

2010 ABAC Report to APEC Finance Ministers

The APEC Business Advisory Council (ABAC) is pleased to present its report and recommendations for the year 2010 to the APEC Finance Ministers. This year, ABAC focused its efforts on delineating growth strategies which are balanced, inclusive, sustainable, innovative and secure. ABAC's Finance and Economics Working Group, representing the views of the financial industry, has been working on the issues of sustainable development, economic integration and addressing the needs of vulnerable sectors through capacity building and regional economic cooperation so that capital markets are deepened, strengthened, and integrated with enhanced industrial and social infrastructure.

Amidst the nascent recovery of the global economy after the unprecedented financial crisis, the Asia Pacific region has been recognized as an important center of growth. Stimulus programs have contributed to this growth. While there is market concern about heightened sovereign risk and G20 leaders have committed to regain a sound fiscal standing, care must be taken in selecting the timing of implementation of exit strategies. Premature implementation of exit strategies will ruin a nascent economic recovery while belated action will have significant side effects especially on the APEC growth center economies. Fiscal and monetary policies should reflect each economy's specific situation while maintaining close collaboration across the globe. A mid and long term credible plan to restore fiscal sustainability should be developed. APEC economies should also well prepare for emergencies which occur outside the region. The Chiang Mai Initiative Multilateralisation agreement is most welcomed. Complementary measures to provide liquidity to the markets such as cross-border securities collateral management need to be developed promptly. Close communication and collaboration among APEC leaders is urged to achieve regional stability and to avoid any form of protectionism through any new trade impediments, new or increased tariff, transfer price manipulation, financial and industrial policies.

In light of much increased importance of the region, a series of objectives are required. First, APEC economies must maintain policy cooperation and open markets to promote balanced growth and economic integration. Second, sound and efficient financial systems should that address the region's needs be established through regulatory reform and improved risk monitoring. Third, a stable global financial and currency architecture should be developed, and existing international institutions to support liberalization and facilitation of trade and investment should be strengthened. Fourth, capacity building and regional economic and financial cooperation should be enhanced so that strong and sustainable growth is facilitated for all.

In developing our recommendations, we aligned our recommendations in accordance with the three growth agenda (stronger, more sustainable and balanced) of APEC Finance Ministers Process and G20. We paid particular attention to promoting regional integration through sub-regional financial integration; promoting Islamic finance to complement traditional banking; promoting infrastructure public-private partnership; enhancing bond and equity markets; improving regulatory frameworks, particularly for financial institutions; improving international accounting standards; environmental finance; lending to small, medium and micro enterprises; enhancing social safety nets; and financial inclusion.

Capacity-building is an important element of regional cooperation, and ABAC continues to intensify its collaboration with major international institutions to develop ideas for regional public-private partnership through the Advisory Group on APEC Financial System Capacity-Building (“Advisory Group”). This year, the Advisory Group continued to undertake several important activities to discuss a number of issues and provide recommendations on the way forward. ABAC endorses the 2010 Report of the Advisory Group, which contains valuable ideas and recommendations that are also reflected in various parts of this report.

1. PROMOTING STRONGER GROWTH

A. Promoting regional integration through sub-regional financial integration

Today, economies face another crisis emerging outside the APEC region, which could potentially hinder them from attaining well-balanced and sustainable economic growth. The promotion of regional financial integration continues to be immediate importance. At the 13th meeting in Tashkent, Uzbekistan on 2 May 2010, the ASEAN Plus Three Finance Ministers announced that the Chiang Mai Initiative Multilateralisation (CMIM) agreement came into effect on 24 March 2010, and that consensus has been reached on all the key elements of the regional macroeconomic surveillance unit of the CMIM, called the ASEAN + 3 Macroeconomic Research Office (AMRO). ABAC supports such recent international initiatives for regional financial cooperation that provide a good model for APEC. ABAC expects that the establishment of AMRO will enhance supervision on volatile cross-border capital flows, especially into and out of emerging economies, and provide more assistance in strengthening the financial capacity building of emerging economies, including the study of Regional Monetary Unit (RMU). Development of regional structures, however, should compliment, not replace or replicate, existing global institutions and structures.

- *Promote regional financial integration to mitigate vulnerability to financial contagion from outside the region. Advance CMIM as a platform to enhance financial stability*

in the APEC region.

