

Deb Henretta
ABAC Chair 2011

5 September 2011

The Honorable
Timothy Geithner
Chair, APEC Finance Ministers' Meeting
Secretary of the Treasury
United States

Dear Secretary Geithner:

On behalf of the APEC Business Advisory Council (ABAC), we are honored to share with you and fellow APEC Finance Ministers the current business priorities we see as integral to enhancing greater economic integration across the APEC economies.

In supporting the outcomes set by APEC this year, our recommendations aim to achieve two long term objectives:

1. Building on our goal of realizing economic growth that is balanced, inclusive, sustainable, innovative and secure.
2. Strengthening APEC's economic and financial frameworks to enable the APEC region to mitigate the impact of unforeseen shocks, including financial, economic and natural disasters.

Recent strains on financial markets brought about by the tensions from the current challenges of fiscal deficits, high debt and low growth have created an environment of volatility and uncertainty. It is imperative that strong and coordinated leadership prevails and economies resist protectionism, which would undermine trade and investment.

Accordingly, our report requests that you and your fellow Finance Ministers individually and collaboratively focus on long term structural reforms and policies that not only strengthen the fundamentals of your respective economies but also facilitate the efficient allocation of economic resources through effective financial systems and markets. We therefore call on you to address the following issues:

1. A regional regulatory forum is needed to improve collaboration among financial market regulators and to achieve much needed redesign of the oversight of financial markets in view of increasing regional financial integration and the huge potential of rapidly growing Asian economies.
2. Develop policies and initiatives that support the capacity building of SMEs (including micro-enterprises) in terms of their ability to access finance. This would include development of SME management capabilities, accessibility and consistency of credit information for lenders, innovative risk sharing frameworks for lending and practices

that enhance a more transparent market for information. Such initiatives will support both lenders and investors in being less risk adverse, reduce the costs of capital and finance, encourage a more inclusive lending and investment environment and thereby enhance a more efficient allocation of economic resources.

3. In the context of the region's growing needs for infrastructure and the limited resources available in the public sector and multinational institutions, an enabling environment to channel more private capital into infrastructure is becoming ever more important. ABAC has formed a private sector panel and held initial Asia-Pacific Dialogues in 2011 with several APEC member economies in Asia and Latin America. ABAC calls on APEC to support the Asia-Pacific Infrastructure Partnership Dialogues and encourages member economies and the private sector to continue and further expand these dialogues in 2012.
4. Develop policies and initiatives that support capacity building in enhancing the efficiency of capital markets. This would include evaluating strategies that look to improve accessibility and consistency of credit information for lenders and innovative risk sharing frameworks and practices that enhance a more transparent market for information. In support of this, all member economies need to expedite the uptake of universally accepted accounting and auditing standards such as the International Financial Reporting Standards and the Institute of Internal Auditors standards.

Regional integration of financial markets and the efficiencies it brings is seen by ABAC as integral for enhancing financial support to economic growth across the APEC region. To this end, ABAC decided at its meeting in Lima to commence work to develop a proposal to be put to Leaders for improving the regional financial system. ABAC recognizes the importance of working collaboratively to improve the regional financial system, including strengthening monitoring of cross-border capital flows, and supporting the efficient allocation of resources through ongoing review of international credit rating systems, so as to promote the stable development of financial markets.

Finally, we remain concerned about the capitalization requirements of the financial institutions not only within the APEC region but also globally. We affirm that these requirements should be maintained and closely monitored in order to reinforce the confidence of business and industry.

In conclusion, we are cognizant that these issues are not a quick fix and will require sustained long term policy initiatives and structural reform. We therefore urge that you and your fellow Finance Ministers commence dialogue and action on these issues both between yourselves and individually with the ABAC members in your respective economies in an effort to create an environment conducive to renewed private sector investment and inclusive growth.

Sincerely,



Deb Henretta
ABAC Chair 2011



John W. H. Denton
Chair, ABAC Finance & Economics Working Group

2011 ABAC Report to APEC Finance Ministers

Finance and Economics Working Group

The APEC Business Advisory Council (ABAC) Finance and Working Group (FEWG) is pleased to present its report and recommendations for the year 2011 to the APEC Finance Ministers.

In supporting the outcomes set by APEC this year, our recommendations aim to achieve two long term objectives.

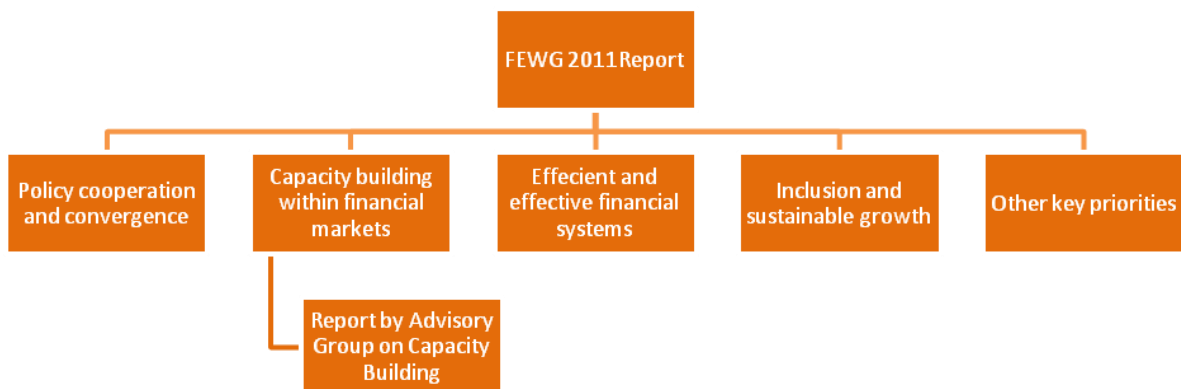
1. Building on our goal of realizing economic growth that is balanced, inclusive, sustainable, innovative and secure.
2. Strengthening APEC's economic and financial frameworks to enable the APEC region to mitigate the impact of unforeseen shocks, including financial, economic and natural disasters.

These recommendations are consistent with the key priorities established by FEWG in 2011 in light of APEC's growth strategy and 2011 APEC priorities and include:

1. Promote policy cooperation and coherence within the APEC economies.
2. Enhance capacity building within financial markets across the APEC region.
3. Improve the efficiency and effectiveness of regional financial systems.
4. Promote practical solutions to support the importance of inclusiveness and sustainable growth.

The list of our recommendations and report on our activities are compatible with these priorities and provide the structure for this report (refer diagram 1). This report also draws from recommendations and activities of the Advisory Group on APEC Financial System Capacity Building. The Advisory Group is an informal organization led by ABAC that serves as a vehicle for collaboration among public and private sectors and key international institutions in promoting capacity building efforts to strengthen and develop the region's financial systems. The Advisory Group's 2011 Report, which contains details of these recommendations, which ABAC endorses, is annexed to this report (please see Appendix A).

Diagram 1 Report Structure



In keeping with the theme this year of small and medium enterprise (SME) (including micro-enterprises) support, it is the “behind-the-border” issues that ABAC, as advisor to APEC on pertinent business issues, can have significant impact on in terms of both advice to our respective governments and value add in terms of building a seamless regional economy. While international transaction costs depend, to a certain degree, on exogenous factors (like geographic location and distance between trading economies), appropriate policy measures (e.g. improvements in infrastructure, improved flow of capital, greater access to capital, risk sharing, harmonization of reporting standards or reduction in administrative barriers to trade) can significantly improve the efficiency of trade, boosting the potential for greater trade across APEC economies.

Promote policy cooperation and coherence within the APEC economies

To enhance improved efficiency in the financial markets, there is a need for regulatory coherence on a broad range of issues. Without coherence of regulation, cross border capital flows may be constrained and opportunities for regulatory arbitrage may emerge thereby impeding investment and market efficiencies, adding compliance and enforcement costs for both government and industry. For consumers, regulatory divergence is tantamount to a concealed “inefficiency tax” that citizens pay on everything they purchase. This tax is the sum of the costs of duplicate regulations, cross border administration delays and fees, and other regulatory impediments. For businesses, and in particular SMEs, higher costs of compliance hinder international competitiveness and complicate the most efficient deployment of economic resources.

