

ISSUES

PACIFIC ECONOMIC COOPERATION COUNCIL



Policy Agenda for Financial Stability and Development in the Asia-Pacific

PECC Recommendations to the
APEC Finance Ministers

PECC Finance Forum's Recommendations to the 9th APEC Finance Ministers' Meeting Los Cabos, Mexico, September 5-6, 2002

Background

The PECC Finance Forum was created in 2001 to carry out two tasks: first, to assist in promoting financial liberalization and strengthening financial markets and institutions in the region and second, to contribute to regional financial and monetary cooperation. The Forum draws its members from among the financial policy experts of APEC and other PECC economies. These members are assisted by experts invited from major international financial organizations. The Forum convened its first conference in Honolulu on August 12-13, 2002, to discuss the prospects for regional financial cooperation as well as current policy challenges in those two areas on the basis of country surveys undertaken by the Forum's two task forces as well as papers contributed by individual experts. The forty or so participants in this conference are listed at the end of this report. Also listed are the papers contributed by experts. These papers as well as other background materials may be found on the PECC Finance Forum website, <http://www.pecc.net/finance/conference-papers.htm>.

The participants in the conference have formulated a number of specific recommendations to APEC Finance Ministers from these discussions, and submitted them to the 9th APEC Finance Ministers' Meeting held in Los Cabos, Mexico, on September 5-6, 2002. The following is the main text of the report:

Global context and the critical role of APEC

We, the participants in the first conference of the PECC Finance Forum, believe that the APEC Finance Ministers' ongoing focus on financial reform in the region should take on new urgency in light of recent major corporate failures and their implications for confidence, and in light of deteriorating outlook for the global economy. These concerns present two key risks. The first is the danger of exacerbating financial fragility in the APEC region; and the second is the danger of resurgent protectionist pressures in major world markets.

APEC is the key regional forum to counteract these trends. Two of the world's largest economies actively participate, as do many of the world's most dynamic emerging market economies. And all of its member economies share these concerns. APEC is committed to free and open trade and investment in the region -- a commitment that should be reaffirmed. The APEC support is critical for the regional cooperative arrangements emerging in East Asia to help economies in this sub-region overcome their financial vulnerabilities.

Six Policy Recommendations

We recommend that the continuing work of the APEC Finance Ministers to address the concerns over the financial fragility of the regional economies include their appropriate and prompt actions in the following six areas:

- *First, address continued risks of volatile global capital flows;*
- *Second, renew leadership to improve corporate governance;*
- *Third, implement Basel II, the new BIS Capital Accord, but be aware of its potential impacts on emerging markets;*
- *Fourth, focus capacity-building programs on risk management by banks;*
- *Fifth, support building regional financial arrangements; and,*
- *Sixth, support increasing the IMF quotas for Asian economies.*

Addressing global capital flows

We recommend the APEC Finance Ministers to give further attention to *the supply side of the capital markets, that is, creditors;*

- International capital flows are intermediated by a small number of very large financial institutions located in some of the G-10 economies;
- More attention should be paid to correcting flaws in the incentive structures for these suppliers of capital, for example, to the need to facilitate greater private sector involvement in prevention and resolution of financial crises;
- Concerning highly-leveraged institutions, the perception persists in Asia that implementation of recommendations to contain the excesses of these institutions has been slow, including the recommendations for better disclosure and transparency of their activities.

Since the 1997-98 Asian financial crisis, extensive work has been undertaken in global and regional institutions and forums to apply the lessons learned. Many lessons were drawn for the debtors in emerging market economies on the "demand side" of international capital flows. Our work assists in implementing those lessons. Other lessons have been drawn for creditors on the "supply side" of international capital that is intermediated by a small number of very large financial institutions located mainly in some of the G-10 economies. We recommend that APEC Finance Ministers scrutinize more closely whether adequate official attention has been paid to correcting flaws in the incentive structures for these suppliers of capital. For example, there still remains the need to facilitate greater private sector involvement in prevention and resolution of financial crises.

One of the areas of particular concern to emerging market economies is the role played by highly-leveraged institutions such as hedge funds in destabilizing speculation. We believe that Finance Ministers should consider the perception that following through on recommendations to contain the excesses of these institutions has been rather slow, including on those for better disclosure and transparency of their activities.

Improving corporate governance

We believe that there is an urgent need for improved governance standards for both borrowers and lenders in the international markets, as well as for publicly-held corporations;

- APEC should renew and deepen its dialogue on this issue;
- Reforms to promote transparency, better market monitoring, and improved corporate governance should be carried through in the G-10 economies as well;
- As to the emerging market economies, particular attention should be paid to the corporate governance of their financial institutions, both banks and non-banks;
- APEC should strengthen its support for the work of the Financial Stability Forum to evaluate existing codes, standards, and rules.