- *Consider further improvements in CMIM's disbursement mechanism to enhance its effectiveness, in particular, by changing the 20 % threshold of the IMF support program compliance.*
- *Strengthen the regional macroeconomic surveillance through AMRO.*

B. Encouraging Islamic finance

The co-existence of Islamic and conventional financial systems can promote greater financial system resilience by broadening and deepening financial markets. Islamic funds, mobilized from APEC Muslim communities kept unused and funds from the Middle East, can support financial needs in the region such as infrastructure development to accelerate the region's growth. Increased access by the Islam community to finance will enhance the economic integration and stability of the community. Important values such as business ethics, conscience, responsibility, and equitable contracts between investors and investees are embedded in the basic principles of Islamic finance. Islamic finance has a direct link to the real economy and possesses certainty, supported by underlying activities. Thus it could be a good basis for enhancing business ethics and promoting greater transparency and disclosure. In addition, Islamic finance could prevent some financial bubble as Shariah compliance eliminates speculative transactions. Recently, the Islamic finance industry has evolved to become an essential part of the international financial system, and almost 80 % of Shariah compliant assets are in Islamic Banking. Islamic finance is inclusive and is for both for Muslims and non-Muslims, and can co-exist with conventional financial systems. Nonetheless, there are many impediments for promoting it due to its transactional nature. Efforts are needed to address tax, regulatory and accounting issues to ensure a level playing field for Islamic finance and to become viable in APEC economies.

- *Enhance the market awareness of Islamic finance, and increase the capacity of professionals and scholars to drive growth. Establish and develop regional educational and training institutions in economies which can function as a hub of the Islamic finance in the region.*
- *Remove such impediments as tax treatment for domestic/cross-border transactions (stamp duty; mark-ups and treatment of profit and deposits) with enhanced collaboration among domestic tax authorities, central banks and Ministries of Finance (MOFs). Maintain regulatory frameworks, including rules and procedures, for Islamic financial products.*

C. Promoting infrastructure public-private partnership

According to a joint study of the ADB and the ADBI, Asia would need to invest about US\$750 billion annually on average to meet domestic and regional infrastructure needs over the period of

2010-2020. There is a huge potential for public-private partnership (PPP) to help meet these needs. However, for PPP to be effectively harnessed toward this objective, key issues need to be addressed: the information asymmetry between the public and private sectors, broader and deeper capital markets and a more active role for multilateral institutions in partnership with public and private sectors. A regional infrastructure partnership among governments, international financial institutions and the private sector would help address these issues. A key element of this partnership is a structure to ensure sustained and continuous private sector inputs into the process of promoting infrastructure PPP in the region, which can work closely with APEC, multilateral institutions and governments.

- ***Launch an Asia-Pacific Infrastructure Partnership (APIP) as a pathfinder initiative to bring together private sector, government and multilateral development institutions to facilitate the growth of infrastructure PPP in the region.***

D. Developing bond and equity markets

While the region's bond markets have undergone significant development in recent years, emerging bond markets are still far from adequate in meeting the financing needs of the private sector. Supply constraints related to depth and liquidity, market infrastructure and the legal, policy and regulatory framework continue to pose significant obstacles to market development, in particular for the corporate bond markets. Economies in the region also need to meet the challenges in developing the broader capital market, including equity markets.

Encouraging greater cross border flows of funds and the introduction of new products and services will contribute greatly to the development of bond, equity and regional capital markets. The cross listing of listed funds from outside and within the region, such as Exchange Traded Funds (ETFs), should continue to offer investors greater investment choice along with potentially lower costs and better returns. But governments should begin discussions on an important missing element – the cross border recognition of unlisted funds.

In the absence of regional agreement on the cross border recognition of unlisted funds some regional economies are relying on European regulated structures (UCITS). If APEC members can agree to a set of regulations that allow for the manufacture, distribution, management and administration of unlisted funds within the region an important new range of investment options and employment opportunities for APEC member economies would emerge. Recycling of funds within the region and regional integration would also be encouraged.

- ***Develop wholesale securities markets open only to professional investors (with less strict disclosure rules than those designed to protect retail investors), to encourage***

the expansion of the issuer base, including foreign issuers. Individual economies could establish such arrangements and eventually collaborate to develop regional arrangements for securities settlement, removing barriers to entry and undertaking further steps to create a regional professional securities market.