ABAC identifies that the goal of regulatory coherence is to develop effective regulation that facilitates the trade of goods and services, as well as stimulates competitive economies and the region’s economic growth. Regulatory coherence however is not about less or more regulation. More than just harmonization of regulation, it is also about improving the process by which economies develop regulations, developing best practice and finding common standards acceptable to multiple economies.

EXPANDING REGULATORY COOPERATION AND REGULATORY COHERENCE THROUGH THE ADOPTION OF IFRS

ABAC observed in its 2010 Report to the APEC Economic Leaders that it believes the introduction of robust common accounting standards such as International Financial Reporting Standards (IFRS) has the potential to enhance development of capital markets in the APEC region, as well as to promote sustainable economic growth.

ABAC also noted that a number of complex issues remained for jurisdictions in interpreting important aspects of IFRS including approaches to “fair value”, comprehensive income reporting and the potential liability of company directors and others who may unwittingly incorrectly interpret financial reporting requirements. Work is ongoing in refining International Accounting Standards and in clarifying the requirements of IFRS. While a number of APEC economies are moving to or have issued reporting standards equivalent to IFRS – Australia; Canada; Japan; Hong Kong, China; Chinese Taipei; Russian Federation; and Singapore – the principles-based approach of IFRS means that national interpretations of aspects of the standards are the norm.

Despite there being overall support for implementation of IFRS, many private sector organizations have their concerns. As pointed out last year, ABAC has concerns on some of the newly proposed accounting standards, including fair value measurement (IFRS 7 and IAS 39) and pension (IAS 19) given they may have significant impact on companies’ Profit and Loss statements. In addition, the proposed changes on lease accounting (IAS 17) may have potential business and economic impact, such as on the availability of financing for SMEs. During the implementation of IFRS, it is important to examine the economic and business impact of the accounting standards, so that the economies are activated as a whole.

As part of APEC’s goal of encouraging regulatory coherence and promoting regional economic integration, ABAC wrote twice during 2011 to the Chairman of the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) conveying ABAC’s strong support for adoption of IFRS throughout the APEC region, one on lease finance and another on insurance contracts. At the time, ABAC noted that adoption of IFRS should be undertaken in a manner that minimizes the impact on real economic activities. In particular, ABAC identified that it would be concerned with any impact of implementation on the financing activities of SMEs, as this is a focus area for Inclusive Growth initiatives, one of the pillars of APEC’s growth strategy.

In this context, ABAC noted that IASB and FASB jointly released an exposure draft (ED) on lease finance dated 17 August 2010, proposing new accounting rules for treatment of lease financing and calling for finalization of the rules by June 2011. The IASB/FASB preliminary analysis of submissions noted that significant concerns were raised with the ED, including, as most concerns ABAC, the potential for the rules to have a negative impact on lease financing availability for SMEs. Among the concerns ABAC shared, was the reduction in the ability of businesses, particularly SMEs to access funding in many APEC economies and the funding ability of both lessees and lessors would be constrained as lease financing, currently a significant component of overall liquidity available to businesses, would become scarcer.

ABAC stated its belief that ABAC has a duty to underscore at a higher level that the ED be implemented in a way that does not impair APEC’s overarching themes of Inclusive Growth, and think this consistent with the IASB/FASB conceptual framework that implementation of accounting standards should be neutral with respect to economic impact.

ABAC also noted that IASB released an exposure draft on insurance contracts dated 31 July 2010, proposing a new accounting standard for insurance contracts, including new standards for the valuation and disclosure of insurance liabilities, and the introduction of the margin approach in the presentation of financial statements. ABAC considers, however, that such changes would have significant negative

impact on the insurance industry, including non-economic volatility and non-transparency in the reported results of insurance companies in the region, as well as the reduced availability and/or increase in the price of many long-duration insurance products that are particularly important for economies in the region with aging populations.

A copy of these letters is provided as appendix B and ABAC now calls on all Finance Ministers to support this view.

The efficient operation of capital markets is best served through coherence and harmonization on how market information is reported. Hence, ABAC believes that the adoption of coherence to internationally agreed accounting and reporting standards will reduce risk and the cost of undertaking foreign investment.

In supporting the adoption of IFRS, ABAC requests that the Finance Ministers acknowledge that in the process of promoting the coherence of standards, relevant issues to be addressed are the identification of the current issues in IFRS such as the impact on SMEs and an understanding of the current status of adoption of IFRS across APEC. ABAC therefore request the following commitment of APEC Finance Ministers to:

- **Establish a task force to discuss studies on smooth introduction of IFRS to ensure appropriate communication among IASB, FASB, APEC and ABAC.**
- **Undertake an impact study on certain provisions, such as those related to lease financing and insurance contracts noted above, and make suitable adjustments, to avoid negative business and economic impact.**
- **Continue to encourage a dialogue between business groups and IASB/FASB on ways that would align IFRS principles with the interests of SMEs and other business groups, such as insurance companies, that will be affected. Adoption by economies of IFRS should take into account ways of satisfactorily dealing with the concerns raised by business groups.**

INTERNATIONAL INTERNAL AUDIT STANDARDS

Reduction of risk and ultimately the cost of undertaking cross border investments and capital flows are intrinsically linked to the availability of acceptable market information. Accordingly, the efficient operation of capital markets is best served through coherence and harmonization on how this market information is reported. One area where this can pragmatically be served is through the introduction of common accounting standards and Internal Audit Standards.

Good governance and risk management are central to the effective performance and sustainability of economies' public and private sector institutions. Internal audit is a major component of an institutions' governance system and its capacity to manage risk and internal control systems. In all sectors, internal audit can contribute to stronger organizations, more efficient and effective performance of organizations, organizations being better able to safeguard their assets, the reduction of the likelihood and severity of fraud and corruption and the prevention of unexpected market shocks.

The Basel Committee on Banking Supervision (BCBS) encourages internal audit in principle 9 of its October 2010 paper on "Enhancing Corporate Governance".

While internal audit is mandated in some APEC economies, this approach is not common in all APEC members. APEC is encouraged to explore how the profession of internal audit can be advanced in all member economies. This could be achieved by mandating or encouraging internal audit in relevant public sector institutions; in financial services and in the largest listed companies (for example, the top 100 or 200 companies).

The Institute of Internal Auditors (IIA) is the global body that advances the profession of internal audit. It has more than 160,000 members worldwide and there are IIA Institutes in the majority of APEC member economies. Where mandating is implemented, the application of the IIA standards (referenced in the BCBS paper “The International Professional Practices Framework”) should be mandated or encouraged.

Recommendation:

- **Promote coherence in regulatory approaches and cooperation; APEC economies consider mandating or at least encouraging the adoption of IIA standards in member economies and to consider ways to advance the profession of internal audit.**

Enhance capacity building within financial markets across the APEC region- Report

PUBLIC-PRIVATE REGIONAL COLLABORATION TO PROMOTE INFRASTRUCTURE PPP

In the context of the region’s exponentially growing need for infrastructure and the limited resources available in the public sector and multilateral institutions, an enabling environment to channel more private capital into infrastructure is becoming ever more important. Noting the Advisory Group’s view that these challenges could be effectively met through closer collaboration among the public and the private sector and multilateral development banks (MDBs), ABAC recommended that APEC launch a regional infrastructure partnership involving all of them. ABAC has formed a private sector panel and held initial *Asia-Pacific Infrastructure Partnership (APIP) Dialogues* in 2011 with several APEC member economies in Asia and Latin America. These dialogues, which are tailored to the specific needs and priorities of member economies, are designed to complement other initiatives within and outside the APEC framework.

