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SUMMARY RECORD OF

OECD-ADBI 15TH ROUNDTABLE ON CAPITAL MARKET

AND FINANCIAL REFORM IN ASIA

("TOKYO ROUNDTABLE")

11-12 MARCH 2015

TOKYO, JAPAN

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OECD-ADBI 15TH ROUNDTABLE ON CAPITAL MARKET AND FINANCIAL REFORM IN ASIA

Introduction and background

The Tokyo Roundtable was established in 1999 in the aftermath of the Asian financial crisis, and has provided an annual forum for high-level policy dialogue among OECD and Asian countries on topical issues of high interest from the viewpoint of capital market reform in Asia.

The 15th Tokyo Roundtable featured participation of high-level representatives from finance ministries/treasuries, central banks and securities regulatory bodies from 13 non-OECD economies in Asia, including China, Indonesia, Philippines, Thailand and other Asian countries (Bangladesh, Cambodia, Lao, Mongolia, Myanmar, Pakistan, and Vietnam) as well as several OECD member countries, namely Australia, Canada, France, Germany, Japan, Korea, Switzerland and Turkey.

Experts from the private sector and international organisations such as the ADB, BIS, the IMF and WB also participated. The Roundtable was held back-to-back with IOSCO's Asia-Pacific Regional Committee (APRC), enabling participants from this seminar to take part in the Roundtable.

Mr. Takahide Kiuchi, Member of the Monetary Policy Board, Bank of Japan, gave a keynote speech on the first day of the Roundtable.

11 MARCH 2014 (DAY 1)

Session 1: Developments and major challenges in the Asian financial markets

- ***Mr. Jaehong Suh, Director-General for International Cooperation, Korean Financial Services Commission,*** presented the current situation of the Korean Financial Market and measures it has taken in reponse to the 2008 financial crisis. The outflow of foreign capital, the increase in household debt and deterioration of firms' financial stability were addressed as challenges ahead. The importance of enhancing the regulatory framework and carrying out creditor-driven corporate restructuring was highlighted. It was observed that from Korea's experience of the global crises, reducing financial pro-cyclicality and active financial injection are effective measures. Several risks were highlighted, including a rise in the US Federal Reserve's policy rate, Eurozone recession, a slowdown of the Chinese economy, and uncertainty in the Middle East.
- ***Mr. Zeng Hui, Director, International Finance Division, People's Bank of China,*** addressed the fact that monetary policies, in the major advanced economies would bring uncertainty and spillovers to Asian economies. While capital inflows under quantitative easing (QE) have brought currency appreciation and asset inflation, normalisation will likely reverse such flows and their effects. It is important to maintain macroeconomic fundamentals through strengthened resilience in the financial sector against external shocks. At the same time, the major currency issuers need to control the pace of normalisation since premature normalisation may trigger unexpected adjustments. On the other hand, a delay could encourage risk appetite and cause risk accumulation. Domestic structural reforms, improving the monetary policy framework and strengthening macro prudential management, as well as enhancing the international monetary system, international liquidity monitoring and supervision, are all suggested policies for Asian countries. The role of China in terms of global stability and development was also stressed, demonstrated by its efforts to accelerate the liberalisation of interest rates and the move towards a market-based RMB exchange-rate mechanism as well as the upcoming introduction of a deposit insurance system.
- ***Mr. Muhammad Ali Malik, Director, Financial Markets and Reserve Management, State Bank of Pakistan,*** outlined the current situation of the banking sector and corporate debt financing in Pakistan. The lack of a corporate debt market, which stands at less than 1% of GDP, tends to lead to low-quality consumer financing. The absence of a corporate bond market makes it difficult to mobilise long-term investment. While a profitable and well-capitalised banking sector is developing, it is important to implement planned reforms as well as bring in investment for a strong economic performance.
- ***Mr. Dwityapoetra S. Besar, Deputy Director, Department of Macroprudential Policy, Bank Indonesia,*** discussed emerging market vulnerabilities, and challenges and prospects for Indonesia in light of the possibility of global liquidity increases in 2015. Further quantitative easing by the Fed, the European Central Bank (ECB) and the Bank of Japan (BoJ) could trigger additional capital inflows for emerging markets. As emerging markets are affected by external factors - such as QE by the ECB, commodity price drops including oil, the slow-down of China's economy and uncertainty of recovery in Greece - it is important to prevent potential vulnerabilities from being exacerbated. There is a need to have prudent macroeconomic policies to achieve financial stability especially for USD-denominated debts. Indonesia is taking measures on several domestic issues including the current

account deficit, deflation and weak economic growth as well as the impacts of global regulatory change and capital fluctuations. It is necessary to monitor and implement good policies taking into account the impact of the Fed's exit from tapering and devise an 'optimal' macroeconomic policy that mitigates volatility and credit risk in the capital market. Overall, Indonesia's economic outlook is favourable, but is dependent on movements of the oil price. The current government allocates more than 16% of its budget to infrastructure, which is its highest priority.