- *Collaborate between government and regulatory officials and market players to reduce barriers to cross-border settlement. The public sector should take the lead in addressing barriers related to tax, foreign exchange controls, investor registration, omnibus accounts and quotas. The private sector should lead efforts to address barriers related to messaging formats and pre-matching. Both public and private sectors should collaborate in addressing barriers related to cash controls, physical certificates, securities numbering and settlement cycle.*
- *Promote the use of foreign securities as eligible collateral throughout the region to enable major domestic and foreign financial institutions and investors to participate in cross-border collateral markets. In these markets, bonds can be actively used as collateral in money market transactions or traded in repurchase agreements, contributing toward more liquid bond markets. Existing arrangements can be considered as starting points in developing new bilateral arrangements, with a view toward a region-wide system.*
- *Continue collaborative efforts among governments, regulatory agencies, credit rating agencies and market players to promote region-wide convergence of accounting standards, disclosure regimes and corporate governance practices toward robust global standards.*
- *Establish a pathfinder initiative to introduce a funds passport scheme. Such a scheme is intended to facilitate the distribution of collective investment funds complying with a widely agreed common set of fund investment guidelines across participating jurisdictions. It should be designed to provide superior standards of retail investor protection and regulation compared to non-qualifying funds. Development of the common set of guidelines under which funds can apply for distribution across participating economies will need to be accompanied by efforts to address related regulatory and tax barriers as well as currency issues. In particular for corporate bond markets, efforts should be made to first strengthen the enabling framework – including common rating standards, availability/transparency of issuer informer, bankruptcy codes, etc. – before additional funds are introduced to pursue the already limited supply of bond, driving spreads even lower and possibly distorting the capital allocation process. Investors will clearly benefit from a strong legal, policy and regulatory framework.*

2. ENSURING MORE SUSTAINABLE GROWTH

A. Advancing regulatory reform

Although faster than expected, global economic recovery remains largely driven by massive fiscal stimulus undertaken by major economies rather than a recovery of private demand, and the full recovery of financial intermediation remains uncertain. In certain economies, impaired assets in financial institutions' balance sheets continue to pose a challenge. ABAC believes that sustainable economic recovery is the foundation of any growth agenda. The development of a resilient, stable and flexible business environment is extremely important.

ABAC notes that a variety of regulatory reform efforts is undertaken across the globe. ABAC would like to, however, underscore the fact that the social and economic structures, stages of development and business models of many economies in the Asia-Pacific region are quite different from those whose financial system weaknesses current regulatory reform efforts are intended to address. Most financial institutions in Asia, for example, have a relatively broader deposit base compared to their counterparts in Europe or in the US and have a stronger focus on relationship banking.

While ABAC supports the establishment of a strong global regulatory framework designed to reduce excessive risk taking by financial institutions, it believes that general increases in regulatory capital will not help significantly in accomplishing that aim and will be counterproductive by inhibiting sustainable economic recovery. Concurrent requirements for minimum liquidity could compound this problem by disincentivizing financial intermediation and provision of needed liquidity, particularly to SMME (Small, Medium and Micro Enterprise) borrowers that are a main source of innovation, financial inclusion and employment in both developing and many developed economies. Considering that the crisis was caused in large part by excessive risk taking in the investment banking and non-bank sectors, the new regulations proposed by the Basel Committee should not unduly affect the financial intermediary functions of commercial banks or equivalent lending by non-banks.

Regulations need to be coordinated globally, and implementation should take into account economic conditions, financial institutions' business models (e.g., differences between the business models of banks and insurance companies), and tax and accounting systems particular to each economy. And they need to ensure that in each economy all market participants who supply financial services on a commercial basis or in competition with other service suppliers are subject to the same laws and regulations administered by the same regulator in the same manner. Given that regulatory reform should aim to strengthen and stabilize financial intermediation, ABAC fears that while many of the proposed regulatory changes taken individually may seem to

be optimal, taken together they might be damaging banks' and other regulated financial institutions' ability to intermediate finance. The Basel Committee's response to the global financial crisis, for example, should not be to advance "one size fits all" regulatory changes. New regulations should be cognizant of differences between economies. Supervisory capacities need to be strengthened to enable developing economies to effectively adapt the Basel framework to local conditions, particularly where issues are best addressed through supervisory review (Pillar 2). Most fundamentally, care must be taken that the new BASEL standards and related global reform measures do not swing too far toward impeding prudent, risk-based lending to SMME and other higher-risk borrowers, a result that could imperil more broad-based and inclusive economic growth policies.

ABAC supports the G20 agreement in Toronto. In particular, ABAC agrees with their assessment that excess volatility and disorderly movements in exchange rates can have adverse implications for economic and financial stability. ABAC also welcomes their agreement to phase the implementations of the rules for stronger capital and liquidity standards of financial institutions as financial conditions improve and economic recovery is assured. ABAC also believes it important to ensure that there is no divergence and conflict between the direction of the G20's efforts and the direction of regional efforts within APEC to develop liquid capital markets and efficient financial services, which are vital to achieving balanced growth.