Recommendations:

- **ABAC calls on APEC to support the Asia-Pacific Infrastructure Partnership (APIP) Dialogues and encourage member economies and the private sector to continue and further expand these dialogues from 2012 onward.**
- **ABAC calls on APEC to develop a benchmarking index to assess the capacity of Asian member economies to carry out sustainable infrastructure PPPs, building on the Infrascopie index developed for Latin American economies by the Economist Intelligence Unit with the support of the Inter-American Development Bank.**

Improve the efficiency and effectiveness of regional financial systems

Economic integration can be enhanced by providing a cohesive financial and regulatory environment across the APEC region that not only supports the flow of capital and investment but enhances the ability to trade more openly, freely and transparently. A specific focus should be the “behind-the-border” regulatory impediments to the free flow of capital and goods. Such a focus will make it cheaper, easier and faster for businesses, - particularly SMEs (including micro-enterprises) - to trade in the region.

Consideration also needs to be given to the development of policies and initiatives that support SMEs and those organizations often excluded in terms of their ability to access finance.

A recent APEC survey conducted by the Japan Chamber of Commerce and Industry¹ concluded that inadequacies in the information and legal environments are the most serious problems affecting SME finance. The absence of clear legal frameworks to enforce rights of secured lenders is an impediment to credit availability, disproportionately affecting SMEs and other businesses that have historically had difficulty accessing bank credit. Systems for creating and perfecting valid security interests in the first instance are often not exclusive, universal and accessible to prospective lenders. Legal rules often do not clearly contemplate various forms of structured finance that are useful to providing SMEs with operating liquidity.

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

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

Recommendations:

ABAC calls for an APEC Financial Inclusion Initiative that, with regard to SME financing, would aim to improve and harmonize standards for perfection and enforcement of security interests in collateral, as part of a system for developing a robust commercial finance market, would promote innovative financial products, enhance overall liquidity for the SME sector, and advance the goal of financial sector inclusion and sustainable growth. In addition to facilitating financing for SMEs, a harmonized approach would promote regional investment and trade in financial services in the APEC region. Such an initiative could focus on the following activities:

- **A survey of key enablers of financing availability**
- **Developing model elements of an APEC or region-wide code of security interest creation, perfection and enforcement, which could include clear perfection rules, broad coverage of collateral types, exclusivity to eliminate the “hidden lien” problem, and provisions for debtor-in-possession financing.**

¹ A Survey on Actual SME Business Conditions in the APEC Region, Japan Chamber of Commerce and Industry 2010.

- **A model treatment of floating charges/accounts receivable financing**
- **Establishment of a public-private dialogue to validate improvements**
- **An APEC checklist for statutory/regulatory implementation**
- **Promoting broad licensing authority for commercial finance, such as non-bank financial company charters.**

Such an initiative will support lenders and investors in being less risk adverse, thereby reducing the costs of finance and encourage a more inclusive and efficient lending and investment environment.

CONSTRUCTION OF NEW INTERNATIONAL CREDIT RATING SYSTEM

Credit rating systems have the responsibility of revealing risks, determining market price, and providing credit certainty. They are also an important component of the capital markets, especially bond market infrastructure, and could be a useful tool to accelerate financial market development in Asia. High-quality credit rating can help investors to understand the issuer's solvency and credit conditions, and it is an important reference standard for investors to choose bonds and to determine bond's interest rates.

The outbreaks of global financial crisis and the European sovereign debt crisis have highlighted the problems in the current international credit rating system. The international community has voiced a growing desire to increase competition in the current market, which is characterized by an oligopoly, and to improve the overall international credit rating system. Europe has accelerated the pace of establishing an independent credit rating system, and Asian economies have lifted the promotion of local rating systems to a strategic height, actively participating in the reform and reconstruction of international credit rating system.

Recommendation

ABAC calls on APEC to support the development of open and effective competition in the global credit rating industry by fostering an environment conducive to the establishment of a market-driven and independent regional credit rating agency. A regional agency must be independent of any sovereigns to ensure impartial and transparent ratings. Credit rating is an important tool for addressing the problem of information asymmetry in financial markets, and could be a useful tool to accelerate financial market development in Asia. It would play an important role in revealing risks, determining market price, and providing credit certainty in capital markets, especially the bond market.

ADVANCING FINANCIAL INTEGRATION AND COOPERATION IN THE ASIA-PACIFIC REGION

There is need for a more robust discussion of regional integration, including its scope and meaning for the region. A regional regulatory forum is needed to improve collaboration among financial market regulators within the region and to achieve the much needed redesign of oversight of financial markets, in view of increasing financial integration and the huge potential of rapidly growing Asian economies. ABAC believes that APEC, with the involvement of the private sector, key international institutions and systemically important economies and financial centers in the region, can provide an excellent platform for advancing regional financial cooperation and integration. APEC also has an opportunity to make a significant contribution to regional financial integration through a pathfinder initiative building upon the Asia Region Funds Management Passport currently being discussed under the APEC Finance Ministers' Process.

Recommendations:

- **ABAC calls on APEC to initiate discussions to establish a regional financial forum that will include all relevant financial market regulators and institutions playing key roles in financial policy in member economies. The task of such a forum would be to redesign the oversight of financial markets, for the purpose of enabling member economies to more effectively capture the benefits of growing financial integration and rapid economic growth in the region.**
- **ABAC recommends that APEC economies that are able to meaningfully participate in a regional funds management passport regime join together to advance the work of the APEC Finance Ministers' Process on this issue through a pathfinder initiative. This initiative should be pursued in conjunction with capacity building programs on cross-border recognition of equivalent regulatory regimes for issuing and trading financial products and services for developing APEC member economies, with a view to these economies joining the pathfinder initiative once they are ready to do so.**

CROSS BORDER DATA FLOWS FOR THE FINANCIAL SERVICES INDUSTRY

The facilitation of cross border data flows builds upon the work done by ABAC in the last year to promote financial inclusion, a key APEC initiative for 2011, which itself was built upon the Inclusive Growth of the APEC Growth Strategy in 2010. Financial institutions rely heavily on gathering, processing, and analyzing customer information in order to provide financial services tailored to client needs, but are frequently confronted with non-tariff barriers in the form of regulatory restrictions, lack of regulatory coherence, and poor transparency in the development, implementation, and application of regulations. Data processing operations therefore are a critical component of financial services providers' business. Credit bureaus rely on gathering and transferring credit information to facilitate the review of credit files, authorize the extension of credit to borrowers, and help lenders comply with prudential lending norms, including Basel-related risk capital requirements. Restricting the cross border flow of data by forcing operations onshore constitutes a non-tariff barrier to trade and hinders the ability of financial services firms in the region to support their clients.

Data processing operations are a critical component of financial services providers' information technology environment. They are also important to the credit bureaus that facilitate modern risk management and underwriting, and ensure portable credit files to an increasingly mobile talent force across the APEC region. Full-file credit bureaus are a key component of APEC's financial inclusion initiative, but can be hampered by undue restrictions on cross-border data flows. Regional data centers enhance risk management for capital and liquidity because financial institutions can mitigate or accept risks based on a composite impact analysis, rather than through isolated and market-specific analyses. The economies of scale that exist in data hubs yield cost savings that allow firms to develop and employ state-of-the-art technology to protect the integrity, security, and confidentiality of data. Processing data at regional centers also provides a better vantage point to determine what is working well and how the financial institution can build on the product or service to further optimize the experience for the customer, thereby enhancing innovation in the region.

Recommendations:

- **Avoid taking steps that localize and fragment data flows in the region, which increase barriers to entry and hinder regional commerce.**

- Recognize that domestic legislation concerning privacy protection and cross border flows of personal data may hinder cross border flows;
 - Remove or avoid creating, in the name of privacy protection, unjustified obstacles to cross border flows of personal data;
 - Take all reasonable and appropriate steps to ensure that cross border flows of personal data, including transit through member economies, are uninterrupted and secure.
 - Ensure that procedures for cross border flows of personal data and for the protection of privacy and individual liberties are simple and compatible with those of other APEC economies.
- Do not limit the utility of regional data centers and instead allow financial institutions to transfer information into and out of their territory for data processing and storage.
 - Make commitments that allow financial institutions to perform certain functions, such as trade and transaction processing, in their home office rather than requiring that those activities be conducted by a local affiliate.
 - Ensure that the APEC Privacy Framework, as part of the APEC Pathfinder, and any enforcement agreements entered into pursuant to the APEC Cross-Border Privacy Enforcement Arrangement (CPEA), reflect the above principles of free flow of data across borders, and are consistent with APEC initiatives to promote regional economic integration.

