

# THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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## Third Meeting 2013

10 July 2013

7:30 AM – 9:30 AM

Gyoun Room, Kyoto Hotel Okura  
Kyoto, Japan

## Meeting Paper 3-A Draft Sydney Symposium Report (*2<sup>nd</sup> Draft with Tracked Changes*) Office of the Advisory Group Chair

<b>PURPOSE</b>	For consideration.
<b>ISSUE</b>	Report of the Sydney Symposium
<b>BACKGROUND</b>	In 2012, the Advisory Group and ABAC proposed the establishment of an Asia-Pacific Financial Forum (APFF), a regional platform for enhanced public-private collaboration to accelerate the development of robust and integrated financial markets in the Asia-Pacific. At their meeting in Moscow, the APEC Finance Ministers welcomed the idea behind this proposal and supported the holding of a symposium to explore the creation of the APFF and the Australian Treasury's offer to host the event. The symposium was hosted by the Australian Government at the Sydney Four Seasons Hotel on 10-11 April 2013.
<b>PROPOSAL</b>	Recommend that APEC Finance Ministers endorse the launch of the Asia-Pacific Financial Forum (APFF) based on the work program priorities proposed in the report of the Sydney Symposium.
<b>DECISION POINT</b>	Endorse the recommendation.

# **THE ASIA-PACIFIC FINANCIAL MARKET DEVELOPMENT SYMPOSIUM**

**10-11 April 2013**

**Four Seasons Hotel, Sydney, Australia**

## **CONFERENCE REPORT**

### **INTRODUCTION**

In 2012, the APEC Business Advisory Council (ABAC) proposed the establishment of an Asia-Pacific Financial Forum (APFF), a regional platform for enhanced public-private collaboration to accelerate the development of robust and integrated financial markets in the Asia-Pacific. At their meeting in Moscow, the APEC Finance Ministers welcomed the idea behind this proposal and supported the holding of a symposium to explore the creation of the APFF and the Australian Treasury's offer to host the event.

The symposium was co-organized by ABAC through the Advisory Group on APEC Financial System Capacity Building and hosted by the Australian Government at the Sydney Four Seasons Hotel on 10-11 April 2013. A total of 98 participants representing a wide spectrum of organizations in the region's public and private sectors as well as international institutions, standard-setting bodies and academic and research institutions attended the event.

Participants discussed the state and evolution of Asia-Pacific financial markets, their role in the region's development agenda, and the regulatory frameworks and market infrastructure that are needed to accelerate the development and integration of these markets. Participants discussed how the proposed APFF can add value to ongoing domestic and regional initiatives, what priority issues would be useful to include in its work program, and the kind of structure and process that would be most effective in advancing its work.

The discussions in the symposium reflected broad support across economies, sectors and institutions for the APFF concept and the potential value of such a platform in helping build the financial markets that are needed for the region to attain its development objectives. Participants agreed on a number of priorities for consideration as part of the proposed APFF work program. They also agreed on an initial structure and process for the Forum. This conference report describes the outcomes of these discussions.

### **ASIA-PACIFIC FINANCIAL MARKETS: CURRENT STATE AND EVOLUTION IN A GLOBAL AND REGIONAL CONTEXT**

The fundamental role of financial markets is to sustain the health and development of the real economy by soundly and efficiently channeling savings to productive investments. Are Asia-Pacific financial markets effectively playing this role? The short answer is no; they remain inadequate in serving the needs of the real sector. While the region's economic structure has undergone a steady transformation in the wake of rapid growth, its financing structure has not substantially changed, remaining heavily reliant on the banking system, which still accounts for almost 60 percent of total financial assets.

Continued growth of the region's developing economies will require greater financial depth and a much larger role for capital markets, particularly fixed income markets, which are the major

sources of funding in most advanced economies.<sup>1</sup> Emerging markets' financial depth (as measured by the ratio of debt and equities to GDP), which remains far below that of advanced economies, has been declining since the Global Financial Crisis (GFC).<sup>2</sup>

This situation is reflected in a number of trends:

- While accounting for a major portion of the world's population and an increasing share in global economic activity, emerging markets' share of the world's financial assets remains small compared to the G-4 (US, Eurozone, Japan and UK), where around 70 percent of the world's total financial assets are concentrated.<sup>3</sup>
- The bulk (around 86 percent) of emerging markets' foreign investment flows to developed economies. Of these, slightly more than half are central bank assets.<sup>4</sup>
- Emerging markets continue to receive a much smaller share of global capital inflows (less than a quarter of the cumulative total of US\$31.1 trillion from 2007 to mid-2012), of which only 16 percent were invested in equity and bond markets (more than half of these capital inflows were in the form of foreign direct investment). In comparison, 41 percent of capital inflows to advanced economies flowed into equities and bonds.<sup>5</sup> Among all regions, emerging Asia has the lowest percentage of foreign ownership of equity and debt securities.<sup>6</sup>

Viewed against the backdrop of stagnant global financial assets and declining cross-border capital flows (especially lending) since 2007,<sup>7</sup> the lack of sound and efficient financial markets poses a serious problem for developing APEC economies. With rapid demographic change, urbanization and a rising middle class, they face a growing need to finance physical and social infrastructure, business activities and consumption growth and to provide the opportunities to invest savings safely and profitably in long-term assets.

In this context, development of Asia-Pacific financial markets is crucial to addressing imbalances

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<sup>1</sup> Debt securities' share of financial assets amount to 49 percent in advanced markets, compared to only 27 percent in emerging markets. Source: *McKinsey Global Institute Financial Assets Database*.

<sup>2</sup> Debt and equities as of mid-2012 amounted to 408 percent of GDP on average in advanced economies, compared to only 226 percent in China and 151 percent in other emerging Asia. While emerging markets' share of total global GDP has increased rapidly from 28 to 38 percent from 2007 to mid-2012, their share of global financial assets has remained stagnant and increased only from 16 percent to 19 percent, based on *McKinsey Global Institute Financial Assets Database* and McKinsey Global Institute analysis.

<sup>3</sup> Andrew Sheng, *Issues on APEC Financial Architecture in a Global and Regional Context* (presentation delivered at the forum). Data based on *IMF Global Financial Stability Report* and the author's own calculations.

<sup>4</sup> Total foreign investment from developing economies in 2011 amounted to US\$14.4 trillion, see Sheng. Data based on *McKinsey Global Institute Bilateral Foreign Investment Database* and McKinsey Global Institute analysis.

<sup>5</sup> Sheng. Data sourced from *IMF Balance of Payments*, Institute of International Finance and McKinsey Global Institute analysis.

<sup>6</sup> Figures for 2011 are 53 percent for Western Europe (35 percent intra-Europe), 29 percent for Central/Eastern Europe and the CIS, 23 percent for North America, 23 percent for Latin America, 17 percent for other developed economies, 14 percent for Middle East and North Africa and 8 percent for Emerging Asia, see Sheng. Data based on *McKinsey Global Institute Financial Assets Database*, *IMF Balance of Payments* and McKinsey Global Institute analysis.

<sup>7</sup> Compound annual growth rate of global financial assets considerably slowed from 8.1 percent during 2000-07 to 1.9 percent during 2007-2Q12. Figures for the stock of global foreign investment assets are 17 percent during 2000-07 and 2 percent for 2007-11. Total capital flows declined by 6.6 percent during 2007-11, of which cross-border lending accounted for about half of the total drop, see Sheng. Data for global financial assets based on *McKinsey Global Institute Financial Assets Database* and analysis. Data for global foreign investment assets based on *IMF Balance of Payments* and McKinsey Global Institute analysis.

underlying present economic problems. Rebalancing involves efforts to address mismatches and gaps at the domestic level (e.g., maturity and currency mismatches, current account, fiscal and social gaps) and at the international level (e.g., imbalances in trade and capital flows). However, it requires adequate understanding of complex network effects of inter-connectivity and inter-dependence, as well as the trade-offs involved between efficiency, stability and equity.

Financial market development involves a number of key elements for building institutions:<sup>8</sup>

- people (shared values, beliefs, ownership, knowledge and experience, mind sets);
- property rights (fair and efficient judiciary, fair enforcement, low transactions costs, ownership);
- knowledge intensity (information access, learning, experience and education);
- standards (FSF core standards, IOSCO regulatory standards, corporate governance, transparency);
- codes, rules and laws (tax codes, accounting and auditing rules, disclosure laws);
- processes and procedures (vertical and silo processes, horizontal coordinating processes, interconnectivity and inter-operability);
- structure (efficiency, robustness and adaptability); and
- institutional design (incentives and governance).

Financial infrastructure in the region's emerging markets continues to lag behind that of advanced economies. Improvements are needed in both the infrastructure for property rights (judiciary and arbitration panels, laws and regulations, standards, corporate governance and risk management processes) and financial hardware (payment systems, clearing and settlement systems, custodians and registries and telecommunications network systems).

Much remains to be done to deepen long-term institutions that can finance long-term infrastructure and enable the real sector to deleverage, as well as promote liquidity in bond and financial derivatives markets. Greater involvement of private equity, sovereign wealth funds, pension funds and insurance companies is needed to meet economies' huge future financing requirements and help them avoid the recurrence of maturity and currency mismatches that have led to the Asian Financial Crisis.

This is particularly important in light of Asia's rapidly aging population, especially in Japan, China and the Newly Industrialized Economies (NIEs), where fertility rates have gone below the level of most advanced economies in Europe. Faced with an inevitable surge of retirees, the region needs to urgently develop its pension systems and insurance and mutual fund industries. As this coincides with the region's growing need for long-term funding, this has become a priority area that requires the development of a blueprint for action and cooperation across relevant public and private sector institutions and agencies.

In the meantime, there is a need for a deeper understanding of how regulations affect the capacity of current bank-dominated financial systems to continue funding the region's shift toward a domestic and regionally-driven engine of growth. There is a need to better understand the impact of regulatory capital and liquidity requirements and limits on leverage not just on systemic stability but also on trade finance, SME funding and long-term lending for infrastructure. All these are critical to the growth of emerging markets, particularly in the context of avoiding synchronized global economic slowdowns and vicious cycles progressively choking off lending to SMEs.

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<sup>8</sup> Sheng.

Financing the future growth of the region's emerging economies will require structural adjustment. It will require the adoption of technology and innovation to compensate for the negative effects of an aging population and fiscal drag. Adaptive business models are needed for financial systems to take full advantage of new growth trends in the region such as urbanization, rising incomes, growing cross-border business, innovation, new trade corridors and new payments opportunities that can help expand access to finance.

The region needs to seize these opportunities to create financial systems that can better serve the real sector through improved risk management, resource allocation, financial access and capacity to fund innovation and growth. In order to do so, it is important to overcome the "collective action trap" – the challenge posed to domestic regulators by regulatory structures that operate in silos and the lack of international systems to effectively deal with global markets that have complex feedback mechanisms.

Fortunately, the foundations for regional financial market development have been laid in the wake of the Asian Financial Crisis and continue to be steadily developed and deepened. Although development has been uneven and financial market integration continues to lag behind the region's trade integration, significant progress has been achieved, which enabled Asia-Pacific economies to remain resilient in the face of the GFC and the Eurozone Crisis.

Financial fundamentals have been strengthened, as is evident in the levels of foreign exchange reserves, reduction of short-term external debt, improved macroeconomic policy frameworks and enhanced financial sector regulation and supervision. Higher capital adequacy and lower non-performing loan ratios indicate improved soundness of Asian banks. Most jurisdictions in the region have completed implementation of Basel II. Many have completed or are in the process of publishing the final rules for Basel III, and have macro-prudential policy measures in place to address pro-cyclicality and ensure systemic oversight.