- ***Mr. Noritaka Akamatsu, Senior Advisor, Regional and Sustainable Development Department, ADB,*** observed how the borrowing of China's state-owned-enterprises (SOEs) would affect the overall outlook for China's public finances. The magnitude of China's shadow banking sector would be limited as long as this is part of "wealth management" by commercial banks and the practices are under the supervision of the China Banking Regulatory Commission (CBRC). Pakistan's efforts to implement Basel III, in particular the liquidity requirement, was mentioned as it may cause difficulties in the development of the corporate bond market. The Indonesian decision to increase infrastructure financing was welcomed.
- ***Ms. Visakha Amarasekere, Director, Department of External Resources, Ministry of Finance and Planning, Sri Lanka,*** expressed concern about the lack of capital market finance and bank lending in Sri Lanka which severely affects the development of SMEs, while access to Multilateral Development Banks (MDBs) resources and bilateral lending is decreasing. Even under the current low interest rate conditions, such financing is costly.

Discussion

A comment was made that the creation of a long-term bond market is needed to develop infrastructure without over-reliance on tax revenue. The establishment and development of pension funds and private insurers should be taken into account in Asia when considering capital market development. There were several questions and comments from the floor on the following topics: the background of the increased household debt in Korea, as well as the measures to maintain the stability of the market related to short-term borrowing and foreign currency borrowing; SME financing in Sri Lanka and Korea; structural reform of the financial sector in China; progress in the implementation of Basel III in Pakistan; and the increase of speculative capital inflows into Asia.

Session 2: International financial reforms after the global financial crisis: impact and implications for financial stability and sustainable economic growth

- ***Ms. Vanaporn Laksanasut, Head, Financial Markets Analysis and Development Division, Bank of Thailand,*** presented an overview of the implications for Asian countries affected by regulatory reforms. Thailand's Basel III implementation timeline for both capital requirement and liquidity requirement were outlined. Overall, the impact on Thailand's financial sector by the new regulatory regime is limited at this stage. For Asian economies, a tailored adaptation of the Basel III reforms is expected. As shadow banking may grow, the regulators should be ready to introduce adequate surveillance as well. Authorities should respond proactively to the implementation of new regulations and adequately inform financial institutions and other market participants of the change in regulations. For the Asian market, both "hard" and "soft" financial infrastructure development is required and should be given priority. "Soft" infrastructure are laws and regulations to limit arbitrage, avoid unintended effects or consequences, and ensure the smooth introduction of new regulations.

A deeper bond market would benefit alternative funding and more investment sources for the corporate sector, which is currently weighed towards the banking system and stock market.

- ***Mr. Shinichi Yoshikuni, Senior Managing Director, Mizuho Securities Research and Consulting Co,*** analysed the economic consequences of new financial regulations and the anticipated Basel IV. The question was raised whether non-bank international standard setters (IOSCO, IAIS) should follow Basel reforms in their areas of regulation. A premature exit from a loose monetary policy and strict implementation of new regulations may squeeze financing for the real economy. On the other hand, any delay in implementing the exit policy or unexpected loopholes for regulations may serve to cause financial bubbles.
- ***Mr. Michio Saito, Deputy Director-General, Planning and Coordination Bureau, FSA Japan,*** explained that while the capital adequacy ratios of globally systemically important banks (G-SIBs) have been rising steadily in advanced countries since the crisis, the leverage ratio has declined. On the whole, the soundness of the traditional banking sector has been maintained. At the same time, financial intermediation by the non-banking sector – hedge funds, mutual funds and other 'shadow banks' – has been dramatically expanding since the global financial crisis, notably in the UK, as well as other countries. The players in the shadow banking sector are investing in various areas including high-yield assets in emerging markets. Private sector debt in emerging market economies has also been increasing significantly and faster than the real economy since the global financial crisis, notably in China.
- ***Ms. Yuko Kinoshita, Deputy Head, Regional Office for Asia and the Pacific, IMF,*** outlined the global challenges in the wake of financial reform including excessive risk-taking, further need of banking sector support, and shifting credit to the non-bank financial sector. The appreciation of the US dollar, the oil price plunge and geopolitical uncertainties have also increased volatility in markets. Emerging market economies (EMEs) face the constant challenge of strengthening their fundamentals. The very low long-term interest rate in the US was highlighted as an important issue. So far, the Asian market seems to be responding well to global regulatory reforms, including Basel III. Overall progress has been made with Basel III, the systematically important financial institutions (SIFIs) framework, and OTC derivatives and accounting reforms, with progress due for shadow banking in data collection and aggregation. It was pointed out that the macro impact of Basel III in reducing the risks has, on the other hand, increased the cost of intermediation, allowing shadow banking to emerge.
- ***Mr. Nguyen Vin Hung, Deputy Director-General, State Bank of Viet Nam,*** discussed that developing countries need to adjust the implementation of international financial regulatory reforms based on the input of local financial authorities in Asia. Mr. Vin Hung posed the question of what exactly "unintended consequences" are, which regulators have to be aware of this and be proactive, in order for Viet Nam to learn from the experiences of other Asian countries which have already implemented Basel III, considering that Viet Nam is currently in the process of implementing Basel II.