LETTER TO THE BASEL COMMITTEE ON BANKING SUPERVISION

In encouraging efficient and effective financial systems ABAC wrote to Mr. Stefan Walter (Secretary General, Basel Committee on Banking Supervision) conveying ABAC's strong support for targeted policies that accelerate SME capacity building efforts including improved SME access to finance and raised concern for the impact of Basel III on SMEs. Given recent World Economic Outlook of a broad but uneven recovery in APEC economies, ABAC has identified access to finance as one of the most important issues facing SMEs today. At the global level, the capital flows that existed three years ago – cash flowing from resource rich economies to indebted developed economies – has not returned to the same levels, resulting in the world economy enduring a slow, tentative recovery.

Further to these market issues, Basel III has the potential to impact the availability and cost of trade finance. This may have the unintended consequence of worsening trade finance conditions and access for companies, particularly SME enterprises, from emerging markets involved in import and export activities thus negatively impacting on SMEs in the developing world and in the APEC region. ABAC seeks support from the Finance Ministers on this issues and a copy of our letters is provided as Appendix C.

Recommendations:

- Coordinate with G20 so that the Basel Committee pays special attention to the risk weighting of trade finance to ensure that SMEs are not disadvantaged in any way and have an equal opportunity to participate, in line with the request of the G20 following its meeting in November 2010.

Promote practical solutions to support the importance of inclusiveness and sustainable growth

From a sustainable growth perspective, while APEC has pledged to promote green growth and help economies make a successful transition to a clean energy future, businesses report a reluctance to invest in projects in the current investment environment due to low expectations of reasonable return on investment. This impediment can be overcome by providing greater opportunities for industry through trade expansion and identifying risk sharing and market information policies that increase the viability of infrastructure projects, in particular green growth projects.

Even though conducive policy initiatives in APEC economies exist, progress toward investing in sustainable projects and hence green growth is at best, flat. Despite readily available financial resources earmarked for investment in sustainable energy and a healthy stream of new, innovative ideas, relatively little investment in sustainable projects is being made. ABAC urges APEC economies to identify policies and initiatives where government and the private sector can share risk and the development of capacity building and information standards to enhance the sustainable growth investment markets.

From a business perspective there are a number of risks and cost related issues that deter the private sector from inclusive financing dealings. If some risks can be shared, private sector involvement could be enhanced. APEC economies therefore have an opportunity to contribute to expanding financial inclusion by providing an effective platform for sharing of information and policy reforms and identifying potential solutions where government and the private sector can share risk. ABAC therefore calls on all APEC economies to identify capacity building and information sharing policies to further develop financial inclusion through risk mitigation strategies.

GREEN BOND CONCEPT

Science suggests greenhouse gas emissions need to decrease substantially against a business as usual scenario to avert the direct consequences of climate change. Achieving the pathway to a low carbon economy is possible using a variety of technologies and policy mechanisms. Narrowing the capital gap to finance environmental solutions requires financially sound investment products and the mobilization of private investment to supplement public funds. In this way, bond financing is critical in the transition to a low carbon economy.

Despite this importance, there has been a slow pace in investor buy in of the green bonds available due to a number of reasons:

- To date, projects have not existed on the scale necessary to attract large institutional investors
- Lack of resources and standards for bond investors to identify, screen and monitor individual green finance opportunities
- No “aggregator” has existed to either ring fence existing projects or create captive pools of capital that would be earmarked to fund green projects
- Wide array of project types due to the numerous pathways to combat climate change.

To combat this slow buy in rate, the private sector has commenced green bond initiatives of which include: giving clients transparent, low risk ways to invest in the green bond sector; creating market practices and investment vehicles to give investors better access to green investment opportunities; providing investors with more highly specialized and targeted green bond investment alternatives;

allocating capital to existing green bond programs; and developing targeted allocations based on the existing investable universe.

Recommendations:

- **Develop market standards and vehicles to give investors broader access to green investment options to overcome the current bottlenecks experienced in the green bond domain. These initiatives will overcome the bottlenecks by creating a platform for efficient financial intermediation between issuers and investors in green bonds.**
- **Establish an impartial forum for cooperation between all key sectors and specialists to promote idea sharing, research and barrier identification.**

SUGGESTIONS ON POLICY SOLUTIONS FOR SME FINANCE

SMEs (including micro-enterprises) play important roles in economic and social development, especially in creating jobs and promoting innovation. Yet it is well recognized that financing problems of SMEs is a worldwide issue and hampers a SMEs whole life cycle.

Since 2010 SMEs, especially those of the emerging markets, have been presented huge challenges. On the one hand, some economies keep raising the benchmark interest rate and deposit reserve ratio and reining in credit limits, leading to fund shortage in the market and making it more difficult and costly for SMEs to seek for funding. On the other, rapid rising cost of raw material and labour since 2011 has increased by a large margin the operation cost of corporations. At the same time, bills decline due to saggy demand from European and U.S. market. All the above factors lead to shrinking profitability decline, increasing operation difficulty and bankruptcy.

The current challenges faced by SMEs in their operation and funding is even bigger than that during the global financial crisis period of 2008. If this financing challenge cannot be properly solved in the long run, it will have negative impact on the comprehensive, coordinated and sustainable development of the region's economy and society. However, economies of the region are increasing their support to solve SME funding difficulties.

Recommendations:

- **Develop SME financing system and step up policy support through the following five activities:**
 - **Set up and enhance a policy-based finance system for SMEs.**
 - **Facilitate the establishment of a multi-layer direct funding system.**
 - **Enhance the macro environment for SME operation.**
 - **Increase fiscal subsidy and favourable taxation treatment for SMEs.**
 - **Increase educational support.**
- **Stronger support from financial institutions – economies of the APEC region should promote SME funding in three aspects:**

- Central governments should standardize and guide the positive role of informal finance.
- Local governments should set up gradual risk reimbursement funds for SME loans and develop SME credit risk sharing system.
- Financial institutions should increase funding to SMEs, take SME funding as the strategic focus of corporate financing and adapt supportive measures in their organisational structure, product and service innovation, marketing strategy, and risk prevention.
- Solving SME financing difficulty by insurance mechanism as solving technical risk is the key to SME financing difficulty.
- Greatly promote private financial credit mechanism with multiple forms.
- Promote innovation of SME finance forms through the following two activities:
 - Actively promote supply chain financing.
 - Greatly promote financing through leasing.

EXPANDING ACCESS TO FINANCE FOR LOW-INCOME HOUSEHOLDS AND SMEs (INCLUDING MICRO-ENTERPRISES)

Addressing the needs of many people living in poverty and promoting the growth of enterprises in the Asia-Pacific region through improved access to finance remains a major challenge. With growing constraints on public resources in the wake of the recent crisis, mobilizing private resources to serve financial needs of low-income households and small enterprises has become ever more important. ABAC sees the need for public and private sectors and institutions to collaborate more closely and coordinate their efforts and to identify and focus their efforts on areas that address specific needs of APEC member economies, activities that effectively harness APEC's strengths, and issues that promote APEC's broader goal of regional economic integration.

Recommendations:

- ABAC urges APEC member economies, relevant institutions and the private sector to closely coordinate their activities under the APEC Financial Inclusion Initiative, and to discuss how APEC can provide a robust regional platform to help expand the availability of credit to micro-enterprises and low-income consumers on a sound and sustainable basis, more widely mobilize grassroots savings, and more effectively harness remittances within the region to facilitate financial inclusion.
- ABAC calls on APEC to intensify and broaden capacity building activities to assist key officials and regulators in undertaking legal, policy and regulatory reforms to develop properly structured credit information sharing systems and improve the legal architecture for secured lending, including rules for filing and perfecting security interests in collateral, ease of diligence and completeness of lien registries, as well as rules governing licensing and market access that will facilitate the flow of credit to small enterprises.

