persuasive so there is a need to ensure central agencies drive the PPP agenda.

Session 3

Defining the value of a Partnership for key stakeholders

It was noted that self-interest was the motivating force for organisations thinking of participating in a partnership. There is a need to establish the objectives of a partnership and to clearly establish the benefits that could be expected to arise. The objectives should not be too broad. The value in a partnership could arise from discussions of issues and ways to resolve them. (The IPA forum in Australia does some heavy lifting in pushing forward with an agenda). But is it feasible to consider a partnership in a region as big as Asia?

A useful focus should be on the challenge of self-interest with the private sector. It is important to have a dialogue with the government and external stakeholders. A growing issue is that of external stakeholders such as the community and the environment. It is important that governments communicate the wider benefit of the PPPs and the possible tax and efficiency gains for taxpayers. Communications on bankable projects, how to enhance probity and integrity and the relevant decision-making processes would be relevant issues for a partnership to consider. The role of the partnership should be distinct, immediate and practical.

Emphasis was placed on the importance of case studies and a focus on the practical. The value-add benefits in two recent Victorian projects were highlighted. In the Peninsula link project, the builder will partner the community by forging links with local schools and developing a cultural legacy in partnership with a local art gallery for sculptures along the road. A schools project, involved a unique partnership with YMCA providing services to schools and local communities from purpose-built facilities. These arrangements provided additional benefits from the project beyond value for money.

Any partnership should not deal in generalities but focus on actual projects. IFIs could eliminate sovereign risk out of a project

Discussions following this session focused on the value of partnerships and collaboration. Positive outcomes could arise from an APEC harmonisation of local standards committees and the contribution of best practices and discussions between economies. Case studies were emphasised, including messages from negative examples. Why a project failed? Local examples are very important as well as best practice examples from say, Australia, UK and Korea.

It is very important to develop PPP champions in governments. Premier Brumby in Victoria was a good example. There are significant benefits for the sector when public officials and the private sector work together on collaborative projects. APEC might well represent the political forum that would be important in developing a partnership. It was noted that frankness and openness in advice would be critical; it was realistic for any partnership to get engaged slowly but bold steps would be necessary.

Emphasis should be placed on building capacities in member economies of APEC; some fundamental steps could be taken immediately in economies, for example, by

providing funding in budgets. As a private sector led group, a partnership could build a capacity to manager advisors, and develop advice on utilising resources.

Session 4

Establishing, maintaining and utilisation of a data base

It was observed that different users seek different information from PPP data bases. The timing and collection of data was often very difficult to manage. An APEC database which provided broad information on PPP projects and on general market conditions would be achievable but the timing and value was questioned. Understanding the nature of the recipient of data would be important and clearly if a data base were to be established it ought to provide a useful input to APEC processes. It should be practical and relevant.

If a data base were to be linked to case study material it could be useful. There is value in some data bases in driving cultural change. Issues of comprehensiveness, coverage and comparability were important. Achieving these objectives across APEC economies and which would involve projects at national and sub-national levels of government would be problematic. A question was raised as to whether a database would be a useful first step for APEC. Would it solve problems or create them? Some databases are available, including at the World Bank but this focuses on investment in infrastructure and not on PPPs as such. Building some useful PPP models offered a more realistic approach than focusing on a data base.

Perhaps a more useful approach would be to consider the role of an independent National Audit Office, similar to one in the UK which provided audited analysis of PPPs and had proven to be extremely useful in determining value propositions underpinning PPPs. A case study approach was again reemphasised. The International Finance Magazine was noted as being a useful source of information on PPPs.

Discussion focused on other initiatives that a partnership might consider, including manuals to cover evaluation and policy guidelines, the type of initiatives in Victoria known as "Gateway Initiatives", and support in putting together a business case for a PPP. Other work could focus on bidding processes and providing advice to the private sector on the grounds on which an investment decision should be considered, and the facilities to support financing risk.

In summarising the workshop outcomes, the Chairman thanked participants most warmly for their frank and open advice. He concluded that there was strong support from all participants for developing a concept of a partnership and taking it a step further. APEC and the Advisory Group were seen as having a unique opportunity to bring the concept together. He suggested that the idea of a next step involving a high level dialogue to which could involve Ministers and senior officials, the IFIs and senior business representatives involved in PPPs in the region; this was endorsed by the working group. He concluded that such a dialogue should best take place in the region later this year. All APEC economies should be invited. Momentum generated by such a dialogue would be a vital ingredient to realising the concept.