Discussion

There was discussion on Thailand's experience between the time of the Asian financial crisis and the crisis in 2008, and the current effects of regulatory reform on the real economy amidst the decline of financial intermediation in Europe and the negative impact on the balance sheets of life insurance companies and pension funds caused by low interest rates. The decline in project financing could be replaced by financing by institutional investors. Questions were raised on the optimal level and quality of regulation, particularly for economies that are developing. Financial innovation should be supported, and further cooperation and integration among neighbours is needed to foster the capital markets in the region. There was discussion on how much impact the Basel III requirements have had on financial regulation in Asian emerging financial markets and comments were also made on shadow banking and financial stability.

Session 3: Functioning of capital markets and their role in value creation

- ***Mr. Mats Isaksson, Head of Division, Corporate Affairs Division, OECD,*** presented recent trends in corporate bond markets and the role of bondholders in corporate governance. Bond issues by non-financial companies in emerging markets have grown since the crisis as bank lending shrank. Bondholders may play a role in corporate governance by expressing their views by exit or voice. Longer bond maturities, the increase in non-investment grade and callable bonds, as well as less stringent covenants, show that investors are taking more risks for higher yields, which may undermine the role of bondholders. In addition, the secondary markets are not liquid, which suggests that passive investment strategies may be suitable for bondholders.
- ***Mr. Vedat Akgiray, Professor of Finance, Bogazici University, Turkey,*** observed that in Turkish financial markets a small number of foreign investors own a dominant portion of equities and public bonds, and that "short-termism" is prevalent among investors. These factors could be a source of systemic risk in Turkish financial markets. Pension funds with a long-term investment perspective could mitigate such risks and contribute to financial stability and long-term value creation.
- ***Mr. Eric Vermeulen, Professor of Business Law and Finance, Tilburg University, and Vice-President, Corporate Legal Department, Philips International B.V., the Netherlands,*** pointed out that acquisitions have been the dominant exit strategy for venture capital/private equity recently and that the IPO market is "ageing" as companies tend to stay private longer, raising capital from private investors. IPOs should be stimulated by establishing new metrics which are forward-looking and promote interactive discussion between executives, directors and investors.
- ***Mr. Kenji Okamura, Deputy Commissioner for International Affairs, Financial Services Agency, Japan,*** highlighted that establishing the Corporate Governance (CG) Code in Japan was regarded as a major pillar of Japan's growth strategy. Together with the recently published Stewardship Code, the CG Code aims to stimulate timely and decisive decision-making, better allocation of resources and more efficient capital allocation, which is hoped to lead to improved corporate profitability and capital efficiency in the economy.
- ***Mr. Liu Fuzhong, Vice Director, Strategy and International Relations, Shenzhen Stock Exchange,*** argued that SMEs were the backbone of the real economy, but have difficulty in obtaining bank lending, as banks do not have the expertise to carry out credit research for a large number of SMEs. Stock exchanges could serve as a platform for interaction among companies, investors and financial intermediaries. Shenzhen Stock Exchange facilitates information disclosure and access using IT, thus enhancing financial intermediaries and protecting investors.
- ***Ms. Shoko Negishi, Professor, Doshisha University, Japan*** discussed recent bond market developments which provide lower yield for investors, but better access to bond financing for companies, although SMEs scarcely enjoy access to bond financing.

Discussion

Among a wide range of questions and comments after the presentations, views were exchanged on the recent corporate bond market developments in the US and Europe, and its relevance in the Asian context. Evidence shows that corporate bond issuance has been increasing in some Asian countries, such as China. However, where corporate finance is dominated by banks, it was not clear how a corporate bond market might develop.