- **ABAC recommends that APEC undertake a policy dialogue involving relevant government agencies, international institutions and the private sector to examine best practices in facilitating the development of venture capital, including the use of public resources and tax policy to effectively mobilize private investment in venture capital funds and the promotion of an environment that is conducive to innovation.**
- **ABAC also recommends that APEC Finance Ministers underscore the need for financial sector standard setters and regulators to address unintended consequences of regulatory reforms affecting SMEs access to finance. In particular, they could encourage: a) the IASB and FASB to allow sufficient time for an impact analysis of new accounting rules for treatment of lease financing before appropriate revisions are made; and b) banking regulators and the Basel Committee to consider appropriate refinements to Basel rules on capital, leverage and liquidity that recognise the low risk nature of trade finance.**

Other key priorities

Whilst in 2011 the FEWG focused on micro-economic issues, monitoring of the macro environment is paramount in terms of short term impacts on the development of regional economic integration. Many of the more collaborative global policies are now developed within the context of the G20 forum. ABAC identifies that there remains a key priority of APEC economies to commit to the ongoing monitoring of G20 initiatives and policies.

Ongoing Monitoring of the G20 Agenda

Balanced growth without excess volatility of currency exchange and capital flow is G20's main agenda. In this context, G20 discusses the international monetary system and the impact of developing economies. It is a consensus that the recovery of the global economy is important within APEC's regional economic growth.

From a business point of view, the crucial point is to decrease the transaction cost, excessive volatility and irregular capital flows with regard to currency. In order to decrease these obstacles, policy cooperation is necessary as a package which combines macroeconomic policies (including monetary, currency and international balance) with growth policies through liberalization of trade and investment and structural reforms of each economy.

Recommendations:

- **Avoid financial transaction tax and its negative impact on financial integration and coherence by regulatory reform.**
- **Promote and establish methodologies for macroeconomic policy cooperation and coordination, liberalization of trade and investment and growth strategies with structural reform as a package in light of their complementary nature at G20.**
- **Invent methodologies and mechanisms to monitor and control excess volatility of exchange rate and capital flow in the APEC region.**

ANNEX TO THE 2011 ABAC REPORT TO THE APEC FINANCE MINISTERS

2011 REPORT ON CAPACITY-BUILDING MEASURES TO STRENGTHEN AND DEVELOP FINANCIAL SYSTEMS

Table of Contents

<i>SUMMARY OF RECOMMENDATIONS</i>	I
INTRODUCTION	1
I. EXPANDING ACCESS TO FINANCE FOR LOW-INCOME HOUSEHOLDS AND MICRO-, SMALL AND MEDIUM ENTERPRISES	2
II. PROMOTING PRIVATE INVESTMENT IN INFRASTRUCTURE	5
III. ADVANCING FINANCIAL INTEGRATION AND COOPERATION IN THE ASIA-PACIFIC REGION	6

**THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM
CAPACITY-BUILDING**

**2011 REPORT ON CAPACITY-BUILDING
MEASURES TO STRENGTHEN AND DEVELOP
FINANCIAL SYSTEMS**

Summary of Recommendations

This year, the Advisory Group continues to build on its previous work focused on promoting greater financial inclusion, expanding private investment in infrastructure, and strengthening regional financial cooperation and integration. As a platform for collaboration among key international institutions, public agencies, and the private sector led by the APEC Business Advisory Council (ABAC), the Advisory Group convened and promoted discussions among key institutions and organizations this year. The results of these discussions are reflected in the following conclusions and recommendations.

Expanding Access to Finance for Low-Income Households and Micro-, Small and Medium Enterprises. Addressing the needs of many people living in poverty and promoting the growth of enterprises in the Asia-Pacific region through improved access to finance remains a major challenge. With growing constraints on public resources in the wake of the recent crisis, mobilizing private resources to serve financial needs of low-income households and small enterprises has become ever more important. The Advisory Group sees the need for public and private sectors and institutions to collaborate more closely and coordinate their efforts and to identify and focus their efforts on areas that address specific needs of APEC member economies, activities that effectively harness APEC's strengths, and issues that promote APEC's broader goal of regional economic integration.

- *The Advisory Group urges APEC member economies, relevant institutions and the private sector to closely coordinate their activities under the APEC Financial Inclusion Initiative, and to discuss how APEC can provide a robust regional platform to help expand the availability of credit to micro-enterprises and low-income consumers on a sound and sustainable basis, more widely mobilize grassroots savings, and more effectively harness remittances within the region to facilitate financial inclusion.*
- *The Advisory Group calls on APEC to intensify and broaden capacity building activities to assist key officials and regulators in undertaking legal, policy and regulatory reforms to develop properly structured credit information sharing systems and improve the legal architecture for secured lending, including rules for filing and perfecting security interests in collateral, ease of diligence and completeness of lien registries, as well as rules governing licensing and market access that will facilitate the flow of credit to small enterprises.*
- *The Advisory Group recommends that APEC undertake a policy dialogue involving relevant government agencies, international institutions and the private sector to examine best practices in facilitating the development of venture capital, including the use of public resources and tax policy to effectively mobilize private investment in*

venture capital funds and the promotion of an environment that is conducive to innovation.

Promoting Private Investment in Infrastructure. In the context of the region's exponentially growing need for infrastructure and the limited resources available in the public sector and multilateral institutions, an enabling environment to channel more private capital into infrastructure is becoming ever more important. Noting that these challenges could be effectively met through closer collaboration among the public and the private sectors and MDBs, the Advisory Group recommended that APEC launch a regional infrastructure partnership involving all of them. Through the Advisory Group, ABAC has formed a private sector panel and arranged initial *Asia-Pacific Infrastructure Partnership (APIP) Dialogues* in 2011 with several APEC member economies in Asia and Latin America. These dialogues, which are tailored to the specific needs and priorities of member economies, are designed to complement other initiatives within and outside the APEC framework.

- *The Advisory Group calls on APEC to support the Asia-Pacific Infrastructure Partnership (APIP) Dialogues and encourage member economies and the private sector to continue and further expand these dialogues in 2012 onward.*
- *The Advisory Group calls on APEC to develop a benchmarking index to assess the capacity of Asian member economies to carry out sustainable infrastructure PPPs, building on the Infrascopes index developed for Latin American economies by the Economist Intelligence Unit with the support of the Inter-American Development Bank.*

Advancing Financial Integration and Cooperation in the Asia-Pacific Region. There is need for a more robust discussion of regional integration, including its scope and meaning for the region. A regional regulatory forum is needed to improve collaboration among financial market regulators within the region and to achieve the much needed redesign of oversight of financial markets, in view of increasing financial integration and the huge potential of rapidly growing Asian economies. The Advisory Group believes that APEC, with the involvement of the private sector, key international institutions and systemically important economies and financial centers in the region, can provide an excellent platform for advancing regional financial cooperation and integration. APEC also has an opportunity to make a significant contribution to regional financial integration through a pathfinder initiative building upon the Asia Region Funds Management Passport currently being discussed under the APEC Finance Ministers' Process.

- *The Advisory Group calls on APEC to initiate discussions to establish a regional financial forum that will include all relevant financial market regulators and institutions playing key roles in financial policy in member economies. The task of such a forum would be to redesign the oversight of financial markets, for the purpose of enabling member economies to more effectively capture the benefits of growing financial integration and rapid economic growth in the region.*
- *The Advisory Group recommends that APEC economies that are able to meaningfully participate in a regional funds management passport regime join together to advance the work of the APEC Finance Ministers' Process on this issue through a pathfinder initiative. This initiative should be pursued in conjunction with capacity building programs on cross-border recognition of equivalent regulatory regimes for issuing and trading financial products and services for developing APEC member economies, with a view to these economies joining the pathfinder initiative once they are ready to do so.*

**THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM
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In last year's report, the Advisory Group underscored the uncertainties surrounding the sustainability of the global economic recovery following the recent financial crisis. The report cited persistently high unemployment, unresolved problems in banking systems and rising sovereign risks in advanced economies as factors abetting continued financial market turbulence, with the latter also limiting the scope for further public stimulus. The Advisory Group noted that, lacking clear signs of sustained recovery in private demand in these advanced markets, the global economy stands to enter another difficult period, once the effects of stimulus packages have run their course.