Regional financial cooperation has advanced significantly in three key areas:

- *Macroeconomic and financial stability:* The Chiang Mai Initiative, established in 2000 as a network of bilateral swap arrangements to help economies to manage regional short-term liquidity problems, has been expanded in 2012 into a US\$240 billion multilateral currency swap arrangement (CMIM) among members of the Association of Southeast Asian Nations, China, Japan and South Korea (ASEAN+3). The grouping's economic review and policy dialogue (ERPD) process has been integrated with this regional liquidity support facility, which is supported by a regional macroeconomic surveillance unit, the ASEAN+3 Macroeconomic Research Office (AMRO).
- *Bond market development:* The Asian Bond Markets Initiative (ABMI) was launched by ASEAN+3 in 2003 to help develop deep and liquid local currency bond markets in Asia, better intermediate domestic savings and address currency and maturity mismatches. In 2010, the Credit Guarantee and Investment Facility (CGIF) was established to promote the development of local currency corporate bond markets through the provision of credit guarantees for local currency bonds issued by investment grade companies in the ASEAN+3 economies. In the same year, the ASEAN+3 Bond Market Forum (ABMF), involving both public and private sector experts, was also established to help harmonize market practices and regulations related to cross-border bond transactions. Through the Executives' Meeting of East Asia Pacific Central Banks (EMEAP), the region's central banks also initiated the first and second Asian Bond Fund (ABF1 and ABF2) projects.
- *Infrastructure finance:* In 2012, ASEAN members and the ADB established the ASEAN Infrastructure Fund (AIF) with an initial equity capital of \$485.2 million that will be

augmented with hybrid long-term bonds. The AIF is designed to support priority projects in the Master Plan on ASEAN Connectivity. It seeks to help mitigate particular risks and encourage greater private sector interest in PPP projects.

Over the past 20 years, more businesses in the region's emerging markets have learned to access finance through the banking system and equity markets, as measured by the ratio of private credit and market capitalization to GDP. However, their corporate bond markets remain generally underdeveloped relative to loan and equity markets, though modest gains have been made in a few economies, particularly Korea and Malaysia.

Various measures indicate that Asia-Pacific financial market integration is generally making progress, albeit slowly.

- The region presents a mixed picture with respect to capital account openness. In general, more developed economies maintain high levels of openness, while most developing economies continue to exhibit low levels or have become less open since the early 1990s.<sup>9</sup>
- In the region's emerging markets, ratios of external assets and liabilities to GDP have steadily risen over the past 20 years, led by Hong Kong and Singapore.
- Intra-regional holdings of equity and debt securities have risen, but remain at relatively low levels. Portfolio investment flows out of and into developed economies in Asia are still largely dominated by the US and Europe. There is more diversity in the case of developing economies, where the NIEs and China have increased their share of investment flows.
- Measured by the ratio of financial services to total service exports, financial services trade openness in the region is gradually rising as incomes grow.
- Co-movements of prices in capital markets indicate some progress in financial integration within Asia over the past decade.<sup>10</sup> This has been more pronounced in the case of equity markets. There was convergence in bond markets until the GFC but Asian bond yields have diverged thereafter, although there has been some recent convergence within subregions, such as among middle-income ASEAN economies and within Northeast Asia.<sup>11</sup>

The need for greater regional financial cooperation is growing as emerging economies feel the impact of advanced economies' massive monetary easing in the wake of recent crises. Concerns have focused on the potential for large-scale capital inflows, upward pressure on their currencies and impacts on goods and asset price inflation, as well as the dangers of their sudden reversal. These developments call for stronger macroeconomic management and monitoring of financial sector soundness, macro-prudential policy measures, building up of foreign exchange reserves and strengthening of global and regional financial safety nets.

This underscores the importance of financial architecture to ensure stability, at both the domestic and international levels. Among measures being considered to strengthen the regional financial architecture are continued enhancement of the CMIM, AMRO and ERPD, expansion of the CGIF and AIF, and the establishment of a regional corporate bond fund, sub-regional infrastructure funds, a regional funds passport scheme, a regional bond settlement and clearing

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<sup>9</sup> Based on data from the index developed by Menzie D. Chinn and Hiro Ito (the Chinn-Ito Index). See [http://web.pdx.edu/~ito/Chinn-Ito\\_website.htm](http://web.pdx.edu/~ito/Chinn-Ito_website.htm).

<sup>10</sup> Prices for assets that have similar expected risk-adjusted returns are expected to converge as a result of capital flows and arbitrage. As a result, co-movement of these prices is used as an indicator of financial integration.

<sup>11</sup> ADB, Asian Economic Integration Monitor (March 2013), p. 21.

system, and a regional financial stability dialogue in Asia.

Asian economies are looking to greater regional financial cooperation, as they begin to feel the effects on financial market infrastructure, trading and investment of policy and financial regulatory measures that are being put in place globally and outside the region. These include Basel III, the Dodd-Frank Act (DFA), the European Market Infrastructure Regulation (EMIR), the U.S. Foreign Account Tax Compliance Act (FATCA) and the EU Financial Transaction Tax (FTT), among others.<sup>12</sup>

Several of these have significant extraterritorial effects on the region's financial markets. EMIR requires non-EU central counterparties (CCPs), including those clearing cash securities, to apply for recognition by the European Securities and Markets Authority (ESMA) in order for branches of EU banks and investment firms to benefit from the preferential risk weighting for exposures to them under Basel III as implemented by the EU. AIFMD affects all non-EU managers of funds to be marketed in its jurisdiction, regardless of whether the fund is based within or outside the EU. The FTT will apply to transactions between financial institutions, including funds that are distributed outside the EU (such as UCITS, which is distributed in Asia). FATCA requires non-US financial institutions to report to the US Internal Revenue Service information on US

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<sup>12</sup> Following are a number of key regulatory measures and their impact:

- **Dodd-Frank Act:** It will affect financial institutions and central counterparties (CCPs), particularly through the introduction of centralized clearing of standardized over-the-counter (OTC) derivatives and new record keeping and reporting requirements and stricter oversight and inspection. These new requirements are expected to result in a greater need to connect to multiple clearing houses, locking up of capital in default funds, increased need for collateral, higher capital requirements and increased demand for reporting.
- **European Market Infrastructure Regulation (EMIR):** This mandates central clearing for standardized contracts and risk mitigation standards for non-centrally cleared contracts. Its impact on financial institutions and CCPs are expected to be similar to that of Dodd-Frank.
- **Central Securities Depository Regulation (CSDR):** This was introduced to ensure the role of CSDs, carrying out core functions, as a systemically vital part of the market infrastructure and will particularly affect CSDs and custodians. It is expected to improve efficiency and automation through harmonization and enhance governance in the case of CSD business models but also to increase costs during the implementation phase and have an impact on costs and operations for ICSD business models.
- **Target-2 Securities (T2S):** Affecting the settlement layer of the market infrastructure and custodians, T2S aims to provide a standardized platform for cross-border and domestic processing of securities transactions in the Eurozone and to reduce cross-border settlement costs. While facilitating automation through settlement harmonization, it is expected to result in additional costs and risks during the implementation stage, which could take several years.
- **Basel III:** This will increase risk-weighted assets on OTC transactions and capital and liquidity requirements for financial institutions and encourage greater use of risk-based pricing.
- **Markets in Financial Instruments Directive II:** Focused on high frequency/algorithmic trading, this was introduced to enhance pre- and post-trade transparency, promote the establishment of organized trading facilities and encourage the movement of derivatives onto electronic platforms. It is expected to increase reporting and regulatory oversight for financial institutions, limit the trading of eligible derivatives to regulated trading venues and impact internal systems and processes that will need to meet requirements on transparency and changes to market structure.
- **Alternative Investment Fund Managers Directive (AIFMD):** Particularly affecting hedge funds, depositaries and prime brokers, this was introduced to promote greater transparency and better investor protection. A key feature is the requirement for each Alternative Investment Fund to appoint a depositary. It is expected to impact prime brokers through depositary liability when the depositary demands indemnification for asset loss risk.
- **Foreign Account Tax Compliance Act (FATCA):** This subjects financial institutions to a new disclosure and withholding regime and requires the investor's custodian bank to carry out identification of shareholders. It is expected to significantly increase regulatory reporting requirements and entail significant system changes for financial institutions, in addition to its extra-territorial impact, in particular through the need to prove an entity is not a US entity.
- **Financial Transaction Tax (FTT):** This especially affects the trading layer of the market infrastructure. Its potential implications include reduction of the volume of executed trades in Europe (particularly high-frequency trading), reporting with respect to tax identification, and settlement. The EU Finance Ministers gave clearance in January 2013 for this to be put into law in 11 EU member economies. Shortly thereafter, industry groups in the US expressed serious concerns to the EU regarding its extra-territorial effects.

Source: Deutsche Bank Direct Securities Services, as presented by Mr. Boon-Hiong Chan, *Adjusting to the New Normal: Asia-Pacific Themes* (February 2013)

account holders, withholding tax on US sourced dividends and interest, income and gross proceeds.

These new measures will bring intended benefits, such as improved oversight, risk mitigation, transparency and reduction of certain costs (e.g., settlement costs through Target-2 Securities). However, they are also bound to have consequences on costs, risks, capital and reporting requirements and changes to internal systems and market structure that could impact Asia-Pacific economies' domestic and regional goals and aspirations, especially in developing their capital markets. It is expected, for example, that capital requirements will, in time, begin to increase constraints on bank credit and effective working capital management and raise the cost of capital. The momentum behind Asia-Pacific financial integration is growing, as most economies in the region are too small to develop deep and liquid capital markets on their own. This is also being facilitated by a number of factors.

- The first is the progress of broader regional economic integration efforts. Several major trade initiatives are being undertaken – the Trans-Pacific Partnership (TPP), the Regional Comprehensive Economic Partnership (RCEP) and the ASEAN Economic Community, which will have an impact on the regional financial supply chain. Business opportunities are being regionalized as a consequence of continuing economic integration within Southeast Asia and Greater China.
- The second is the emergence of various new regional initiatives following the launch of the ABMI and ABF. Examples are the Asia Region Funds Passport (ARFP) under APEC, the ASEAN+3 Bond Market Forum, the ASEAN Capital Markets Forum (ACMF), the ASEAN Exchanges Link, ASEAN Banking Integration Framework (ABIF), mutual recognition of funds between China and Hong Kong, the Euroclear-Malaysia-Hong Kong international bond settlement platform and the Euroclear-Hong Kong-JPM Chase tri-party repurchase platform.
- The third is the development of the Chinese renminbi (RMB) as a potential quasi-regional currency with the prospects of future RMB liberalization and further expansion of trade with Southeast Asia. RMB offshore centers have been established in Hong Kong, Chinese Taipei, Singapore, Malaysia, London and Paris. The Qualified Foreign Institutional Investor (QFII) and RMB QFII (RQFII) quotas and investment destinations for the Insurance Qualified Domestic Institutional Investor (QDII) program have been expanded. Pilot schemes are in place allowing RMB lending to overseas related companies by Shanghai-based companies that can settle RMB-denominated invoices, direct RMB lending out of Hong Kong for registered projects in mainland special economic zones, and simplified RMB cross-border payments.
- The fourth is the changing landscape of stock exchanges in the region. New developments include the merger of the Tokyo and Osaka stock exchanges, the establishment of the Pilot ASEAN Exchanges Link, the launch of cross-trading between the Singapore and London Stock Exchanges and the spread of new trading technologies, such as the new securities trading platform of the Shenzhen Stock Exchange and Direct Market Access (DMA) launched by Singapore. Monopolist exchanges are also being opened up to competition by alternative trading venues, which have significantly driven up the cost of trading in the USA and Europe. For example, alternative trading systems in South Korea will now be able to compete against Korea Exchange although with some important restrictions.
- The fifth is the deepening of the region's fund industry, which has benefited from recent measures related to short-selling, collateral management, securities borrowing and lending, investor protection and market practice regulation. Some examples are the new guidelines on disclosure in Singapore, various regulatory and disclosure requirements across



Asia-Pacific markets, CSDs expanding into securities borrowing and lending, fund mutual recognition initiatives under APEC and ASEAN and between Hong Kong and China, relaxation of market entry requirements for domestic hedge funds in Korea, opening up of open-ended mutual fund industry in Vietnam and the recent update of China's Securities Investment Law.

These trends are capturing the interest of US and European institutional investors and fund managers. However, attracting more intra-regional portfolio investments will require measures that will bring down the costs of investing in Asian markets (currently much higher than in the US and Europe), particularly as a regional portfolio. Such measures would include harmonizing market access requirements, legal documentations and withholding tax regimes; developing much-needed financial market infrastructure, and expanding the domestic institutional investor base, particularly through the growth of insurers and pension funds.