12 MARCH 2014 (DAY 2)

Session 4: Impact and challenges of global financial reforms on Asian banks

- ***Mr. Eli Remolona, Chief Representative, Bank for International Settlements, Asia and the Pacific Office,*** highlighted how to learn from the global finance crisis by reviewing the experiences in 2008, including the “too big to fail”, shadow banking and OTC derivative transactions. New supervisory principles have been set up, which include stress testing. Asia has a tendency to implement the Basel III requirements as early as possible because of the lessons learned from the Asian crisis. In terms of international claims when comparing Euro banks and Asia-Pacific banks, Asia-Pacific banks have steadily increased their claims since the 2008 crisis, whereas banks in the Euro area have remained at a similar volume or slightly less, compared with before the crisis. Cross-border lending in Asia is mainly inter-regional.
- ***Mr. Toshiyuki Suzuki, Senior Market Economist, The Bank of Tokyo-Mitsubishi,*** observed that the US and Japan have had relatively stable growth in the financial sector although Japan is still in a credit trap and continuing deflation. The current situation of the Eurozone’s nominal GDP and credit extension to the private sector may be similar to Japan’s.
- ***Mr. Ba Jinsong, Director, Policy Research Department, China Banking Regulatory Commission,*** outlined China’s efforts to implement global regulatory reform to strengthen the resilience of the domestic financial system, to improve functioning financial markets and deepen financial markets. Banks' internal risk culture, systems and procedures are also being upgraded. At the same time, improved regulatory capacity is necessary to mitigate systemic risks. A less developed capital market and calculation of risk-weighted assets were pointed out as the main challenges for China. There is a need to combine international rules and domestic risk-management practices through establishing different regulatory requirements according to the different stages of economic development. Developing countries should be given a reasonable transition period for the implementation of international regulatory rules.
- ***Mr. Stephen Lumpkin, Senior Economist, Financial Affairs, OECD,*** observed that there are real challenges for policy makers in finding a balance between risk-taking and the stability of banking sector. International efforts to establish safe global banks are essential. Financial flow data show that US banks were intermediating global flows in the 1970s, followed by Japan in the 1980s and Europe more recently. Data show the financial intermediation gaps as well as when and how much these gaps were filled by central banks. This type of data would be even more useful if more countries contributed.
- ***Mr. Kenichi Ueda, Associate Professor, Faculty of Economics, University of Tokyo,*** discussed the too-big-to-fail issue. He suggested that better policy options could be based on classification of systemically important banks (SIBs). It was emphasised that better disclosure and transparent stress-tests are essential to assess if a bank should be bailed out or not, to minimise bailout costs and protect depositors.

Discussion

Comments were made on the fact that US dollar-denominated lending was dominant in Asia although saving are mainly in local currencies giving rise to currency mismatches. The issue of limited lending and non-performing loans (NPLs) of Japanese banks were mentioned. The bailout policy, not only for big banks but also for the non-bank sector, as well as the impact of liberalisation of interest rates in China, the Chinese insolvency procedure, and the objectives of the Basel framework on stabilisation and financial innovation were discussed.

Session 5: Comparative evaluation of different forms of SME financing

- ***Dr. Naoyuki Yoshino, Dean, Asian Development Bank Institute,*** discussed the challenges posed by the asymmetry of information between borrower and lender that may hinder the development of SME financing. Cluster analysis results for Iran and Thailand using the average linkage method were presented. The Japanese Credit Guarantee Mechanism for SMEs was shown to be an effective policy tool to enhance the development of SME finance. In that mechanism, the guarantee ratio is different for each bank based on its past performance to avoid moral hazard.
- ***Mr. Imansyah, Head, Department for Financial Stability, OJK, Indonesia,*** explained the background of the establishment of the Indonesian Financial Services Agency (OJK) and regulations, policies and initiatives on SMEs in general and SME financing in particular, such as the obligation to provide financing to SMEs for a minimum of 20% of total loans (from 2018 onward), the relaxation of commercial banks' SME loan assessment, and incentives such as calculation of risk-weighted assets, and optimising the role of venture capital in SMEs and startups. The share of loans to medium-sized enterprises has increased, while the shares of micro and small enterprises has decreased. In terms of the high NPLs to SMEs, the OJK has made progress in identifying the triggers and taking necessary remedial actions.
- ***Mr. Gert Wehinger, Principal Administrator, Financial Affairs Division, Directorate for Financial and Enterprise Affairs, OECD,*** illustrated how to unlock SME finance through market-based debt, securitisation, private placements and bonds. The risks and benefits of securitisation were laid out, with risks including inadequate regulation, complex structuring, misalignment of interests and insufficient due diligence. Among the benefits were alleviating credit constraints and improving the diversity of credit, unlocking resources and increasing the capacity for a greater lending supply as well as broadening of the investor base for SMEs. While both US and EU securitisations had plunged after the crisis, US issuance has gone up since but EU issuance has been lagging; issuance in Japan is comparatively small overall. SMEs securitisation shares still remain small compared with other types of securitisations. It was argued that public intervention is an important driver of SME securitisation activity.
- ***Mr. Shigehiro Shinozaki, Financial Sector Specialist (SME Finance),Sector Advisory Service Division, Regional and Sustainable Development Department, ADB,*** compared the different models of bank lending aimed at encouraging the growth of capital financing for SMEs in Asia. Although SMEs are already considered to be one of the backbones of the Asian economy, there is room to further improve SMEs' productivity, since only 35% of GDP comes from the SME sector in Asia. As SMEs take part of the global supply chains, there is further potential to enhance trade in Asia. Basel III may negatively affect bank lending to - including trade finance for --- SMEs. Collateral and guarantee requirements create hurdles for SMEs in raising the necessary growth capital from financial