Recent developments have confirmed the correctness of this analysis, and the events unfolding in Europe and the US as this report is being completed underscore the importance of addressing the fundamental causes of global economic imbalances. These internal and external imbalances in advanced and developing economies have driven unprecedented growth prior to the crisis and resulted in the build-up of huge productive capacities. As the report pointed out, the region faces the challenge of how to revive demand to preserve these capacities and prevent the significant economic and financial dislocations that would arise were these to be scaled down.

The Advisory Group has postulated that mitigating such painful adjustments would require expanding the world economy's growth potential, particularly through increased consumption in emerging markets. APEC can significantly contribute to this effort through the promotion of conditions in developing member economies to accelerate the movement of labor from low-productivity to high-productivity sectors and to spur the rapid growth of domestic private demand, paving the way for the emergence of a new engine for global economic growth.

Echoing its reports from previous years, the Advisory Group maintains that there is considerable potential for domestic demand-led growth in these developing member economies. Harnessing this potential, however, requires action to address constraints to the growth of domestic consumption and investment. These include, among others, the lack of access to finance of small enterprises and of the large low-income segment of the population, policy environments that hinder expanded private investment in infrastructure, and underdeveloped financial markets, especially those for long-term local currency financing. Underpinning these are financial regulatory systems and policies that need to be improved and updated through capacity-building.

This year, the Advisory Group continues to build on its previous work focused on financial sector solutions to these issues. As a platform for collaboration among key international institutions, public agencies, and the private sector led by the APEC Business Advisory Council (ABAC), the Advisory Group presents its proposals in this report, which is divided into three major sections: (a) expanding access to finance for low-income households and micro-, small and medium enterprises; (b) expanding private investment in infrastructure; and (c) strengthening regional financial cooperation and integration.

I. EXPANDING ACCESS TO FINANCE FOR LOW-INCOME HOUSEHOLDS AND MICRO-, SMALL AND MEDIUM ENTERPRISES

Addressing the needs of many people living in poverty and promoting the growth of enterprises in the Asia-Pacific region through improved access to finance remains a major challenge. With growing constraints on public resources in the wake of the recent crisis, mobilizing private resources to serve financial needs of low-income households and small enterprises has become ever more important. Stronger, more balanced and more inclusive growth also requires efforts to further expand financial access through new channels, while addressing the key obstacles small enterprises face in accessing traditional sources of finance.

The Advisory Group notes the various efforts being undertaken in the region to promote greater financial inclusion, in particular the following:

- The APEC Financial Inclusion Initiative, which was proposed by the Advisory Group and included by ABAC in its 2009 and 2010 reports, was launched by the APEC Finance Ministers at their meeting in Kyoto in November 2010. APEC senior finance officials have started work on the Initiative with an inaugural workshop in San Francisco in February 2011 and a follow-up workshop in Bangkok in July 2011. This work has focused on (a) the design of a framework to guide the development of government leadership strategies; (b) testing new globally consistent methods to gather financial inclusion data; and (c) advancing the adoption of financial inclusion-friendly government-to-person (G2P) payment systems.
- Promoting SMEs' access to credit is also very much part of the work being undertaken under the APEC Leaders' Growth Strategy. Ease of Getting Credit is a sub-priority area under Ease of Doing Business (EoDB), which in turn is one of the five priority areas under the structural agenda of APEC for 2011-2015. Building on the work done in 2010 that was focused on seminars and workshops to share information and experiences, efforts from 2011 onwards are focused on in-depth diagnostics, customized action plans and follow-up. APEC is seeking to identify tailor-made approaches for member economies and offer capacity building activities, information-sharing workshops and technical experts to help economies introduce financing facilities for movable collateral, including inventories, and to improve credit information.
- The Asia-Pacific Financial Inclusion Forum, with the theme "Expanding Financial Access through Regional Public-Private Cooperation," is a collaborative undertaking by Advisory Group partner institutions hosted by the Asian Development Bank Institute in Tokyo in September 2011,¹ following up on the first APEC Financial Inclusion Forum organized by the Advisory Group in May 2010 in Sapporo. The Forum has been designed to focus on expanding new channels to serve the financial needs of the unbanked and addressing two key issues for expanding credit to micro-, small and medium enterprises – credit information and legal frameworks for secured lending.
- The regional symposium "Financial Inclusion: Regulations to Support MSME Financing Availability," held in Manila in June 2011,² focused on regional and global concerns, challenges and opportunities for MSME finance, as well as on the promotion of regulatory and supervisory environments that would help increase the flow of funds to these enterprises through banking systems and capital markets.

¹ The convenors are led by ABAC and the Asian Development Bank Institute (ADBI), and include the Asia-Pacific Credit Coalition/PERC, the Asia-Pacific Finance and Development Center (AFDC), the Banking with the Poor Network (BWTP), the Foundation for Development Cooperation (FDC), the Institute for International Monetary Affairs (IIMA) and the Organisation for Economic Co-operation and Development (OECD).

² This was jointly convened by the Australian APEC Study Centre at RMIT University and the Association of Development Financing Institutions in Asia and the Pacific (ADFIAP).

- The ADBI-AFDC-ABAC International Seminar on Financial Inclusion was held in Urumqi, China in July 2011. This focused on the problems and prospects of financial inclusion in the region, rural finance, balanced regulatory and legal systems to encourage the expansion and self-sustainability of microfinance institutions (MFIs) and protect consumers' rights, innovation and service diversification to promote self-sustainability of MFIs, and Islamic microfinance.

Following are key points arising from relevant discussions that the Advisory Group wishes to highlight:

- To effectively promote financial inclusion, it is important to clearly demarcate measures aimed at promoting the financing of small and medium enterprises from those aimed at mobilizing micro-savings to promote microfinance for households and micro-enterprises. Financial inclusion should also focus on expanding access of the financially excluded to all manner of financial services relevant to their lives.
- Multilateral development banks (MDBs), export credit and investment insurance agencies and similar institutions can collaborate with banks, firms and communities to offer affordable loans to low-income consumers and expand financing for micro- and small enterprises in developing economies. To support the expansion of such undertakings, it is important to identify measures to promote sustainability, including measures related to credit information, financial literacy and consumer protection, among others.
- Deposits offer low-income households many benefits and enable MFIs to reduce their vulnerability to external shocks. There is great potential for micro-savings, which has proven to be commercially viable with the introduction of innovative approaches and technology. Actualizing this potential will involve identifying the roles that the private sector, government, regulators, apex institutions and technical and development assistance can effectively play in promoting micro-savings in developing economies. Key issues include policies and regulations, capacity building for MFIs and financial education of low-income consumers.
- Remittances are vital to many economies, and their importance will grow as regional integration advances. Increased financial access both for migrants and remittance recipients (including services such as housing or business loans linked to remittances), measures and innovations to facilitate settlement, and technology (e.g., mobile technologies, prepaid cards) can significantly expand financial inclusion. It is important for the private sector, government and regulators to discuss how they can collaborate to facilitate innovative business models and address key issues, including transparency, consumer protection, payment system infrastructure, legal and regulatory environment and risk management, among others.
- Throughout the region, regulators are concerned with balancing two important policy goals – ensuring an adequate supply of credit to foster financial inclusion while preventing excesses that could endanger the longer term strength of financial institutions. Modern full-file credit information systems involving full-file and comprehensive credit reporting are key to achieving this balance. The development of these systems must also include adequate frameworks for protection of consumers' and enterprises' financial information, the ownership and structure of credit bureaus, and how the use of information can best be turned toward encouraging the responsible extension and use of credit.
- The importance of securing small businesses' access to financing and reforming lending systems to achieve that goal is widely recognized in both the public and private sectors. One of the most significant areas requiring reform is the legal rules around secured lending.