- *Maintain close consultation and dialogue with the private sector to determine any threshold of important ratios, including but not limited to, capital and leverage. Review and evaluate the impact of new regulations on costs of doing business.*
- *Consider possible withdrawal effects in introducing a capital buffer. ABAC believes it extremely difficult to adjust the size of capital in accordance with economic cycles. Thus, ABAC is of the opinion that careful thought must be given to the intersection of reserve and capital for addressing potential losses.*
- *Regulate activities beyond risk taking capabilities of financial institutions. Strengthen financial institutions' risk monitoring capabilities and financial standing.*
- *Undertake capacity building efforts to help financial regulators in developing economies strengthen supervisory capabilities and in effectively adapting the Basel framework to fit local conditions and business models.*
- *Ensure consistency between G20 regulatory reform outcomes and regional efforts to develop liquid capital markets and efficient financial services.*

B. Adopting International Financial Reporting Standards ("IFRS")

ABAC supports G20's initiatives to achieve a single set of high quality, global accounting standards. ABAC believes that introduction of robust common accounting standards such as

IFRS would enhance further development of capital markets in the APEC region, and promote sustainable economic growth. Nonetheless, various elements of IFRS should be studied to minimize cyclical effects on private sector economic activities. The studies should focus on impacts of accounting policies on the real economy and management of companies. Consistency with other regulatory frameworks such as Basel II (and its revisions) and the principles of the International Association of Insurance Supervisors should be also carefully studied. In studying these frameworks, it is particularly important to recognize that not all industries are the same. Insurance, for instance, is very different from banking despite superficial similarities.

In addition, the APEC region should commit itself to make effective contributions to the global discussions on the accounting standards. Accounting standards is one of the most important managerial tools for management to use to understand the company's operational results and create corporate value in the long run. Implementation of IFRS should have some flexibility, reflecting each economy's business practices to soothe the burdens of financial statement preparation, but should not allow jurisdiction to pick and choose which pieces of a standard to accept, nor should we allow regionally tailored version of IFRS.

- *Establish a task force to discuss studies on smooth introduction of IFRS to ensure appropriate communication among IASB, APEC and ABAC.*
- *Establish clear guidelines to avoid arbitrary treatment, in calculating the fair value of non-financial information and financial products, in particular illiquid assets, for example, Level 3 assets in accordance with IFRS 7.*
- *Consider the costs of marking-to-market each loan extended by the financial sector and maintain close dialogue with the private sector when implementing forward looking provisioning as proposed in IAS 39.*
- *Coordinate diligently with the private sector in introducing changes which may have significant impact on companies' P/L statements (for example, IAS 19 on pension accounting).*

C. Financing the environment

Business faces a much higher level of environmental regulatory risk in the post-Copenhagen world. The international community has rightly eschewed any idea of a "one size fits all" policy response to environmental challenges. Also, many policy approaches to improve environmental quality and reduce greenhouse gas emissions are based on highly centralized and highly prescriptive. These approaches can be far more expensive in economic terms than an approach which defines the environmental outcomes required in precise and measurable terms but lets

each market participant find the particular solution that best accords with their knowledge and circumstances.

On the other hand, currently the private sector faces significant challenges to expand our activities in the area of renewable energy projects, particularly in developing economies. Enhancement of renewable energy projects needs active public sector involvement in the form of providing guarantees, subsidies or preferential tax treatment to fill any commercial viability gap, making projects feasible for private investors. Such commercial viability gap includes the retail price of electricity set at a low level by regulation or based on inexpensive energy sources (cost or hydro); risks related to each economy's credit standing; weak financial standing of power purchasers; lack of (or inadequate) renewable incentives and regulations; lack of transparency of licensing procedures and legal systems; lack of efficiency and liquidity of financial markets.

- *Establish a set of high level principles in a policy framework, including the following; a recommitment to reduce subsidies on fossil fuel use; a preference for tax credits or fiscal subsidies to promote private applied research and development in energy technology and the promotion of alternative energy sources; in designing regulatory regimes governments ought to consult with industry.*
- *Introduce incentives and regulations to provide sufficient cash flows for renewal energy projects. The host governments should maintain strong and viable commitments to maintain these incentive programs.*
- *Introduce credit enhancement for the power purchaser from the host governments or IFIs. Also, measures need to be introduced to increase efficiency and liquidity of financial markets or to fill in the funding gap.*

3. ACHIEVING MORE BALANCED GROWTH

A. Expanding SMME access to finance

ABAC has strongly supported reform initiatives to facilitate financing for enterprises, particularly SMMEs, in the areas of promoting commercial lending through an enhanced secured lending framework. SMMEs are, in general, more vulnerable and prone to be much more affected by global economic circumstances than large corporations. Often lacking deep banking relationships, they also rely on more varied forms of asset based financings. As SMMEs play a pivotal role to drive the economic growth in the region, regulatory initiatives should be undertaken to promote a transparent and efficient legal infrastructure for secured lending, to incentivize asset based lenders to provide liquidity to this market.