Much work remains to be done on the technical side with respect to bond markets. Among these are the development of classic repo and futures markets to facilitate market making and hedging tools to promote liquidity through the use of derivatives, including bond futures and interest rate swaps, promoting better corporate governance, bringing down withholding and transaction taxes and developing legal systems to better protect creditors and investors. As policy makers and regulators design new policies and regulations in response to these needs, greater coordination among them and the involvement of market participants, as well as coordinated market-led initiatives, will be needed.

The basic foundations underpinning financial markets in many economies, especially the legal, policy and institutional frameworks, need to be strengthened and further developed. Problems faced by many advanced economies today also underscore the importance of sound macroeconomic, monetary and structural policies, fiscal and market discipline, open markets, transparency and good governance, which would help emerging markets in the region effectively and efficiently channel savings to investment. The process of regional financial market development and integration will be gradual, especially given the region's diversity, but this can be significantly accelerated through close collaboration between the public and private sectors.

Active collaboration between Asian and Latin American emerging markets will benefit their efforts to develop their financial markets through the sharing of valuable experiences. In Latin America, the Pacific Alliance (*Alianza del Pacífico*) formed by Chile, Colombia, Mexico and Peru, is pursuing the goals of free trade and economic integration, with a view to expanding relations with Asia. With a combined nominal GDP exceeding US\$2 trillion (larger than India's) and exports of about U.S.\$ 545 billion in 2012 (larger than MERCOSUR's), this market-oriented Latin American grouping represents an important potential partner for Asia.

At the moment, Chile, Colombia and Peru have integrated their stock markets into the Mercado Integrado Latinoamericano (MILA), which Mexico is set to join and become the largest stock market in Latin America. Particular areas where Pacific Alliance economies are interested in seeking further collaboration include reduction of taxes on the financial sector (such as financial transactions and capital gains taxes), improving the ease of doing business, promoting cross-border flows of capital and promoting sound and robust financial regulatory and supervisory regimes.

The breadth, complexity and inter-relationship of these cross-cutting issues, their importance and the large number and diversity of relevant players at domestic and international levels require a

“grand process.” Such a process is needed to overcome barriers to closer collaboration among agencies and institutions that have traditionally operated independently of each other. It requires the closer integration of finance with the overall process of economic development planning. It requires effective public-private sector consultative and collaborative mechanisms.

## **FINANCIAL MARKET DEVELOPMENT AND CONNECTIVITY IN THE CONTEXT OF THE REGION’S DEVELOPMENT AGENDA**

Financial market development is not an end in itself. Financial systems serve broader economic goals, and consequently, need to be developed with the attainment of these goals in mind. Charting the future of Asia-Pacific financial markets will need to begin with the question: what is the region’s development agenda?

Most economies in the region have experienced unparalleled growth over the past several decades, driven by private capital inflows and exports to the consumer markets of North America and Europe. This growth was sustained through the expansion of global supply chains and innovations that kept enterprises competitive in the face of rising wages and prices that came with growing affluence. However, this also created domestic and global imbalances that became more pronounced over time.

The global economy has now reached a turning point, where the development model that has served the region well in the past is no longer viable. Asia-Pacific economies will need to depend more on domestic demand in order to avoid the “middle income trap”<sup>13</sup> and achieve sustained economic growth. Very much related to this is the need to address poverty, environmental issues and aging, which are key challenges for many economies in the region.

Meeting these needs requires the expansion of physical and social infrastructure. It requires facilitating competitiveness and innovation and the growth of small and medium enterprises. It requires promoting domestic consumption and the development of the services sector. It requires ensuring that the needs of the growing elderly population are met. It requires providing the environment to enable lower-income households (particularly those in rural areas) to narrow the income gap, while mitigating the impact of development on the environment and promoting sustainable practices. Much of the region’s development agenda thus revolves around balanced, inclusive, sustainable and innovative growth.

From a global perspective, accelerating economic growth in Asia-Pacific emerging markets on the basis of this development agenda is crucial to the healthy development and stability of the world economy. It offers a way to sustain global economic growth while enabling advanced economies to attend to the urgent business of bringing down high debt levels in both public and private sectors. It promises to help fix the imbalances that have resulted from divergent patterns of consumption and trade in developed and emerging markets and ensure more balanced trade flows in the future. Development of capital markets and bankable infrastructure project pipelines in the region’s developing economies can greatly expand the range of assets where savings from anywhere can be productively and profitably invested.

Such a development agenda has certain implications on the direction of financial market

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<sup>13</sup> Middle income trap refers to a situation where an economy grows to reach a certain income level but fails to move beyond it as a result of declining competitiveness vis-à-vis lower-cost producers due to rising labor costs in conjunction with an inability to compete with more advanced economies in higher-value products.

development in the Asia-Pacific region.

- First, the region's economies must develop deeper and more liquid financial markets, including local currency corporate and municipal bond markets. This would require regulations that support greater liquidity, a more diverse issuer base and an institutional and retail investor base that is able to take and manage a wide variety of risks. It would require the development of financial market infrastructure and markets for hedging instruments.
- Second, efforts are needed to make financial systems more inclusive and sustainable. This would involve measures to enable financial institutions to expand their services to the financially unserved and underserved, including lower-income households, women, young people and micro-enterprises. It would also involve addressing barriers to expanded financing of small and medium enterprises, including trade finance, as well as encouraging investment in environmentally friendly products and services.
- Third, attention needs to be focused on infrastructure finance and the development of the institutional investor base, including the insurance and pension and mutual fund industries. Multilateral institutions and governments need to provide facilities that can assist the development of infrastructure markets at their early stages, such as through funding of project development and mitigating risks that the private sector is unable to assume. Infrastructure provides a valuable opportunity for capital to migrate from banks to fixed income markets, supporting the development of capital markets. Economies need to develop regulatory frameworks that can facilitate the channeling of foreign and domestic capital into infrastructure and frameworks for domestic and international bankers, investors and fund managers to collaborate in funding large projects. The public sector needs to improve its capacity to develop a pipeline of bankable projects and create a more favorable environment for PPPs, including simplified tax regimes and regulations and credit enhancement to mitigate default risks.
- Fourth, economies need to actively pursue regional financial integration to help realize economies of scale and create larger, more competitive and more liquid markets, which can offer better opportunities for risk diversification and attract investors, issuers and financial intermediaries to the region. This would require promoting greater cross-border connectivity and convergence of regulations and market practices.
- Fifth, policies and regulations that promote growth by allowing more leeway for risk-taking and providing greater liquidity to markets need to be balanced by measures to ensure continued financial stability. This requires greater capacity on the part of regulators and closer cross-border collaboration among regulatory authorities and policy makers, to strengthen financial systems against domestic instability and spillovers from markets outside the region.

The experience of Hong Kong provides some insight on key factors behind the development of a regional financial center.

- The first is a business environment that facilitates the free flow of capital. Consistency and transparency in applying rules have played an important role in promoting confidence in the market by investors, who need to know the rules of the game.
- The second is connectivity. Hong Kong is fully connected to both the global market and China and so has become a key intermediary between China and the rest of the world. In particular, It was able to develop an offshore RMB market and gained access to a large amount of liquidity.
- The third relates to macro risk policies. Hong Kong has earned the confidence of global

investors by following all international standards related to macro-prudential policies.

Within the broader region, Southeast Asian emerging markets are taking the lead in efforts to achieve greater financial development and integration. With a large and relatively young population,<sup>14</sup> ASEAN has significant potential for long-term growth. It has achieved major strides in regional trade integration, and is now looking at more deeply integrating its financial markets. ASEAN members have committed to integrate their financial markets under the Roadmap for Monetary and Financial Integration of ASEAN and the ASEAN Economic Community Blueprint. More than four-fifths of these commitments have already been achieved to date.

Much work remains to be done, as ASEAN financial markets are more integrated with global markets than with each other, and capital markets in most of these economies remain small relative to the banking sector. Significant reforms were undertaken in the wake of the Asian Financial Crisis, but capital market liquidity in most markets remain limited, major gaps in regulatory capacity persist, market infrastructure is inadequate to provide connectivity, and opportunities for risk diversification are insufficient. Southeast Asia's fragmented capital markets remain vulnerable to spillovers from markets outside the region.

ASEAN is beginning to move forward on three fronts to achieve regional financial integration among member economies, but there are many challenges.

- The first is financial services liberalization through the ASEAN Banking Framework, which will allow ASEAN banks that meet specific qualifications to gain access to markets in member economies. This poses challenges to domestic regulators, who will need to improve capacity to harmonize banking regulations, better coordinate among themselves and establish critical infrastructure for regional banking market integration.
- The second is capital market integration. ASEAN has already agreed to develop common disclosure standards and a common prospectus framework to facilitate securities offerings across markets. The stock exchanges of Thailand, Malaysia and Singapore are undertaking a linkage project that the Philippines is currently working to join. The grouping is also collaborating on the mutual recognition of collective investment schemes. The ABMI has already produced significant results for government bond markets, but the development of corporate bond markets is still at a very early stage.
- The third is capital account liberalization. An assessment of capital account regimes indicates that there remain various restrictions on capital flows, mostly on outflows. While all member economies (with the exception of Myanmar) have adopted Article VIII of the International Monetary Fund (IMF) Articles of Agreement, many regulators have remained cautious and continue to maintain various payment restrictions related to their current accounts, as well as on offshore use of currencies, external borrowing and lending in their own currencies and on the ability of investors to hedge foreign currency risks.<sup>15</sup>

An important challenge for financial integration is reconciling the existence of various initiatives involving different sets of participants. A flexible approach that identifies the set of participants that can most effectively work together on a particular initiative, is non-binding and allows for

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<sup>14</sup> The median age in ASEAN is 27, compared to 45 in Japan, 41 in the EU and 35 in China..

<sup>15</sup> See also Asian Development Bank and ASEAN, *The Road to ASEAN Financial Integration: A Combined Study on Assessing the Financial Landscape and Formulating Milestones for Monetary and Financial Integration in ASEAN* (Manila 2013).

pathfinder initiatives is more likely to produce positive results. Given that finance occupies a highly political space, it is also important to have a better understanding of the political situation in each economy at the outset, develop an appropriate sequencing process and consider the holders of political capital as a key audience.

Finally, success in this undertaking requires substantial capacity building. While many institutions are undertaking such initiatives, these remain inadequate to meet the region's great needs and ambitious goals. Closer coordination among institutions, innovative approaches that maximize the possibilities of new technologies, and a process that combines benchmarking with the sharing of best practices offer promising ways forward to advance along the process of regional financial market development and integration.

## DEVELOPING THE REGION'S FINANCIAL INFRASTRUCTURE

Financial infrastructure, defined broadly for purposes of this report as “the set of institutions that enable effective operation of financial intermediaries,”<sup>16</sup> is an important aspect of any effort to develop robust and integrated financial markets. Indeed, many of the obstacles to greater depth and liquidity of capital markets, financial inclusion, regional financial integration, infrastructure funding and financial market stability stem from underdeveloped financial infrastructure. Addressing these inadequacies is an important task where regional public-private collaboration could make significant contributions.

### *Credit reporting systems*

Good credit reporting systems provide lenders the accurate and credible information they need to reduce lending risks, and thus play important roles in expanding access to credit. Lenders' inability to accurately infer the risk profile of borrowers often causes low-risk borrowers to face high interest rates that act as subsidies for high-risk borrowers. These rates price many low-risk borrowers out of the market. On the other hand, high-risk borrowers receive subsidies and are thereby drawn into the market. Average prices go up to reflect the disproportionate presence of high-risk borrowers, resulting in higher delinquency rates and leading lenders to ration loans. In presenting information about potential borrowers to lenders, credit bureaus allow interest rates to be fine-tuned to reflect the risk of individual borrowers, leading to lower average interest rates, greater lending through reduced rationing and lower rates of delinquency and default. However, the extent to which these results are achieved depends on the structure of credit reporting, bureau ownership and the type of information reported.<sup>17</sup>

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<sup>16</sup> Definition provided by the International Finance Corporation (IFC) ([http://www.ifc.org/wps/wcm/connect/Industry\\_EXT\\_Content/IFC\\_External\\_Corporate\\_Site/Industries/Financial+Markets/Financial+Infrastructure/](http://www.ifc.org/wps/wcm/connect/Industry_EXT_Content/IFC_External_Corporate_Site/Industries/Financial+Markets/Financial+Infrastructure/)).