The deteriorating outlook for the world economy serves to underline the urgent need for good governance by both borrowers and lenders in international capital markets as well as by corporations with public share-holding structures. Recent financial crises and corporate fraud not only in emerging markets but also in major markets suggests that Finance Ministers should return their attention to this issue. The APEC dialogue on this issue should be pursued with renewed urgency. Indeed, our discussions of risk management practices by banks and banking regulators in East Asia underlines the need for particular attention to the financial sector. Reforms to promote transparency, better market monitoring and corporate governance of financial and non-financial corporations need to be pushed forward in the G-10 economies as well as the emerging market economies. In particular, the Financial Stability Forum's mandate to evaluate existing codes, standards and rules should be accorded added weight. And APEC Finance Ministers may find *the PECC Guidelines for Good Corporate Governance* useful in this regard.

The potential impacts of Basel II

We recommend the implementation the new BIS Capital Accord. At the same time, we invite attention to some issues of concern it raises to banks and their regulators in emerging markets:

- The new capital requirements for credit risk will impact on the local practice of using real estate as collateral for loans;
- Treatment of home mortgages with no recognition given to commercial real estate may “tilt” credit away from business loans;
- Complexity of Basel II poses serious implementation challenge to emerging market economies.

The Finance Forum has studied the recent proposed revisions to the BIS Capital Adequacy Accord. Significant benefits could be gained from implementing Basel II, particularly through the use of improved risk management in banks and more efficient use of capital. There are, however, some issues of concern to banks and banking regulators in most of the regional economies. Financial systems in the region are bank-dominated. One concern, therefore, is that the revised rules might impose higher capital requirements for credit risk because of local practices including the use of real estate as collateral for business loans. A related concern is the improvement to the positive treatment proposed for home mortgages while no recognition is given to commercial real estate. This decision could “tilt” credit further away from business loans. Another concern is that the maturity of banking lending to emerging market economies could be shortened under the revised accord. While we recommend that the region’s banks adopt Basel II, Finance Ministers should be aware of these and other possible economic implications.

Focusing capacity building

Preliminary results from a Finance Forum survey indicate that risk management skills of domestic banks in the region are underdeveloped.

- We recommend a greater emphasis on training programs on corporate governance;
- The APEC Finance Ministers should give a specific focus in capacity building to models and techniques for risk evaluation and management by banks;
- They should also assist banks and bank regulators to prepare to meet Basel II requirements. They should do so by implementing the initiatives recommended by ABAC in coordination with international financial institutions.

Capacity building has been a traditional focus for APEC Finance Ministers. Our recent work and discussions indicate particular gaps on the "front lines", that is, among the banks themselves. Preliminary results of our survey of banks and bank regulators indicate that, even in the more advanced economies in the region, risk management skills and domestic banks are under-developed. We believe that Finance Ministers should assign a high priority to capacity building in banks with special emphasis on fostering sound risk management and corporate governance systems. APEC should give a specific focus for capacity building to models and techniques for risk evaluation and management by banks. We also recommend a greater emphasis on training programs on corporate governance.

We note that the complexity of Basel II poses an enormous implementation challenge to the emerging market economies, in particular. Assistance will thus be required to prepare the banking systems in these economies to meet Basel II requirements. Such assistance should be coordinated with the international financial institutions. We support the training initiatives that have been recommended by ABAC.

Building regional financial arrangements

We welcome the APEC Economic Leaders' support for the Chiang Mai Initiative and the Manila Framework Group initiative.

- A Finance Forum survey of country perspectives on this issue emphasizes the need for intensified efforts on surveillance;
- The initial focus of the surveillance processes should be on encouraging the strengthening of domestic financial systems, with emphasis on financial standards and regulatory practices;
- We also recommend more intensive work to identify and remove obstacles to integration of national equity and debt markets across East Asia.

We welcome Leaders' support at their Shanghai meeting for the Chiang Mai Initiative and the Manila Framework Group initiative. This support should be reaffirmed.

Our recent survey of regional financial arrangements underscores the desirability of intensifying regional surveillance processes. Strong domestic financial markets and institutions are the sine qua non for reduction of vulnerability to external shocks. Surveillance that encourages the strengthening of domestic financial systems with emphasis on financial standards and regulatory practices is an essential contribution to reducing vulnerability to external shocks. It also provides a basis for closer monetary cooperation in the future.