Most SMMEs have limited access to bank loans because they cannot provide land and buildings as collaterals as required by the banks. Commercial banks normally provide secured loans, i.e., loans that are backed by collaterals. Land and buildings are the most accepted type of assets to be used as collaterals as they usually have a well established ownership registration and valuation system.

In many advanced economies, the law on collaterals is extended to include inventory, machinery and equipment, as well as intangible assets such as receivables, intellectual property, equity ownership in another company, and leasehold. Companies, particularly SMMEs, that have these assets thus would have greater access to financing if more reliable secured lending laws were promoted. These improvements would include not only expanding the classes of collateral that could be subjected to liens, and perfected, but also would include provisions for unified, exclusive and publicly searchable registries of such security interests, avoiding the problem of “hidden liens” that often create uncertainty for lenders and hence chill the provision of credit to higher risk borrowers. Reforms should also look at promoting more detailed provisions for “debtor-in-possession” financing, so as to encourage the provision of liquidity to companies that are experiencing short-term cash flow problems, but with viable business models that can allow for workouts and revitalization.

In addition to improving the regulatory process for secured lending, ABAC considers it important to develop properly structured credit information systems and legal frameworks, which are key issues in expanding SMME’s access to finance in many economies in the region, as well as to fill in any commercial gaps for financing in the form of guarantees. Modern technological developments such as introduction of digital promissory notes may alleviate the fraud risks and expand financing tools for SMMEs. Also it is important to remove any impediments such as taxation issues to support the SMMEs to expand their activities across the globe.

- *Launch an SMME Finance Initiative focused on helping APEC economies develop properly structured credit information systems and legal frameworks for expanding SMMEs’ access to finance.*
- *Support business developments of SMMEs by offering some credit enhancement in the form of credit guarantees, and by introducing better regulatory framework to facilitate financial and international activities of SMMEs.*
- *Introduce an efficient, exclusive and transparent registry of security interests and a reliable valuation system so that the creditor can determine with certainty prior liens, and their own relative lien priority, and move in quickly to foreclose and liquidate the collateral to pay for the loan when the loan defaults. Implement the collateral law to*

recognize a large variety of assets as collaterals in addition to land and buildings to secure the loan. Provide more opportunities for “Debtor-in-possession” financing.

B. Enhancing social safety nets

Implementation of sufficient social security policies plays a proactive role in alleviating difficulties confronted by enterprises and stabilizing employment. It also injects a strong impetus to transform the pattern of economic development. Social security policies thus contribute tremendously to sustaining economic growth, stimulating domestic demand, realizing economic restructuring and improving people’s wellbeing.

- *Implement social security policies with the purpose of raising relevant insurances, basic pensions of enterprise retirees and minimum living standard in accordance with unique characteristics of each economy such as aging population, diversification of employment types, and acceleration of urbanization.*
- *Introduce an adequate pension system on a funded basis. APEC member economies should conclude necessary agreements to facilitate pension systems that will enable sufficient labor mobility within the region.*

C. Promoting financial inclusion

In many developing economies, a majority of the adult population, especially those at the bottom of the economic pyramid, those living in rural areas, and women, remain without access to financial services. In the past few years, microfinance has proven effective as an initial tool to address this issue on a limited basis, especially due to the introduction of technologies and innovations that have lowered the cost of providing services. APEC has great potential to contribute in a major way to expanding financial inclusion by providing an effective platform for sharing of successful experiences of policy reforms that address different aspects of promoting microfinance. Regulatory reform measures should take account of the most recent and extensive research on what policies are needed to promote financial inclusion, allowing the requisite regulatory flexibility to structure products responsive to the needs of consumers while complying with standards of financial soundness. Measures such as interest rate regulation, lending caps, disclosure requirements and underwriting norms should be included in a holistic analysis under this initiative.

- *Launch an APEC Financial Inclusion Initiative under the APEC Finance Ministers’ Process as proposed by ABAC and the Advisory Group on APEC Financial System Capacity Building in 2009.*