<sup>17</sup> In this context, distinctions between the following need to be made:

- **Negative-only reporting versus full-file reporting.** Negative-only reporting is the reporting of only negative information, or adverse payment data on a consumer, such as defaults, delinquencies, collection, bankruptcies and liens. Full-file reporting is the reporting of both negative information and positive information, which includes information on the timeliness of payments, including whether payment was on time, indeterminately late or delinquent, payment information which contains the payment date relative to the due date, oftentimes also data on account type, lender, date opened, inquiries, debt, and can also include credit utilization rates, credit limit and account balance.
- **Segmented versus comprehensive reporting.** Segmented reporting is a system in which only data from one sector, e.g., retail or banking, are contained in reports. Comprehensive reporting is a system in which payment and account information, are not restricted by sector and contains information from multiple sectors, e.g., utilities payments.
- **Public versus private credit bureaus.** Although there is no theoretical reason why a public bureau cannot behave like a private one, there are practical reasons. Public bureaus have been set up largely and primarily for supervisory purposes, to monitor the safety and soundness of the financial sector and determine whether reserves are sufficient, rather than primarily to facilitate greater and sustainable lending. Private bureaus, by contrast, are set up to ease lending, and the

Various studies<sup>18</sup> have concluded that full-file (including both negative and positive information) and comprehensive (containing both financial and non-financial data) credit reporting systems, especially where private credit bureaus are involved, produce the best results with respect to enabling lenders to more accurately judge borrowers' risks and expand lending to traditionally disadvantaged clients such as lower-income borrowers, women, ethnic minorities and young people.

The introduction of full-file and comprehensive credit reporting systems will need to go hand in hand with the development of the legal and regulatory framework to protect consumers and privacy by defining key procedures, such as 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.<sup>19</sup> In addition, a number of technical issues also need to be addressed.<sup>20</sup>

Cross-border data flows can play an important role in regional economic and financial integration. Currently, credit records cannot be used across jurisdictions, making it difficult for migrants to access financial services. Overcoming this challenge will require the development of common approaches to data privacy and data protection and increasing trust in the robustness of legal and regulatory frameworks and their enforcement among economies in the region.

#### *Legal frameworks for secured lending*

Secured lending is the major source of funding and liquidity for SMEs. Transparency and predictability of rules in this area are important for secured creditors to have confidence in the legal system's ability to protect their interest in collateral. The greater this confidence, the less they need to price for the risk of legal uncertainty, and the more credit they are able to provide borrowers at lower cost. Recognizing this reality, a number of APEC economies have already undertaken reforms to strengthen the legal architecture for secured lending.<sup>21</sup>

A key issue is how to allow debtors in secured transactions to make effective use of movable assets and receivables as collateral. The IFC estimates that about \$9.3 trillion worth of property in developing economies is not being used productively as a consequence of non-existing or poorly functioning collateral laws and registries. Without laws allowing use of such assets as collateral and public registries for the protection of interests in these assets, lenders will remain reluctant to take a security interest in debtors' movable assets such as raw materials and inventory

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reasoning behind the data collection by private bureaus lies primarily in reducing information asymmetries and to improve risk assessment in lending. By this account, private bureaus are complements to public bureaus.

<sup>18</sup> There has been extensive research on credit reporting encompassing three generations of studies. The first generation (WorldBank, IDB, Pagano and Jappelli) explained how the existence of credit bureaus increases private sector lending and lowers national financial sector risk. The second (Barron/Staten, IDB, Miller and Galindo) confirmed that comprehensive data leads to wider lending but lower default rates than negative only data, and that wider lending is particularly beneficial to small business. The third generation (Information Policy Institute) established that broader participation by lenders and comprehensive data improves financial performance.

<sup>19</sup> The OECD *Guidelines on the Protection of Privacy and Transborder Flows of Personal Data* (<http://www.oecd.org/internet/ieconomy/oecdguidelinesontheProtectionofPrivacyandTransborderFlowsOfPersonalData.htm>) and the US Federal Trade Commission (FTC) *Fair Information Practice Principles* (<http://www.ftc.gov/reports/privacy3/fairinfo.shtm>) provide useful reference points for developing legal and regulatory frameworks.

<sup>20</sup> There are four key domains that remain important irrespective of variations in methods and technical wherewithal as well as changes in technology. These are: (a) data formatting standards (common standards of reporting make it easier to collect and use information and allow portability of data across borders); (b) identity verification (to help in matching information, improving accuracy and protection against financial identity fraud); (c) data security; and (d) disaster recovery (preservation of the information to help preserve the financial structure).

<sup>21</sup> These include Japan's Perfection Law (2000), China's Personal Property Law reforms (2006) and Korea's Act on Security over Movable Assets and Receivables (2012).

or accounts receivable and unable to expand financing for SMEs, most of which do not have real estate to use as collateral.

Improving the legal regime for secured lending in the region will entail the adoption of reforms. Examples of gaps that need to be addressed are lack of an exclusive security interest registry, which may lead to “hidden lien” and similar issues; unclear perfection rules or lack of coverage of certain types of collateral (movables, receivables, intellectual property), the absence of blocked or pledged account security, untested or non-transparent legal systems, treatment of floating charges and lack of broad licensing authority for commercial lending.

A few APEC economies have some of the best practices on secured lending regimes and creditor protection in the region as well as predictable secured lending regimes that provide a clear and exclusive system for filing broad classes of collateral and perfecting security interests. These can serve as models for policy reforms. While a number of economies have introduced or modernized key aspects of property registration, collateral laws and bankruptcy codes in recent years, structural impediments remain to certain degrees. Secured transaction law reform should aim for a more uniform, exclusive, and transparent system that can enable lenders to make more informed risk decisions.

#### *Financial information services*

Reliable financial information helps markets attract investment, facilitates the efficient flow and allocation of capital, and lowers costs for market participants. Confidence in financial information is fostered through greater transparency and disclosure, which enable the collection of high quality data that in turn can reduce information asymmetry and promote market efficiency.

Promoting regional financial integration will entail agreement on common measurements of risk and harmonization of documentation, including warrants and covenants. Stable, transparent and predictable regulatory and legal information is also important to facilitate deeper understanding by investors of different markets in the region. Establishing a regional platform for promoting the provision of high-quality financial information on a range of markets (e.g., municipal bond markets), such as through facilitating dialogues on disclosure and transparency among relevant officials, and the collection and dissemination of this information is an example of a possible undertaking that can be considered a low-hanging fruit.

The availability of reliable financial information is also important for credit rating agencies (CRAs), which play a key role in the development of bond markets in the region. Credit ratings provide a system that facilitates comparisons across sectors, industries and regions, and they provide investors with a comparative tool to gauge credit risks, which in turn enable issuers to access a broader base of local and cross-border funding. Providing an environment that is favorable to competition among and independence of credit rating agencies and a market-driven development of the industry will also help the region develop financial markets.

#### *Payments and settlements systems*

The technical architecture of the financial industry includes payments market infrastructure consisting of settlement systems for banks’ wholesale and retail customers, as well as securities exchanges, matching utilities, clearing houses, central counterparties, central securities depositories and international securities depositories. For the region to have healthy and secure financial markets, their messaging platforms and services must be able to process transactions among their users efficiently, safely and reliably.

With high growth of demand for investment and trade and the need to expand access to financial services to hundreds of millions of currently unserved and underserved customers, the Asia-Pacific region will need systems that can scale up quickly and allow for new services to be incorporated easily in terms of technology and operations. Not addressing this need will result in

market infrastructure becoming a bottleneck for liquidity in a market that requires ever higher levels of automation.

For regulators to be able to perform their tasks properly, market infrastructures need to be transparent in how they handle transactions with their users. They need to be able to serve both domestic and foreign players in their markets, especially in emerging markets, where access to capital is the key to growth. Developing a harmonized, efficient and less risky payment system environment will support regional integration and growth in trade and investment. By not having to invest in different systems and processes for each market in which they operate, financial institutions and other market players can focus on innovation and delivering value and services to their corporate and retail customers. Seamless connectivity across markets will enable capital to flow smoothly throughout the region.

There are two areas where APEC could fill important gaps and support the development of robust market infrastructure in the region.

- *Automation.* The first is helping market infrastructures in developing economies adopt systems and practices that are aligned with their other counterparts in the region and promote automation. Automation involves less errors and risks; provides greater capacity and ability to cope with peak days; allows for a greater number of participants; and promotes transparency, good governance, improved regulatory and internal reporting and scalability. This can be accomplished by (a) taking the best practice and systems developed in the collaborative space by the financial community and promoting their adoption in emerging markets; (b) helping local communities develop capacity to implement international standards and systems that address local and regional characteristics and needs; and (c) applying lessons learned to develop robust domestic market infrastructures that are accessible to both domestic and foreign players, reduce risks and costs and comply with evolving regulation.
- *ISO 20022 standards.* Institutions in a few of the region's economies, notably Australia and Japan,<sup>22</sup> are taking the lead globally in using the new ISO 20022 standards as they look at innovation in real-time payments. ISO 20022 offers a number of advantages, including local language support, flexibility across all business needs, use of the Extensible Markup Language (XML) format, and being self-evolving and community-driven. It offers a future-proof global standard for the financial services industry that can allow APEC's technical substructure to scale up with maximum automation and cost efficiency. If adopted across the region, it could provide a model for interconnected and inter-operable markets around the world.

#### *OTC Derivatives Clearing*

OTC derivatives are used by firms to manage balance sheet liabilities and cash flows as well as hedge various economic risks, such as interest rate and foreign exchange risks (interest rate derivatives take up around 80 percent of all OTC derivative transactions). The regulatory landscape for these instruments has been changing through new rules such as those being introduced by the G20, the Basel Committee, CPSS, IOSCO, the European Union (Markets in Financial Instruments Regulation or MiFIR and EMIR) and the US (DFA) in the wake of the GFC.

Major features of the new regulatory landscape include the requirement for standardized OTC derivatives contracts to be traded on exchanges or electronic trading platforms, cleared through central counterparties (CCPs) and reported to trade data repositories. Non-centrally cleared contracts are to be subject to higher capital requirements. Rules are also mandating the margining

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<sup>22</sup> These are the Reserve Bank of Australia (RBA) and the Japan Securities Depository Center (JASDEC).



of uncleared trades and the trading of swaps that are subject to clearing on designated contract markets or swap execution facilities, among others. To be added to these are the extraterritorial impact of DFA and EMIR on other markets.

Taken together, these new regulations that were intended to improve transparency in the market, mitigate systemic risk and prevent market abuse are expected to also result in higher costs and wider bid-offer spreads and make certain trades difficult. Asia faces the risk of growing fragmentation as a multiplicity of clearing systems emerge to handle transaction volumes that are much smaller than those in Europe and North America (Asia ex-Japan represents only around 4 percent of global interest rate derivatives turnover).<sup>23</sup> The additional costs are likely to be passed on to the end users, significantly increasing the cost of their hedging activity.

A related issue is the extraterritorial impact of DFA, MiFIR and EMIR requirements on liquidity needed by Asian financial institutions with significant transactions in global currencies, as these result in considerable registration, compliance and administrative costs of trading swaps with US and European banks. While firms may find ways to go around these requirements (e.g., not exceeding de minimis swaps transactions volume thresholds, changing how swap transactions are booked, trading through overseas affiliates or subsidiaries registered as swap dealers), such practices may only make financial markets more complex, less efficient and less integrated.<sup>24</sup>

The emergence of multiple CCPs in the region mandated to clear OTC derivatives contracts, with varying regimes for protecting clients against insolvency of clearing members and different documentation requirements and time frames for mandatory clearing, is an issue that can pose challenges to the development and integration of Asia-Pacific financial markets. Responding to these challenges will require the development of standardized documentation solutions that can work across CCPs and products and structures that can promote standardization, flexibility and simplicity.