There is a great need to further explore regional best practices and opportunities in reforming the legal architecture around secured lending, most particularly the rules for filing and perfecting security interests in collateral, ease of diligence and completeness of lien registries, which are all important for making more credit available on reasonable terms to small businesses. The role of licensing and market access in facilitating credit also needs to be further explored.

- In addition to capital, small enterprises need expertise, connections and assistance to develop their skills. Venture capital, which has enabled many small enterprises in developed markets to meet these needs, can play an important role in expanding access to finance. Experiences in APEC economies, such as in Canada, where public entities have invested in venture capital funds, fund of funds, and international venture capital funds looking to invest in the economy, supported by investment tax credits for angel and corporate investors and a favorable environment for the movement of innovative ideas among universities, government laboratories and businesses, can provide valuable lessons for policy makers in the region.

As APEC begins to roll out its financial inclusion initiative, the Advisory Group sees the need for public and private sectors and institutions engaged in promoting financial inclusion to collaborate more closely and coordinate their efforts among themselves and with other international bodies such as the G20, in order to ensure that resources are used efficiently. They should also identify and focus their efforts on areas that address specific needs of APEC member economies, activities that effectively harness APEC's strengths, and issues that promote APEC's broader goal of regional economic integration.

The Advisory Group urges APEC member economies, relevant institutions and the private sector to closely coordinate their activities under the APEC Financial Inclusion Initiative, and to discuss how APEC can provide a robust regional platform to help expand the availability of credit to micro-enterprises and low-income consumers on a sound and sustainable basis, more widely mobilize grassroots savings, and more effectively harness remittances within the region to facilitate financial inclusion.

The Advisory Group calls on APEC to intensify and broaden capacity building activities to assist key officials and regulators in undertaking legal, policy and regulatory reforms to develop properly structured credit information sharing systems and improve the legal architecture for secured lending, including rules for filing and perfecting security interests in collateral, ease of diligence and completeness of lien registries, as well as rules governing licensing and market access that will facilitate the flow of credit to small enterprises.

The Advisory Group recommends that APEC undertake a policy dialogue involving relevant government agencies, international institutions and the private sector to examine best practices in facilitating the development of venture capital, including the use of public resources and tax policy to effectively mobilize private investment in venture capital funds and the promotion of an environment that is conducive to innovation.

II. PROMOTING PRIVATE INVESTMENT IN INFRASTRUCTURE

The Advisory Group has noted in its previous reports that financing infrastructure, which developing economies need to maintain a healthy pace of economic growth, is a major challenge for the region. Key underlying issues remain to be addressed, including information asymmetries

among the public sector and the various private players involved in infrastructure public-private partnerships (PPP) and the lack of broad and deep capital markets needed for financing infrastructure projects. In the context of the region's exponentially growing need for infrastructure and the limited resources available in the public sector and multilateral institutions, an enabling environment to channel more private capital into infrastructure is becoming ever more important.

Noting that these challenges could be effectively met through closer collaboration among the public and the private sectors and MDBs, the Advisory Group recommended that APEC launch a regional infrastructure partnership. This proposal was further discussed at a forum jointly convened by ABAC, the Asian Development Bank (ADB) and Japan Bank for International Cooperation (JBIC), in collaboration with the Ministry of Finance of Japan.³ The forum yielded the following key messages:

- Despite recent improvements in infrastructure-related policies, key constraints impeding private investment remain – lack of capital market depth, dearth of good quality projects, inadequate regulatory frameworks and concerns about transparency and political, country, exchange and interest rate risk.
- Given the complexity of infrastructure PPPs, overcoming these constraints requires improved understanding and greater trust among relevant parties involved. Structures enabling parties to frankly and objectively discuss and consider complex matters facing each economy can contribute to better understanding of the issues and risks they face.

Building on these discussions, the Advisory Group advanced the concept of the Asia-Pacific Infrastructure Partnership Dialogues. The Advisory Group sees the role of these dialogues as twofold.

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

These dialogues would involve key high-level officials who play important roles in shaping the environment for infrastructure PPP in their respective economies, a panel of senior private sector experts from a wide range of fields relevant to infrastructure PPP and experts from MDBs. Through the Advisory Group, ABAC has formed the private sector panel and arranged initial dialogues in 2011 with several APEC member economies in Asia and Latin America based on this model, where the agenda of discussions are tailored to the specific needs and priorities of member economies.

These dialogues are designed to complement other initiatives that have been or are being undertaken under the APEC Finance Ministers' Process, in particular the recent workshop on *Framework and Options for Public and Private Financing of Infrastructure* held in Washington DC on 23-24 June 2011, the APEC pilot mentoring scheme and the World Bank-Singapore Infrastructure Finance Summit, as well as other initiatives in the region outside the APEC framework such as those being undertaken by the ADB and the Inter-American Development Bank (IADB).

³ This was the Private Infrastructure Finance Forum convened on 7 November 2010 in Yokohama, Japan by the APEC Business Advisory Council (ABAC), Asian Development Bank (ADB) and Japan Bank for International Cooperation (JBIC), in collaboration with the Ministry of Finance, Japan.

The Advisory Group calls on APEC to support the Asia-Pacific Infrastructure Partnership (APIP) Dialogues and encourage member economies and the private sector to continue and further expand these dialogues in 2012 onward.

The Advisory Group calls on APEC to develop a benchmarking index to assess the capacity of Asian member economies to carry out sustainable infrastructure PPPs, building on the Infrascopes index developed for Latin American economies by the Economist Intelligence Unit with the support of the Inter-American Development Bank.

III. ADVANCING FINANCIAL INTEGRATION AND COOPERATION IN THE ASIA-PACIFIC REGION

In previous years, the Advisory Group has undertaken considerable work on the development of the region's capital markets, with special focus on the development and integration of the region's local currency bond markets. In 2010, noting the significant progress that has been made under the work of APEC, the ASEAN Plus Three and the Executives Meeting of East Asia Pacific Central Banks (EMEAP) – particularly the Asian Bond Market Initiative and the Asian Bond Fund – the Advisory Group compiled a proposal for a package of measures to bring the development of the region's financial markets to the next level.

This package included (a) development of wholesale securities markets exclusively for professional investors; (b) regional public-private sector collaboration mechanisms to reduce barriers to cross-border settlement; (c) use of foreign securities as eligible collateral throughout the region; (d) ways to accelerate the region-wide convergence of accounting standards, disclosure regimes and corporate governance practices; and (e) establishment of a pathfinder initiative to introduce a regional funds passport scheme.

A number of domestic, bilateral and regional initiatives are currently under way toward the implementation of these recommendations in the region. Among these are discussions involving some of the region's monetary authorities regarding the use of government bonds as cross-border collateral, the work of the ASEAN Plus Three on reducing barriers to cross-border settlement, and the initiation of work on an Asia Region Funds Management Passport under the APEC Finance Ministers' Process.

The Advisory Group notes the various discussions that have been undertaken this year on how to promote regional financial cooperation and integration, in particular the following:

- The annual dialogue among financial regulators in the region, multilateral institutions and international regulators, and the region's financial industry was organized by several collaborating institutions in the Advisory Group. Over the past seven years, these dialogues have been held back-to-back with the annual meetings of the South East Asian Central Banks (SEACEN) member institutions' directors of bank supervision. This year's dialogue took place in Colombo, Sri Lanka on 5-6 July 2011. The dialogue focused on regulatory issues revolving around global financial regulatory reforms, Basel III, the role of supervision and corporate governance in promoting sound risk management, and regional integration and cooperation.
- A regional symposium on enhancing financial policy and regulatory cooperation was convened on 8-9 March 2011 in Melbourne by the Australian APEC Study Centre at RMIT University. The symposium discussed reform developments and unresolved issues in the region, the impact of reforms, challenges for the region's emerging markets and capacity building.

- In 2010, discussions began under the auspices of the APEC Finance Ministers' Process on the Asia Region Funds Management Passport initiative. Officials met in Hong Kong on 15-16 March 2011 to further progress this work in a policy/technical workshop. A number of players from the funds management industry attended the workshop and dialogue with finance regulators and officials with the aim of seeking their views and input into the proposed design and development of a pilot ARFMP. Another related project being undertaken is a follow-up capacity building program on cross-border recognition of equivalent regulatory regimes for issuing and trading financial products and services for developing APEC member economies in Southeast Asia. The Advisory Group organized briefings for officials and private sector market participants in Tokyo on 4 March 2011 (hosted by the Institute for International Monetary Affairs) and in Seoul on 27 April 2011 (hosted by ABAC Korea).