institutions. The creation of an equity market for SMEs under an ADB initiative, "Public APEX Fund" was explained.

- ***Mr. Yasuo Goto, Senior Research Fellow, the Research Institute of Economy, Trade and Industry (RIETI),*** introduced his study entitled "Regional Financial Soundness, R&D activities". The positive relationship between regional financial prudence and innovation was highlighted. The failure of SME financing is attributable to policy failures in the guarantee system in terms of assessing the appropriate level of guarantee.

Discussion

SME financing issues were discussed from quantitative and qualitative perspectives. Barriers to developing SME financing, such as lack of collateral or ability to due diligence, were cited. There was an extensive discussion on ADB's "crowdfunding" scheme. The potential distortion to credit allocation by credit guarantee schemes backed by government was raised, with some commentators considering that the guarantee should be provided by multinational institutions rather than governments. There was also discussion on the level of NPLs from SME loans in Indonesia as well as optimal policy advice on SMEs for lower income countries.

Session 6: Non-bank financial intermediaries and the role of capital markets in financing growth

- ***Mr. Adrian Blundell-Wignall, Special Advisor to the OECD Secretary General on Financial Markets, and Director, Directorate for Financial & Enterprise Affairs, OECD,*** outlined his hypotheses on stagnation due to the lack of investment, based on data from 10,000 global companies, by comparing the infrastructure investment vs investment in the general industry in advanced countries and emerging economies. The comparison was illustrated by data on global productivity, capital expenditure (CAPEX) and the value-creation gap, as well as comparison of return of equity (ROEs) data between SOEs and private companies. Data shows that open capital markets reduce the cost of equity. Boosting investment leads to enhanced contributions to global value chains, but in emerging market is often driven by tax incentives and high yield borrowing. Such debt-financed, over-investment in emerging markets may result in downward pressure on margins.
- ***Mr. Chiaki Hara, Professor, University of Kyoto,*** discussed the fact that investment in the infrastructure industry remains weak despite the recent loose monetary policy. Two hypotheses were introduced: fundamentals versus interventions. The fundamental hypothesis links weak investment in infrastructure with a fall in the natural real interest rate, over-investment (and debt overhang) and competitive pressures from global value chains. Policy interventions such as capital controls and trade protectionism, cross-border tax treatments and governance issues were cited as a cause of weak investment.
- ***Mr. Andre Belelieu, Associate Director, Financial Services Industries, World Economic Forum,*** observed that emerging capital markets still have room to grow despite significant progress and that there is and momentum for growth of non-bank financial intermediation in emerging markets. The need for non-bank financial intermediaries has emerged on both the capital demand side and the supply side, demonstrated by increasing demand of domestic corporations for flexible terms and use of local currency, and limitations on the capacity for bank balance-sheet lending. Developing capital markets may help filling the gap between investment needs and insufficient infrastructure

investment. Governments could enhance their financial education policies, and address efficiency and transparency of financial markets.

- ***Mr. Yutaka Okada, Deputy Director-General, Financial Markets Department, Bank of Japan,*** discussed the issue of over-investment in emerging market economies (EMEs) and limited investment in advanced economies (AEs), as well as issues related to investment for global sustainable growth, and financing of investment.

Discussion

Participants requested that experiences on co-funding practices and financial education schemes be shared. While there may be over-investment in China, there is under-investment in other emerging economies. There was also discussion on the lack of long-term financing from life insurers and pension funds, as well as the need for further development of the government bond market and the corporate bond market.