In the context of promoting greater connectivity across financial markets in the region, regulators and policy makers will need to have a regional platform for discussions to complement those that are taking place under the G20 framework. The CPSS-IOSCO standards provide the best foundation for developing clearing systems in the region that will be attractive to companies.<sup>25</sup> However, the lack of trust among regulators in the robustness of arrangements in each others' jurisdictions remains a major challenge, which should be addressed by initiatives to promote deeper understanding and mutual recognition of clearing arrangements among regulators.

Both US and European regulators have required that for their respective regulated banking entities to participate in clearing houses outside their common jurisdictions, these clearing houses must, in the US case, register with the Commodity Futures Trading Commission (CFTC) as a Derivatives Clearing Organization (DCO), or in the European case, apply for recognition by ESMA as compliant with EMIR. It remains to be seen which Asia-Pacific CCPs will apply to

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<sup>23</sup> BIS 2010 Triennial Survey. As argued by the International Swaps and Derivatives Association (ISDA), with Australia, Japan, China, Hong Kong, South Korea and Singapore establishing clearing houses, a number of concerns are emerging, which include:

- growing legal, regulatory and financial arbitrage and reduced netting opportunities;
- reduced trading activity as global market participants limit their clearing house memberships, regulators require trades to be cleared through their respective local clearing houses and cost of funding increases with differing eligible collateral requirements; and
- legal credit and operations resources being spread too thinly among too many clearing houses to support the development of the clearing business in the region or a large number of simultaneous clearing house member defaults.

<sup>24</sup> For a more detailed discussion, see Keith Noyes, "Asia rules rift," *The Markit Magazine* (Autumn 2012), pp. 29-31.

<sup>25</sup> Committee on Payment and Settlement Systems (CPSS) and Technical Committee of the International Organization of Securities Commissions (IOSCO), *Principles for financial market infrastructures* (April 2012),

obtain US and European recognition. There is now heightened risk of significant impact to market liquidity, at least in the short run, if US and European banks are compelled to pull out of specific markets because they are not allowed by their home regulators to take part in mandatory local clearing services implemented in accordance with these local jurisdictions' G20 commitments.<sup>26</sup>

The BCBS/IOSCO proposed mandatory margining of uncleared swaps will also have a disproportionate impact on the Asia-Pacific region. In seeking to make uncleared swaps more expensive than cleared swaps to trade in order to promote more clearing, the proposal does not take into account the conclusions of cost-benefit analysis, which indicate that clearing houses are not interested (and should not be interested) in providing clearing services for all types of swaps due to volume or risk profile considerations and that uncleared swaps are actually crucial hedging products for end users. Foreign exchange hedging products make up a significant proportion of the uncleared products and are extensively used across Asia.

Cross currency swaps, in particular, have been singled out by the IMF as playing a crucial role in the hedging of offshore borrowing used to fund the growth of Asia's real economy. The proposed imposition of two-way initial margin on these trades, on top of increased Tier 1 capital requirements and Basel credit valuation adjustment charges, threatens to increase hedging costs significantly.<sup>27</sup> The voices of the "Group of Five" regulators (Australia, Canada, Hong Kong, Japan and Singapore) that have tried to push back against mandatory initial margining for these products have not prevailed, and it now appears likely that the phasing in of the initial margin requirements will begin for the largest financial institutions by mid-2015.

### *Securities Exchanges*

Three important trends are shaping the future of securities exchanges all over the world. The first is the emergence of new exchange models driven by regulatory and technological changes, which will lead to more intense competition among exchanges. The second is the move toward the multi-product and vertically integrated model of exchanges, which supports improved balance sheet and investment capacity. The third trend is the continuation of efforts to merge exchanges.

Exchanges in the region face significant challenges in responding to these trends. The Australian Securities Exchange (ASX) provides a case study of how to develop a globally connected, multi-product and vertically integrated exchange.

- The ASX's experience indicates that the need to respond to changing regulatory and competitive environments is a continuous process that never ends.
- To continue growing under present market conditions, it sees the need to pursue the development and delivery of new products and services, and has started a number of initiatives, including clearing of OTC derivatives, collateral management, the introduction of a new managed funds service, revisions to listing rules to facilitate listing of SMEs and the establishment of a program to promote more research on smaller listed firms.
- The ASX is also undertaking efforts to improve its links to global capital markets, including collaboration with other exchanges to improve liquidity, reduce costs and broaden the products available to customers.

### *Building the regional bond market infrastructure*

Promoting greater connectivity will help accelerate the development of local currency bond

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<sup>26</sup> For a more detailed discussion, see Keith Noyes, "CCPs", *Asia Risk Magazine* (April 2013), pages 69-71.

<sup>27</sup> "Australian banks lobby for reduced margin on cross-currency swaps", *Asia Risk* 29 May 2013. <http://www.risk.net/asia-risk/news/2271187/australian-banks-lobby-for-reduced-margin-on-crosscurrency-swaps>.

markets in the region. Given the diversity of development stages among markets in the region, a key challenge is how to develop a regional platform that will have wider benefits across economies. Policy makers and regulators need to consider three important ingredients of a successful strategy:

- First, it is important to build a foundation of robust, deep and liquid domestic bond markets. This requires more intensive efforts under existing initiatives to develop liquid secondary markets through the expansion of the investor and issuer base and wider availability of hedging and risk management tools, as well as the development of corporate bond markets.
- Second, additional efforts are needed to expand local participation in domestic bond markets, in particular by local companies, SMEs and retail investors.
- Third, the region will need to develop a common overarching market infrastructure that can reduce transaction costs and facilitate cross-border capital flows by reducing credit and foreign exchange risks.

## **REGULATORY ISSUES IN PROMOTING ASIA-PACIFIC FINANCIAL MARKET DEVELOPMENT AND CONVERGENCE**

As regulation plays a central role in the development of financial markets, it is important to look at the current situation and future trends, with respect to the twin objectives of building sound and efficient financial markets and promoting convergence and connectivity among them. How the region's policy makers and regulators are responding to the challenges related to the ongoing reform of global financial regulatory standards and the extra-territorial impact of new policy and regulatory measures in key global markets will also be relevant to the realization of these objectives.

### *Capital Markets*

One of the most important developments in the financial regulatory space in recent years has been the introduction of various regulations designed to address the excessive risk-taking in North American and European markets that has led to the GFC. While the lessons of the GFC need to be adequately understood and sufficiently considered by Asian policy makers and regulators as they shape the domestic and regional regulatory landscape, they also need to consider the need for financial regulations to support the region's growth objective and the need to encourage healthy risk-taking with this in mind.

Two examples of key issues whose impact regulators and policy makers in the region need to address are the following:

- *Impact of Basel III on securitization and bank activity in capital markets.* As of April 2013, final Basel III rules were already in force in 11 Basel Committee member jurisdictions, 5 of which were in Asia (Australia, China, Hong Kong, Japan and Singapore), even as the US and the EU, which had to consider the impact of new regulations on their large and deep capital markets, still needed more time to finalize the rules. Regulators in the region's developed and emerging markets, however, will need to carefully review the potential impact of Basel III on the future development of their capital markets, especially with respect to securitization and the impact on banks' activities in markets where they are the dominant participants.
- *Margin requirements for uncleared swaps and their impact on long term funding.* With the aim of reducing systemic risk and promoting central clearing, the Basel Committee and IOSCO have proposed a policy framework imposing initial margin and variation margin requirements for non-centrally cleared derivatives. The imposition of gross-base initial

margin requirements will significantly increase the cost of swaps between banks, which are expected to be passed on to end-users, including issuers. As cross-currency swaps are used as a principal tool for funding through capital markets in Asia, including long-term funding for infrastructure, the negative impact of this rule, if implemented, would be considerable. Most banks in Asia, which use the standardized calculation method to determine collateral needed for initial margin requirements, stand to have reduced access to global markets vis-à-vis banks using the model method that involves less margin calls. Regulators in the region need to work together to reshape the rule, such as, for example, through the replacement of the initial market requirement by a combination of capital and variation margins.

### *Insurance*

The development of the insurance industry is of great relevance due to the role it can play in channeling more of the region's savings to investment in long-term assets and in reinforcing financial stability. Insurers play an increasing role in the area of social security and retirement income, which has a long-term nature. Regulations can help enable insurers play this role more effectively and, in addition, contribute to the development and integration of the region's emerging markets by facilitating cross-border investment. Inappropriately designed, however, regulations could have the opposite effect. As policy makers and regulators debate far-reaching changes to insurance regulation in the wake of the GFC, a number of proposals are causing concern about their impact on the future role of the industry.

- *Macroprudential surveillance – differentiating insurers from banks.* While monitoring of systemic risk occupies the central place in the case of banks, which form part of the settlement system, it needs to take into account the different roles that insurers play in the overall financial system. Insurers provide stability to the system as long-term investors in bank shares and debt while using derivatives as a fundamental tool of efficient risk management. However, insurers use derivatives mainly for purposes of hedging and efficiency of their investment strategies, and thus behave differently from other market participants who use derivatives for short-term speculation. Consequently, macroprudential surveillance needs to take into account the different nature of insurers' interactions with banks and with financial markets, where systemic risk monitoring may focus on credit default swaps among potentially systemically risky activities in the case of the former and speculative derivatives in the latter.
- *IFRS 4 and insurers' long-term business and investments.* The adoption of International Financial Reporting Standard 4 (on insurance contracts) or IFRS 4 would have a significant impact on the insurance industry and the broader financial system in the region. While there are jurisdictions where short-term investment-type products are dominant, such as in the UK and Australia, long term protection products constitute the large part of the market in most of Asia, (as well as in the USA and Continental Europe). In the latter case, the use of fair value accounting for insurance contracts would significantly increase volatility affecting company valuations and insurers' access to capital, and encourage insurers to shift away from long-term protection business and subsequently long-term assets – which the region needs to develop – toward short-term and investment-type products that transfer more risks to customers. Insurers will also be encouraged to refrain from investing in assets other than fixed income, which would have negative effects on the economy.
- *Impact of economic risk-based solvency regimes on insurers' role in the financial system.* An analysis by the BIS of the impact of Solvency II in Europe illustrates the kind of unintended consequences implementation of economic risk-based solvency regimes could have on

the industry. Solvency II requirements<sup>28</sup> would make it more costly for insurers to maintain long-term business and to hold structured products, long-term corporate bonds and equity-like instruments, and lead to certain portfolio shifts. Such portfolio shifts could result in insurers reducing their exposures to corporate bonds and banks as well as to long-term assets and retreating from their roles of providing long-term risk capital, which may amplify procyclicality in the financial system and market.

- *Consequences of applying Basel III rules to insurance.* Various participants have argued that applying Basel III rules designed for banks to insurance would have a number of unfavorable systemic consequences. Applying the capital deduction rule would encourage insurers to exit from bank shares and subordinated loans, which will also affect banks' ability to enhance their Core Tier 1 capital, and undermine insurers' role as long-term institutional investors and contributor to financial stability. Applying Basel III requirements to deduct overseas investment in financial institutions from insurers' solvency margins would discourage the continuation of such overseas investment and hinder insurers from supporting global financial stability and development of emerging markets.

In shaping and implementing global standards, policy makers and regulators in the region will need to have a deep understanding of products, markets and roles that firms play in their respective economies' insurance sectors, and view these in the context of the region's needs and financial market development goals. Opportunities to deal with these issues within a regional framework are emerging as global standard setting bodies increasingly accept the need for regional discussions and expand their regional-level activities, especially in the Asia-Pacific region. Policy makers, regulators, standard setters and the private sector will need to collaborate closely in creating regulatory frameworks that will enable insurers to contribute to the goals of developing the region's long-term investor base and expanding cross-border investment.

#### *The banking industry*

As banks play dominant roles in intermediation in most of the region's financial systems, Asia-Pacific banking regulators face the challenge of promoting financial sector development to help sustain economic growth amidst challenging times for the global economy. At the same time, they need to ensure the continued soundness of their banking systems as they become more integrated into a global economic and financial system that is going through a turbulent period. Learning lessons from the Asian Financial Crisis, banking regulators in the region have generally been able to create an environment where banks, with a few exceptions, have been able to provide sufficient liquidity to the economy and avoid the failures of their North Atlantic counterparts.