The Advisory Group notes the following key points arising from these discussions:

- There is need for a more robust discussion of regional integration, including its scope and meaning for the region, which may involve discussion of monetary policy issues such as capital flows, as well as macro-prudential regulation. A regional regulatory forum is needed to improve collaboration among financial market regulators within the region and to achieve the much needed redesign of oversight of financial markets, in view of increasing financial integration and the huge potential of rapidly growing Asian economies.
- Consensus has been reached on financial reforms and reforms aimed at increasing capital adequacy, improving liquidity and containing leverage. However, even though these reforms are focused mainly on advanced economies, a number of issues remain even in these markets, including those related to surveillance, peer reviews of imbalances and governance of international financial institutions. There are also divergent interests between advanced and emerging economies within the G20, including in areas such as surveillance and resolution of globally systemically important financial institutions, the development and coordination of regional and international safety nets, the role of a regional financial system authority vis-à-vis the IMF, and the reforms of the IMF's mission and governance.
- There is a general view that significant increases in capital requirements for banks or financial systems that came through the financial crisis are reasonable. Increases of such magnitude have already been made through requirements for Tier 1 capital. Banks' shareholders will face lower returns. Over the next two years, the refinancing of bank debt is expected to raise prospects of material balance sheet and financial stability risks. Investment banks are expected to see their core business lines, particularly trading and securitization, profoundly impacted, with those having substantial capital market and trading businesses likely to face significant challenges to their business models. A fundamental change that is expected to be brought about by increased capital charges is a fall in banks' return on earnings.
- Challenges for the region's emerging markets include implementing Basel III, enhancing macro-prudential frameworks, increasing support for liquidity measures in the region, broadening market infrastructure and expanding financial inclusion. Further work is required in consumer and insurance protection, classification of investment products and mark-to-market valuation. Emerging Asian economies are also dealing with volatile capital flows, limited capacity of local currency capital markets, the need to broaden the investor base across the region and improving access to finance by SMEs. There is a need to strengthen regional policy dialogue on macro-economic and financial conditions and to forge greater regional policy coordination. In addition, the region's interests need to be more

fully reflected in global-level efforts to reshape the financial regulatory and supervisory environment.

- There is need for sharing experiences to develop all layers of crisis management at various levels. Competence and skills as well as knowledge of the different sectors that compose the financial system and their functioning are needed to support ongoing surveillance and management of emerging risks. More work is needed on a wide range of subject areas, requiring specialist inputs as economies and agencies in the region seek to strengthen institutions and systems to minimize the likelihood and impact of future crises.
- APEC has an opportunity to make a significant contribution to regional financial integration through a pathfinder initiative building upon the Asia Region Funds Management Passport currently being discussed under the APEC Finance Ministers' Process. In this context, it is important to consider the following:
 - The time has come for an Asian funds vehicle. There is as yet no cross-border fund vehicle in the region and very limited cross-border recognition of products. Currently, it is easier in Asia to market a UCITS⁴ product regulated in Europe (particularly those domiciled in Luxembourg and Ireland) than a product originating from the region. Penetration of UCITS products in some Asian markets indicates that fund passporting can work if regulators are comfortable. Lack of penetration of such products in other Asian markets suggests the need for an alternative to UCITS to unlock regional funds. An Asian funds passport scheme would encourage regulators to increase cross-border recognition of regional products.
 - An Asian funds passport scheme could bring various benefits for the region. These benefits include development of capital markets, development of domestic financial services sectors, access to a broader range of products, better returns, reduced concentration risk and reduced costs of product manufacturing and investment. Such a scheme would enable Asian regulators to shape regulations surrounding Asian funds, assist regional managers in tapping into funds from Europe and the US, and create a regional brand that is more marketable than individual economy brands.
 - Key challenges are political, regulatory, currency, tax and technical issues. The political challenge is in convincing individual jurisdictions that the benefits are greater compared to any perceived threat to domestic interests. The regulatory challenge is how to overcome differences in regulation in each jurisdiction. The currency challenge is the lack of free convertibility, the lack of a unified currency and the widespread use of the US dollar. The tax challenge is in agreeing to treatment of foreign investors and amending tax regulations multilaterally or, potentially, implementing unilateral measures to avoid a jurisdiction becoming uncompetitive in the Asian market place. The technical challenge is how to offer something that is not being offered by UCITS and how to create incentives for establishing the product.
 - Current economic and political trends are favorable to an Asian funds passport scheme. There is growing support for the idea among governments and the industry due to a number of reasons. More developed capital markets enable more economies to benefit.

⁴ First proposed in 1976, the Undertakings for Collective Investment in Transferable Securities (UCITS) became a reality through the first UCITS Directive (UCITS I) of the European Commission in 1985. Once authorized as UCITS qualified by one participating economy under the harmonized legislative framework, a product can then be sold to retail investors in all participating economies without need for further authorization. Since 1985, the European Commission has amended the scheme by issuing several directives: a draft UCITS II directive (eventually abandoned during the 1990s), UCITS III (2003) and, now, UCITS IV. With the improvements introduced by UCITS III, UCITS funds achieved tremendous growth and expanded their geographical coverage.

Higher degree of regulatory convergence and increased regional financial cooperation will make it easier to reach agreement. Regional assets under management will soon reach critical mass. Greater interest in strengthening local capital markets and cross-border flows predispose more officials to accept the scheme. Desire to improve returns and to access a greater range of products encourages growing private sector support. EU and US investors are becoming more interested in tapping into the region.

- ❑ Asia can learn valuable lessons from the experiences of UCITS and PAIF. UCITS has demonstrated the benefits that economies can gain through funds passporting. The ABF Pan Asia Bond Index Fund (PAIF), which is a prototype of funds passporting in Asia, is the only regionally domiciled large fund offering that can be offered across many Asian jurisdictions. PAIF indicates that success can be attained if regulators cooperate to overcome regulatory and administrative barriers and that cooperation is possible when governments are motivated to act together.
- ❑ The way forward is to begin with simple steps and a core group of pathfinders. Since it is difficult to achieve agreement among all markets in the region all at once, a good way forward is to begin with mutual recognition of a regional funds product by a few jurisdictions, using the US dollar for fund settlement but offering local currency products. Products should be kept simple and limited to traditional asset classes at the beginning. Asia could follow the UCITS model (introducing a separate new regional set of regulations) instead of meshing existing regulations of individual jurisdictions. Eventually, after the vehicle becomes more established, other jurisdictions could be encouraged to join. For the longer term, a link between the regional passport regime and UCITS could be examined.

The Advisory Group believes that APEC can provide an excellent platform for advancing regional financial cooperation and integration. One important factor in this regard is the active and sustained involvement of the private sector, particularly through ABAC, in the APEC process, to a much greater extent than in other international bodies. APEC, particularly the Finance Ministers' Process, also involves key international institutions such as the Asian Development Bank, the IMF and the World Bank. Finally, APEC includes all the systemically important economies and financial centers in the Asia-Pacific region.

The Advisory Group calls on APEC to initiate discussions to establish a regional financial forum that will include all relevant financial market regulators and institutions playing key roles in financial policy in member economies. The task of such a forum would be to redesign the oversight of financial markets, for the purpose of enabling member economies to more effectively capture the benefits of growing financial integration and rapid economic growth in the region.

The Advisory Group recommends that APEC economies that are able to meaningfully participate in a regional funds management passport regime join together to advance the work of the APEC Finance Ministers' Process on this issue through a pathfinder initiative. This initiative should be pursued in conjunction with capacity building programs on cross-border recognition of equivalent regulatory regimes for issuing and trading financial products and services for developing APEC member economies, with a view to these economies joining the pathfinder initiative once they are ready to do so.