The Finance Forum also notes the need for financial analyses to identify and remove obstacles to the

integration of equity and debt markets across East Asia. APEC has launched work in this direction with a focus on the development of domestic debt markets. This work should continue and be strengthened, with its scope extending to equity markets, on the one hand, and to regional integration of those capital markets, on the other hand.

Revising IMF quotas

- There is continuing disparity between the economic as well as financial position of the Asian economies and their representation in the IMF.
- We recommend that the APEC Finance Ministers support implementation of the proposed revision of the IMF quota structure to increase quotas for Asian economies commensurate with their sizes and other relevant measures.

Forum discussions of strengthening regional financial arrangements took note of the continued disparity between the economic as well as financial position of the Asian economies and their representation in the International Monetary Fund. We recommend that APEC Finance Ministers support the proposed revision of the IMF quota structure that reflects more accurately the region's relative economic and financial position in the world economy.

Future Work of the Finance Forum

The forum will continue to:

- Assess the international environment for financial stability and development in the PECC/ APEC region;
- Assess progress in the promotion of financial reforms, integration and cooperation in the region;
- Develop the desired vision of regional financial and monetary cooperation for APEC;
- Pool the best insights and new thoughts of the relevant experts and practitioners from around the region and international organizations;
- Undertake survey-based studies on specific issues;
- Disseminate its findings and views through policy dialogue with the governments and the finance communities in the Asia-Pacific through PECC, APEC and other international forums in the region.

Appendix

Expert Papers Contributed to the Finance Forum Conference

Cho, Yoon Je, Sogang University, “Toward Stronger Financial Sector: Lessons from Korea’s Financial Restructuring after the Crisis”

Dobson, Wendy, University of Toronto, "The Case for Regional Financial and Monetary Cooperation in the PECC Economies"

Eichengreen, Barry, University of California Berkeley, “Whither Monetary and Financial Cooperation in Asia?”

Hayward, Peter, IMF, “Financial Restructuring in East Asia: the Remaining Challenges”

Henning, C. Randall, Institute for International Economics, “The Case for Regional Financial Cooperation in East Asia”

McCauley, Robert N., BIS, “Basel II and East Asian Economies”

Park, Yung Chul, Korea University, “Can East Asia Emulate European Economic Integration?”

Park, Yung Chul, Korea University, “Financial Liberalization and Economic Integration in East Asia”

Parreñas, Julius Caesar, Chinatrust Commercial Bank, “The New Basle Accord: Challenges for Asia’s Banks and Regulators”

Rana, Pradumna B., ADB, “Monetary and Financial Cooperation in East Asia: The Chiang Mai Initiative and Beyond”

Waller, Ken, Commonwealth Bank of Australia, “Risk Management and Pricing: Findings from the ABAC/PECC Symposium”

Wang, Haijun, China Cinda Asset Management Corporation, “Banking Reform in China: Non-Performing Loans Control and Disposal”

Witherell, William, OECD, “Strong Financial Systems: The OECD Approach and Its Relevance for Emerging Markets”



Participants in the First Conference, Finance Forum

Adams, Charles, IMF	Latiff, Salma, Brunei Darussalam
Akrasanee, Narongchai, Thailand	Lehmann, Sergio, Chile
Cha, Baekin, Korea	McCauley, Robert N., BIS
Chang, Rosita P., USA	Morrison, Charles, USA
Cheong, Latifah Merican, Malaysia	Ngiam, Kee Jin, Singapore
Cheung, Stephen Y. L., Hong Kong	Nitithanprapas, Ekniti, Thailand
Cho, Yoon Je, Korea	Park, Yung Chul, Korea
Chu, Tianshu, USA	Parreñas, Julius Caesar, Chinese Taipei
De Brouwer, Gordon, Australia	Parsons, David, PECC International Secretariat
Dietrich, J. Kimball, USA	Rana, Pradumna B., ADB
Dobson, Wendy, Canada	Rhee, S. Ghon, USA
Drobnick, Richard, USA	Rolfe, Jim, New Zealand
Eichengreen, Barry, USA	SaKong, Il, Korea
Han, Taejoon, Korea	Tian, Guoli, China
Hanson, James A., World Bank	Tsai, Jenny, Chinese Taipei
Hayward, Peter, IMF	Waller, Ken, ABAC
Henning, C. Randall, USA	Wang, Haijun, China
Hong, David S., Chinese Taipei	Wang, Yunjong, Korea
Ito, Takatoshi, Japan	Witherell, William, OECD
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