Asian banking regulators have raised their profile in global regulatory fora, particularly the BCBS. Today, seven Asian economies (Australia, China, Hong Kong, Indonesia, Japan, South Korea and Singapore) are full members of the Committee and actively participate in its discussions. Having gone through a major crisis and initiated reforms that have allowed their economies to withstand much of the impact of the GFC, Asian banking regulators are respected by their peers for their views and are in a position to influence the direction of global regulatory reforms.

Asian jurisdictions are also moving quickly to implement Basel III ahead of many advanced economies. Most Asian BCBS members are already fully implementing Basel III, several with higher minimum capital requirements. Asian regulators are working on the implementation of the

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<sup>28</sup> These are the requirements for assets to be marked to market, for liabilities to be discounted at risk-free rates, and for insurers to hold capital against risks on both asset and liability sides to deal fully (with a 99.5% probability) with unexpected losses over a period of one year. Committee on the Global Financial System (CGFS), *Fixed income strategies of insurance companies and pension funds: Report submitted by a Working Group established by the Committee on the Global Financial System* (CGFS Papers No. 44, July 2011).

additional requirements (application of capital surcharges and policies on recovery and resolution planning) for globally and domestically systemically important banks (G-SIBs and D-SIBs) and the minimum leverage ratio. Most Asian BCBS members and other Asian jurisdictions have already announced their intention to implement the liquidity coverage ratio and the net stable funding ratio, with some adjustments to domestic characteristics.

Concerns are being raised, however, on the future impact of tighter banking regulations in the region. At present, most Asian banks do not need to make significant adjustments to meet new regulatory capital requirements, already having traditionally higher capital buffers and less reliance on debt or hybrid capital compared to US and European banks. There is also currently no immediate stress on funding and liquidity in both emerging and developed markets in Asia.

In a few years' time, however, Asian banks' balance sheets may need to expand considerably in order to support the continuation of strong economic performance, where lending typically grows faster than deposits. With high capital and liquidity ratios required under Basel III (especially for systemically important banks), without well-developed securitization markets where bank assets could be offloaded, and with foreign banks deleveraging and retreating from Asia, the region's banking system may find itself under considerable strain to finance continued growth.

#### *Need for regional public-private dialogue on regulatory issues*

The preceding discussions underscored the importance of strengthening the capacity of regulators in the region's emerging markets to effectively respond to a rapidly changing economic and financial landscape, both in terms of reshaping domestic regulatory frameworks and helping shape relevant global regulatory standards. Much remains to be done to promote a deeper understanding of the implications of current trends such as demographic changes, urbanization and technological developments on the requirements for financial regulations and appropriate regulatory approaches for the banking, insurance and securities markets that take into account their respective roles in the financial system and their interconnectedness.

A deeper understanding of developments in the market is also important for regulators to better prepare themselves to avert future crises, which are likely to be different from previous ones, and avoid the error of "fighting yesterday's wars." Recent experiences of governments and financial institutions that have followed established regulatory requirements and scored high on various measures of soundness going into crisis underscore the danger of falling into complacency and over-reliance on standard regulatory frameworks to maintain financial stability. A deeper understanding of the market will enable regulators to create and maintain an environment that fosters good governance and risk management practices.

The region's regulators are already actively involved in the work of global standard-setting bodies. However, they will need to be even more proactive as it becomes necessary for the impact on financial systems and regulatory requirements of rapid changes occurring in the region to be reflected in the further development of global standards. Recent developments already point to the impact of new regulatory standards on such areas as trade finance and insurance, and it is expected that more unintended consequences that need to be addressed will become apparent as the region's financial markets and their various components continue to evolve in coming years.

A platform for regional dialogue that involves both the public and private sectors will be useful in promoting a deeper understanding of how markets are developing and of the unintended consequences of regulations on financial institutions – on their ability to play their proper roles in the economy and to appropriately manage their risks and govern themselves – as well as on the development and integration of financial markets. Aside from promoting effective design and enforcement of regulations, it can also help the region's regulators deal with technical issues, effectively contribute to the global standard-setting process, and respond to the extra-territorial impact of regulations emanating from other jurisdictions.

## **THE LANDSCAPE OF ASIA-PACIFIC FINANCIAL POLICY AND REGULATORY INITIATIVES: CHALLENGES AND OPPORTUNITIES FOR COLLABORATION**

As mentioned earlier in this report, numerous efforts have been underway in the region, at both domestic and international levels, to develop various aspects of financial markets since the Asian Financial Crisis. A number of these have already produced significant results, such as healthier banking systems and larger government bond markets. A multiplicity of regional and international bodies is involved in parallel initiatives, which have grown in number and scope over the years.

As financial systems develop and become more complex, and as this process accelerates in response to rapid economic growth, capacity building needs are also set to increase. At a time of growing constraints on public resources, identifying priorities and ways to achieve synergy becomes ever more important. This requires an adequate understanding of the financial system as a whole and the interconnections among its various components.

The financial system has long outgrown the traditional role ascribed to it as the “handmaiden of industry,” and instead has proven itself to be at the center of the economic process, providing the key functions that sustain it. These include pooling financial resources for investment, clearing and settlement of payments, transferring financial resources through time and space, managing risks, providing information (financial prices) for efficient financing, and resolving incentive issues. An effective financial system is one that is able to perform all these functions well.

It is widely acknowledged that market forces are the key to efficient financial markets and to their continued development, which is driven by innovation. They may, however, be distorted or impeded by various factors such as deficiencies in property rights, barriers to entry, taxes, inadequate information, particular regulations and corruption, among others. Markets may also be impeded from developing by certain outcomes of historical evolution, such as when bank intermediation becomes the dominant source of funding in an economy and the market depth and liquidity that bond markets need to develop are not there. These are areas where policy initiatives can play an important role in financial market development.

Financial markets are complex structures with multiple components that may each be crucial for a market to function. To be successful, policy makers will need to identify these crucial components where issues need to be addressed and prioritize policy initiatives accordingly. The following are typically important components to consider in prioritizing initiatives:

- Information and disclosure (credit rating agencies and credit bureaus)
- Stakeholder rights and protection (investor protection, creditor rights, corporate insolvency regimes, deposit insurance)
- Access to finance, financial deepening and financial security (financial inclusion, microfinance, SME finance, financial literacy, remittances, retirement provision)
- Market development (bond markets, OTC markets, clearing and settlement systems)
- Cross border convergence and connectivity (funds passport, mutual recognition for securities issuance, stock exchange integration through cross-listings and others, financial services trade)
- Financial stability (prudential regulation and supervision, resolution arrangements)
- Insurance
- Infrastructure finance

- Public sector finance and treasury management

Due to the complexity and interconnectedness of financial markets, it would be advisable for governments to consider undertaking occasional strategic-level reviews of ongoing policy and regulatory initiatives. These reviews must look at the impact of these measures on the development of the financial sector as a whole, identifying gaps and follow-up actions or new initiatives that may be needed. Such reviews are best undertaken by policy makers and regulators together with relevant market participants and experts from international organizations, standard-setting bodies and academic institutions, and supported by research and measurement of progress. In view of the objective of regional integration of financial markets, a regional platform such as the APFF that has the potential to gather relevant players together could play a useful role.

A cursory review of ongoing regional financial initiatives would indicate that important gaps are being addressed, but much work remains to be done. The pursuit of regional financial market integration in the Asia-Pacific is an important element that supports and complements efforts to develop domestic markets. Given their relatively small size taken individually, the region's economies stand to reap many benefits from facilitating the movement of capital between those with savings and those that require financing across the whole region. These benefits would include reduced costs of capital and improved ability to manage and hedge financial risks for businesses across the region.

An ideal pan-regional system of efficient capital flows would have the following characteristics:

- Savers can invest across the region's capital market through regional intermediaries.
- Regional competition reduces intermediation costs.
- Regional borrowers have access to regional capital markets.
- Regional regulators define and agree on the scope of their oversight.

The current reality, however, may be described as a relatively complex, fragmented and inefficient regional financial market structure, with the following characteristics:

- Local savers mainly have access to products offered in their own local markets.
- Barriers prevent the expansion of direct cross-border retail intermediation between the region's savers and markets; intermediation remains instead mostly conducted indirectly through established global financial centers.
- Inefficient intermediation limits the product choice of investors from within the region.
- Borrowers mainly have access to their local markets and meet their additional borrowing needs from established global debt markets rather than from the region.
- Cross-border financial intermediation within the region continues to be subject to significant impact of extra-territorial regulations.

Moving towards more integrated financial markets would require pursuing four development objectives: (a) broad market development; (b) improving market infrastructure; (c) regional financial stability; and (d) recycling regional savings. These issues are being addressed by a number of overlapping regional efforts. Among these are the following:

- Asian Bonds Online (initiated 2004): (a) and (b)
- ADB Global Medium-Term Note Program (2005): (a) and (d)
- Asian Bond Funds 2 (2005): (a), (b) and (d)
- Chiang Mai Initiative Multilateralization (2009): (c)



- Asian Bond Market Initiative (a) and (b)
- ASEAN+3 Macroeconomic and Research Office: (2010), (c)
- Credit Guarantee and Investment Facility (2010): (a) and (d)
- ASEAN+3 Bond Market Forum (2011): (a) and (b)
- ASEAN Infrastructure Fund (2012): (a) and (d)

Continued efforts can help address major obstacles to greater integration of financial markets. The following are a few examples:

- *Asia Region Funds Passport (ARFP) Initiative*. Proposed by the Australian Financial Centre Forum in 2009 and recommended to APEC Finance Ministers by ABAC in 2010, the ARFP is being undertaken on a pathfinder basis under the APEC Finance Ministers' Process. It is geared toward improving market integration by expanding cross-border intermediation of financial products among participating economies. The ARFP focuses on retail markets, which through collective investments promise to grow into a major component of capital market activity, driven by regional economic growth, the region's high savings rates, demographic trends and growing affluence and household investment activity. At present, cross-border fund registrations in Asia-Pacific markets are dominated by UCITS (Undertakings for Collective Investment in Transferable Securities) fund products domiciled and regulated in European jurisdictions. By developing a system of mutual recognition of fund products among different jurisdictions that will allow products to be offered to investors across the region, the ARFP aims to promote greater intra-regional intermediation of financial products.
- *Asian Bond Funds (ABF)*. An initiative sponsored by EMEAP, the ABF has advanced considerably since its beginning, particularly in promoting private sector participation. ABF2 aims, among others, to help enhance investor choice through a series of efficient market access funds, some of which are structured as exchange-traded funds (ETFs). It is composed of a pan-Asia regional fund and eight single-market funds covering China, Hong Kong, Indonesia, South Korea, Malaysia, the Philippines, Singapore and Thailand. In providing an alternative market access choice for investors, these funds, which are available to the public and can be cross-listed, help enhance market intermediation within the region. The focus of regulators' attention is now moving on from the quantity side of bond market development to the quality side, with transparency of pricing and regulations becoming the next key concerns. The success of ABF, ABMI and related initiatives in promoting the growth of government bond markets now needs to be followed by efforts to develop repo markets as a next step to take advantage of the availability of government bonds that can be used as collateral.
- *ASEAN+3 Multi-Currency Bond Issuance Framework (AMBIF)*. Developed under the ABMF, the AMBIF will be an arrangement under which a bond issuer in any participating economy could issue bonds in any other participating locations with one standardized set of, or expedited procedure for, documentation and information disclosure. The home regulator and host regulator are assumed to mutually recognize bond issuance approval done by the others or closely cooperate to approve bond issuance in an expedited manner. To address regulators' concerns on investor protection, AMBIF only focuses on the professional market segment where professional investors, but not retail investors, are participating.

The experience with ongoing initiatives so far highlights the potential of mutual recognition among the region's regulators as one promising way forward to advance financial integration. Examples of initiatives that focus on mutual recognition are the ARFP (for the unlisted collective funds market), the AMBIF (for local currency bond issuances) and the China-Hong Kong

initiative for mutual recognition of collective funds. However, the great diversity among economies, especially with respect to widely varying levels of development and quality of regulation and oversight, poses challenges for regional financial market development and integration.

The existence of a number of overlapping regional fora and institutions involved in various initiatives poses another challenge. These include ASEAN, ASEAN+3, APEC, PECC, EMEAP, ADB, the World Bank, IDB, IFC, IMF, the FSB Regional Consultative Group for Asia and the IOSCO Asia-Pacific Regional Committee, among others. There is considerable potential for duplication of efforts across different fora and institutions, which can be minimized through greater coordination with the help of regional platforms such as the APFF.

An important consideration for the success of such a regional public-private platform is whether it presents a clear value proposition in the context of the multiplicity of regional efforts already being undertaken. A number of key requirements need to be fulfilled. One is that the platform should provide concrete mechanisms to achieve tangible outcomes. Another is that it should have established processes that can facilitate effective participation from public and private sectors and other relevant parties. A third is that it can be harnessed to provide regulators a clearer understanding of what works on the ground and of practical and politically feasible ways forward to expand the role of market forces and competition in financial services sectors.

The APFF can complement ongoing efforts in several ways. One is by focusing on important issues that are not yet being adequately dealt with under existing initiatives. Region-wide accounting standards convergence, remittances and insurance are examples of such issues. Another way is by collaborating directly with ongoing initiatives in a way that adds value with different focus and perspectives. Examples of initiatives that APFF could benefit from are the works of ABMF and ACMF on documentation standards, clearing and settlements and automation. The APFF would likely be able to add the most value in areas that require collaboration among governments and regulatory authorities, private sector, multilateral institutions and standard-setting bodies, as well as in areas that are regional rather than purely domestic in scope, such as standardization of regulation and market practices.

The APFF can add value to ongoing regional efforts especially because of its potential for bringing in the private sector to actively collaborate with the public sector, which is an element that is not yet well-developed in many of the ongoing initiatives. Such collaboration can be particularly helpful in moving discussions forward on such issues as mutual recognition of regulatory arrangements where mechanisms to address risks have to be effectively designed. It can also help the public sector identify and prioritize capacity building needs. Experiences of economies such as Australia indicate the usefulness of public-private dialogue in addressing such issues. The successful experience of supervisory colleges in helping financial regulators to deepen their understanding of issues they face in common in discussions with financial institutions also underscores the potential of APFF in promoting similar beneficial outcomes on a wider scale.

A regional platform for public-private sector dialogue would provide valuable opportunities for finding practical solutions that take important concerns of both sides into consideration. Discussions to find pragmatic and widely acceptable solutions to tax and regulatory arbitrage issues in relation to regional funds passport arrangements, for example, could help expand support for ongoing initiatives. Regulators can benefit from regular discussions with the private sector on latest market developments that can provide early warning of overheating in certain markets as well as a clearer understanding of the market implications of policy options.

## PRIORITIES FOR ASIA-PACIFIC FINANCIAL MARKET DEVELOPMENT COOPERATION

Symposium participants held intensive discussions on priorities that may be considered for inclusion in an initial APFF work program. Discussions were conducted both in smaller groups that looked at issues affecting the development of banking, insurance and capital markets and in a plenary session that looked at these issues with respect to their interconnections and importance for the financial system as a whole.

These discussions took into consideration the outcomes of previous sessions of the symposium that are described in the preceding sections of this report, particularly with respect to the context provided by the current state and evolution of financial markets, the underlying regional development agenda, the state of financial infrastructure development, the key regulatory issues affecting the development of Asia-Pacific financial markets and the current landscape of regional policy and regulatory initiatives and cooperation to develop and integrate the region's financial systems.

Priorities were selected based on their expected impact on the development and integration of the region's financial markets and their complementarity with ongoing initiatives and existing institutions. Participants also selected priorities that may realistically be dealt with through initiatives that could yield tangible results within a short- to medium-term time frame harnessing ABAC's existing networks and resources that are or can reasonably be assumed to be available. Following are the priority issues that emerged from these discussions:

1. **Development of the region's insurance industry as a provider of long-term investments.** More efforts are needed to enable the insurance industry to play its proper role of supporting long-term financial stability, economic and infrastructure development, trade expansion and social stability and inclusion, particularly by examining more closely how regulatory requirements affect this role. Collaborative action can be helpful in developing common approaches to address issues in global regulatory, accounting and other relevant standards and regulations that discourage insurers from acting as long-term investors. Another area where efforts may be focused is promoting harmonized interpretation of macro-prudential insurance regulatory requirements, taking into account differences in characteristics, needs and levels of development among jurisdictions and recognizing the specific nature of insurance.
2. **Development of retirement income policies.** This aims to respond to needs arising from demographic trends (aging) and to promote accumulation of long-term funds and their investment in government and corporate sectors and long-life infrastructure assets. Efforts should cover the range of relevant public and private institutions and structures, including sovereign wealth funds, official off-budget and on-budget structures, pension funds, insurance companies, self-funded retirement and investment in bonds and enterprise annuities. Activities should focus on providing advice on a number of key issues. These include development and funding of retirement systems. They include suitable and practical design, structure and regulation that can foster sustainable, stable and trusted institutions, as well as support economic incentives. They should also include public-private sector financial literacy initiatives that encourage long-term savings.
3. **Facilitating full-file, comprehensive and accessible credit reporting systems.** This responds to the need for promoting expanded financial access of households and small businesses in conjunction with sound, risk-based credit decisions and responsible credit behavior. Efforts should aim to help policy makers introduce full-file and comprehensive

credit reporting systems and encourage the establishment and expansion of private credit bureaus. These should be done in conjunction with advice on the development of legal and regulatory frameworks to protect consumers and privacy, and converging approaches to data privacy protection and cross-border data flows that promote regional integration.

4. **Improving legal frameworks for secured financing.** Measures are needed to address gaps in the legal regime for secured lending, which create disincentives for creditors to extend loans to mid-market companies, resulting in increased cost and decreased availability of credit. Addressing this requires enhanced certainty and transparency in the legal regime, through such measures as unified collateral registrations systems, elimination of hidden liens, expanded definitions of eligible collateral, and assignability of claims, among others. Focus will need to be given to improving the ease, predictability and transparency of security interest creation, perfection and netting enforcement by identifying model elements and on the basis of these, developing a secured lending model code that can help guide legal reforms in the region's economies. These will require dialogues among relevant authorities, especially those with direct responsibility over these issues, as well as capacity building to promote deeper understanding and support for legal reforms in this area.
5. **Facilitating trade finance.** There is a need to address the gap in trade finance in the region arising from the scaling back of Asian operations by European banks, which are major players in this business, as a result of challenging economic conditions at home and consequent pressures on them to reduce their balance sheets, increase their capital and repatriate their assets. Work is needed to address regulatory issues, particularly minimum capital requirements that require more regulatory capital to be set aside to back trade finance transactions, affecting the availability and cost of trade finance. Attention also needs to be directed to the promotion of collaborative undertakings among the public and private sectors, multilateral institutions and regional organizations to ensure availability of adequate financial support to trade.
6. **Addressing market infrastructure access, repatriation and financial market issues to facilitate cross-border investment flows.** Issues concerning trading, clearing and settlement infrastructure across markets in the region need to be addressed to improve efficiency and price discovery and reduce trading costs in bond and equity markets. Undertakings will need to focus on promoting cross-border investment flows with collateral, standards and platforms that can selectively harmonize market access and repatriation practices, improve the inter-operability, liquidity and connectivity of domestic and cross-border financial markets, and reduce systemic risks. The potential proliferation of derivatives clearing venues within the region, which threatens to increase fragmentation across markets and collateral requirements, also needs to be addressed through collective efforts to resolve differences and harmonize approaches with respect to clearing, collateral management, trade repositories and development of electronic exchange venues.
7. **Enhancing capital market integrity.** Common standards and high quality of corporate governance across economies in the region are vital for attracting investors to the region and raising funds across asset classes. This involves the development of standards for fair, transparent and predictable resolution regimes, benchmarking issuer governance standards for market entry, and improving the transparency of information for investors through a concrete undertaking to help promote consistency of accounting rules and credit culture. The absence of or significantly reduced and harmonized withholding taxes or tax reclaim procedures will also further investor interest including intra-regional flows.
8. **Improving capital market quality.** Asian markets have made significant progress in this area since the Asian Financial Crisis, as proven by the limited impact that the GFC has had on the region. However, much work remains to be done to help develop corporate bond markets and expand cross-border transactions. Key issues involved in this undertaking

include (a) the development of classic repo markets to facilitate market making and hedging structures for both government and corporate bonds, including bond futures, interest rate swaps and credit default swaps; (b) the development of a roadmap toward a regional funds passport through harmonization of access requirements to local markets and standardization of platforms; and (c) the development of a platform for providing standardized market information to fund managers, such as through development of indexes.

9. **Responding to the extra-territorial impact of new regulations in major markets on Asia-Pacific capital market development.** Legal and policy measures that have extra-territorial impact are a source of concern across markets and asset classes in the region, and require collective efforts among governments to address their implications. This will involve discussions to identify those extra-territorial effects that significantly affect the development of the region's capital markets and develop appropriate and effective responses to cope with them at the domestic and regional levels and to initiate fruitful dialogues at the global level. Examples of these issues are the new US and European OTC derivatives rules which may encourage the withdrawal of participants from markets that are still in the development phase and negatively affect the ability of end-users to hedge risks.

## **THE STRUCTURE AND PROCESS OF REGIONAL PUBLIC-PRIVATE FINANCIAL MARKET COLLABORATION**

The Asia-Pacific has a long history of regional financial cooperation.<sup>29</sup> This cooperation intensified after the Asian Financial Crisis, with ASEAN and the ASEAN+3 becoming focal points.<sup>30</sup> In Latin America, the newly established Pacific Alliance included financial cooperation in its agenda. In addition to regional organizations, a host of international standard setting bodies, multilateral institutions, private sector organizations and institutions involved in capacity-building are also actively involved in various regional activities.<sup>31</sup>

While much has been accomplished, the region still continues to struggle to meet its funding needs (particularly in terms of financing infrastructure, trade and small enterprises) and to achieve the convergence and connectivity that can accelerate market development. More capacity is needed to help ensure that international standards and their implementation effectively facilitate the strengthening and development of financial markets in the context of local and

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<sup>29</sup> Examples are the work of SEANZA (est. 1956), SEACEN (est. 1966), EMEAP (est. 1991) and the APEC Finance Ministers Meeting (started 1994).

<sup>30</sup> These include the Asian Bond Markets Initiative, the Asian Bond Fund, the ASEAN+3 Bond Market Forum and the Implementation Plan for ASEAN Capital Markets Integration under the ASEAN Economic Community, among various others.

<sup>31</sup> The IMF, BIS and IASB have regional offices attending to regional concerns. IOSCO and FSB have active regional groups, while the World Bank Group is undertaking a large number of activities related to the development of financial markets in the region. The ADB and IDB are undertaking programs especially focused on their respective regions, including those undertaken for individual economies and those that support regional cooperation efforts. Among international financial industry organizations that are actively involved in discussions related to financial market development and regulatory issues are the Institute for International Finance (which has a regional office), the Asia Securities Industry & Financial Markets Association (ASIFMA), the Asian Bankers' Association (ABA), the Association of Development Financing Institutions in Asia and the Pacific (ADFIAP) and its Latin American counterpart the Asociación Latinoamericana de Instituciones Financieras para el Desarrollo (ALIDE), the Asian Pacific Bankers Council (APBC), the Federación Latinoamericana de Bancos (FELABAN), and a host of regional associations representing various parts of the financial sector such as the credit rating, business information, credit bureau, insurance and various other industries. Various APEC study centers, e.g., in RMIT University, and academic and research institutions, e.g., those in the PECC network, are involved in discussing, developing and promoting capacity building initiatives to strengthen regional financial systems.

regional characteristics. Unlike Europe, with its supranational institutions, the region continues to rely on a variety of overlapping and independently managed undertakings to advance the development of financial markets.

While the region is not foreseen to develop European-style frameworks, a platform may be established to bring together those institutions, organizations and undertakings geared to the development and strengthening of the region's financial markets. Such a platform would need to be designed to complement and support these ongoing efforts. Its objective would be to help promote greater synergy, identify and address gaps, build institutional capacity and accelerate the evolution of regional cooperation toward greater consistency and coherence.

To fulfill these requirements, the platform will need to have the following characteristics:

- *Informal.* Activities should be organized in the form of informal workshops, conferences, discussions and capacity building activities for policy makers and regulators. Participation should be voluntary.
- *Advisory.* Its role is not to formulate standards and regulations but to evaluate them, nor create market infrastructure, but to examine them and identify ways to promote coherent development, convergence and connectivity of markets.
- *Inclusive.* It should engage all relevant public and private entities whose activities have significant impact on the development and integration of the region's financial markets and promote institutional capacity to achieve those objectives.

APEC has tremendous potential to serve as vehicle for catalyzing the development of such a platform. While its membership does not encompass all economies in Asia and Latin America, it includes the most significant economies and financial markets in the world outside Europe. The most important aspect that makes APEC suited to play such a role, however, is its success in engaging the private sector and capacity building institutions, through ABAC, in its structure and processes.

As the APFF has no specific precedent, an initial structure and process could be established, to be reviewed and revised as necessary in due course as its value and contribution are demonstrated, with a first review to be scheduled sometime within the next two years. With this in mind, the initial structure should be simple, flexible and capable of further evolution. The following features of the APFF, which adopts some features from another ABAC initiative, the Asia-Pacific Infrastructure Partnership (APIP),<sup>32</sup> may be considered:

- General Institutional/Reporting Arrangements: The APFF would be a policy initiative managed by ABAC in partnership with interested economies and IFIs under the APEC Finance Ministers' Process (FMP). ABAC will report regularly to the APEC FMP on progress and outcomes and make presentations as needed at SFOMs, Finance and Central Bank Deputies Meetings, AFMMs and relevant events organized under the APEC FMP. Outcomes will also be conveyed to specific international organizations or standard

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<sup>32</sup> The APIP provides a model for bringing together high-level officials, experts and private sector advisory panelists from a wide range of relevant fields. It utilizes ABAC's private sector network of experts selected for their knowledge of and experience and active engagement in infrastructure projects from a wide range of relevant fields, including the asset management, commercial banking, investment banking, engineering, property development, information technology, legal and consulting sectors. To date, the panel has over 40 members, including current and former ABAC members, chief executives and chairmen of major companies, and other senior executives, legal practitioners and consultants with extensive experience in infrastructure. Activities, which involve the Asian Development Bank, the Inter-American Development Bank, the International Finance Corporation, the World Bank and the ASEAN Infrastructure Fund, include dialogues with high-level officials of interested individual governments as well as regional discussions on infrastructure.

setting bodies as needed. AFMM and relevant international bodies can adopt and incorporate recommendations emerging from APFF into their respective statements, work and activities.

- Coordination: ABAC will volunteer to coordinate activities, in partnership with any other interested institutions or ministries. It will utilize the Advisory Group on APEC Financial System Capacity Building, which is chaired by ABAC and is the vehicle through which it collaborates with IFIs/MDBs/SSBs, public sector bodies and financial industry/private sector organizations. The Advisory Group regularly meets four times a year and can convene workshops, conferences or any additional meetings as needed.
- Participants: Participation in APFF activities would be open to the following and any other relevant institutions deemed appropriate by AFMM, FCBDM and SFOM:
  - *Government officials*: Interested finance ministries, central banks and financial regulatory authorities and agencies from APEC economies. Non-APEC ASEAN+3 and Pacific Alliance member economies may also be invited as deemed appropriate.
  - *IFIs/MDBs/SSBs/IOs*: Experts and representatives from ADB, IDB, WB, IFC, IMF, FSB, OECD, BIS, BCBS, IOSCO, IAIS, IASB, APEC Secretariat, APEC PSU, ASEAN Secretariat, ASEAN Infrastructure Fund and Pacific Alliance Secretariat, particularly those directly involved in regional financial cooperation activities and initiatives.
  - *APFF Private Sector Panel*: ABAC will invite representatives/experts from financial industry and private sector and international organizations, relevant major firms and academic/research and capacity building institutions to join a regional panel and make themselves available, as their normal duties permit, to participate in dialogues, workshops and relevant activities under the APFF.<sup>33</sup>
- Logistics and Funding: For the initial period of its establishment, activities will be organized and funded similarly as current AFMM policy initiatives. Interested economies and/or international and capacity building institutions will be invited to host activities under the work program. Sponsorships will be solicited as appropriate. Participants not covered by sponsorships or project funding will be responsible for financial arrangements to cover their own travel and accommodations.
- Review and Further Development: A review of the initial APFF structure and process will be undertaken by ABAC and interested participating institutions within 2 years. Based on this review, directions for further development will be discussed with APEC Senior Finance Officials and APEC Finance Ministers.

The suitability of an informal, advisory and inclusive structure for a public-private platform like the APFF is borne out by the experience of the ABMF, which has contributed significantly to advancing harmonization of bond market regulations and practices and the development of clearing systems under the ASEAN+3 framework. As harmonization of various aspects of markets is a complex task that can take time to accomplish, the establishment of the APFF could help accelerate this process across the region.

The APFF could also play a role in promoting peer reviews of economies' progress in advancing

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<sup>33</sup> Examples of such institutions include a number who are regular collaborators of ABAC under the Advisory Group on APEC Financial System Capacity Building: the Asia-Pacific Credit Coalition (APCC), Asia Securities Industry & Financial Markets Association (ASIFMA), Asociación Latinoamericana de Instituciones Financieras para el Desarrollo (ALIDE), Association of Development Financing Institutions in Asia and the Pacific (ADFIAP), Business Information Industry Association Asia Pacific, International Valuation Standards Council (IVSC), Federacion Latinoamericana de Bancos (FELABAN), Pacific Economic Cooperation Council (PECC) and Society for Worldwide Interbank Financial Telecommunication (SWIFT), among others.

the development, convergence and connectivity of their financial markets, by providing a forum through which these can be discussed with the participation of both public and private sectors, international organizations and regulators and officials from a wide range of economies.

While regional financial cooperation may appear to be a crowded field, there is a space where APEC through the APFF can play a useful role. APEC can add value to the regional integration processes that have so far been largely focused on the Asian side of the Pacific Ocean, due to its wider heterogeneity. Developed economies can also benefit from such collaboration to address issues such as infrastructure development.

While APEC began its existence as a body focused mainly on trade issues, it has progressively evolved first through the inclusion of behind-the-border issues in its agenda and now through the growing importance of cross-cutting third-generation issues, where finance is at the center. As APEC continues to evolve, it is likely that the APEC Finance Ministers will play a larger role in the future. It is also likely that financial regulators will need to be increasingly involved and coordination with regional groupings of key international organizations such as the FSB will become increasingly useful as the need grows for specialized expertise related to the development and stability of financial markets. These developments underscore the importance of informal structures like the APFF where useful discussions among relevant players can be easily organized. The lack of a proper regional financial forum in the Asia-Pacific that involves both public and private sectors has limited the progress of financial market integration, even in areas that involved mainly the private sector, such as in bilateral cross-border merger efforts among stock exchanges. A regional mechanism through which broader experiences can be shared and opportunities for useful undertakings and reciprocal arrangements across financial markets can be discussed with decision-makers can help accelerate the process of regional integration.

## **THE WAY FORWARD**

In the context of the current global economic situation, governments and the private sector in the Asia-Pacific region bear a serious responsibility for the future of the global economy. While comprising roughly a third of global GDP, the region is now responsible for half of global economic growth. As the ability of traditional consumer markets in Europe and North America to continue absorbing the finished goods exports of the region's emerging markets wanes, economies in the region will need to shift away from the export-dependent economic growth model. Rebalancing toward a model that is increasingly driven by domestic and regional demand will require significant increases in domestic consumption supported by strong investment growth.

Financial markets have an important role to play in this transformation. Before they can do so, however, they need to evolve from the current structure that remains excessively reliant on bank funding to one that provides greater diversity of financing sources, with a larger role to be played by deep and liquid capital markets and institutions that can provide long-term finance, especially for infrastructure development. Financial systems also need to become more inclusive in order to economically empower larger portions of the population and create a broad-based economy that can ensure sustained economic growth.

Financial markets require strong foundations in order to develop in a sustained way and avoid instability. Sound legal and regulatory frameworks that allow markets to develop and encourage financial market players to contribute to broader economic development goals, cost-effective and



efficient market infrastructure that supports intermediation, risk management and related market activities, and an environment that fosters good governance are basic requirements that need to be put in place.

In conjunction with these necessary requirements, regional financial integration, including greater competition, convergence of regulations and market practices and greater connectivity across markets and market infrastructure, will enable the region's financial markets to achieve economies of scale and greater depth and liquidity. It will enable market participants to become more efficient, innovative and competitive. It will enable households and individuals to have more and better choices for their financial services needs, including savings, insurance, investment and payments. It will enable enterprises to have better access to finance at lower costs.

Putting all these elements in place within a time frame that satisfies the urgency of the task is a great challenge that requires much cooperation among a variety of institutions and agencies and the private sector within and across economies, in collaboration with relevant multilateral and standard setting bodies and other institutions that can provide expertise. While a number of collaborative initiatives to develop and strengthen markets such as those under the ASEAN, ASEAN+3, EMEAP and APEC frameworks are already under way, they are not yet sufficient to address all the important issues.

This is a challenge for the region, but also an opportunity for APEC to make a significant contribution. APEC can leverage its unique arrangements for close collaboration between public and private sectors, and in particular the partnership among finance ministries, ABAC and international organizations within the framework of the APEC Finance Ministers' Process. These collaborative arrangements, which have evolved over time through cooperation in various fields such as bond market development, financial inclusion and infrastructure finance, have given rise to a flexible and effective second-track approach to generating useful advice to governments that can operate without the constraints that official structures often have to contend with.

As an informal, inclusive and advisory public-private platform managed by the private sector, the APFF can focus on important issues cutting across the variety of regional and international initiatives and institutions. Through this process, APFF can help design policies that will encourage and enable market participants to direct their business and commercial activities to the development and integration of the region's financial markets. In this context, the APFF has the potential to become a bridge among many institutions and organizations that are striving toward the same goal and to facilitate synergy among them.

Going forward, the region will need to consider the lessons from the recent past, when rapid economic growth and expansion of trade masked underlying imbalances that eventually led the global economy to where it is today. The APFF will need to focus on the most important, basic and urgent issues that will promote the development of financial markets to help correct these imbalances and set the Asia-Pacific and global economies on the right path to growth. These issues include finding the right balance between innovation and regulation for financial stability and consumer protection, identifying common principles for development of financial markets, improving coordination among regulators and market players, and achieving synergy between regulatory reform and the pursuit of other economic policies.

The challenges facing the financial sector are growing as the needs of the real economy continue to outpace the ability of financial markets to provide greater access to finance and funding for infrastructure and developments in these markets outpace the ability of policy makers to adjust

regulations to new realities. In order to realize the vision of Asia fully becoming an engine of global economic growth in this century, the regulatory frameworks and market infrastructure need to be put in place that will enable Asian economies to grow on strong and stable foundations.

APFF has the potential to contribute to attaining this goal, but in order to do so, it needs to have efficient structures, access to resources and mechanisms for coordination and collaboration with relevant authorities and organizations. It can draw lessons from the experience of successful international organizations, in addition to the experiences of ABAC and the Advisory Group on APEC Financial System Capacity Building.

In conclusion, the discussions during the Symposium explicitly confirmed the need for establishing the APFF. They identified the needs and aspirations of the region's economies and the ongoing processes that characterize the development of the region's financial markets. They identified the principal challenge as building the institutions and structures through which savings can be channeled into the kind of investments, particularly long-term investments, that will meet the most important needs of the region. Participants reached consensus on the priority issues that must be dealt with in order to build such institutions and structures and determined that the APFF has a proper role to play in dealing with these issues.

Participants agreed on a basic initial structure for the APFF and the cast of institutions and players who need to be involved in its development. They agreed to propose that ABAC be responsible for developing its activities under the institutional structure of the APEC Finance Ministers' Process, in collaboration with interested ministries and institutions that play important roles in the development of policies and regulations affecting the various components of financial markets. It is hoped that the APEC Finance Ministers will favorably consider these outcomes and the work program based on them that will be presented by ABAC at their 20<sup>th</sup> Annual Meeting in Bali.