

Summary Record of
OECD-ADBI 7th Round Table on Capital Market Reform in Asia
Tokyo, 27th-28th October 2005

I. Introduction

1. The subject conference was held on 27th-28th October 2005 at the Asian Development Bank Institute (ADBI), co-organiser of the conference in Tokyo. This was the seventh in a series of annual meetings held since the 1997-98 Asian financial crisis to provide a forum to discuss the ongoing challenges that financial regulators and policy-makers should address.

2. About 50 people participated in the 7th Round Table, including senior officials from securities regulators, policy makers, capital market experts and academics from Asia and the OECD countries, and representatives from the ADB (including the ADBI), the World Bank, and the IMF. The OECD secretariat team was headed by Carolyn Ervin, Director of the Directorate for Financial and Enterprise Affairs.

3. Although considerable developments have been made in the capital markets in this region since the crisis, there remain a lot of challenges to be addressed for further developing sound and efficient markets. Against this backdrop, the 2005 Round Table covered several topical issues with the following agenda items: (1) Financial Policy Landscape; (2) Integration of Capital Market in the Asian Region; (3) Investor Education; (4) Developments in the Venture Capital and Private Equity since the end of the “Tech Bubble” and (5) Governance Issues Related to Securities Markets.

4. Mr. Andrew Sheng, former Chairman of the Hong Kong Securities and Futures Commission, chaired this Round Table excluding Session 1 and 3 which Mrs. Ervin of the OECD and Mr. Thirachai Phuvanatanarubala, Secretary-General of the Thailand Securities and Exchange Commission moderated respectively.

5. This Round Table was opened by welcoming remarks from Mr. Peter McCawley, Dean of the ADBI, Mrs. Ervin of the OECD and Mr. Sheng, the chairperson.

II. Financial Policy Landscape

6. In the first session, participants discussed different aspects of the formulation of financial policy against the backdrop of a changing financial services landscape.. Mr. Stephen Lumpkin of the OECD led off the discussion in this round with an overview of the general trends and developments in the financial services industry and the challenges they pose for regulators and supervisors. Some challenges can be linked to technological developments and related advances in financial engineering; some challenges are related to the increased internationalisation of some categories of financial services and some problems have their origin in demographic developments. Mr. Lumpkin noted that financial policy in OECD countries is converging on a set of objectives that includes maintaining of systemic stability, ensuring proper market conduct and consumer/investor protection. As well, there is now much greater recognition of the need for competition and efficiency. Before the regulatory reforms of the 1980s and 1990s, however, regulators placed strict controls on financial institutions and their activities, with a view toward preserving safety and soundness and preventing what was deemed undue risk-taking. Mr. Lumpkin pointed out that, as a result of the developments noted above, financial policy has become far less prescriptive and the list of regulatory objectives has converged. Mr. Lumpkin noted, however, that there is still fairly wide variation

in regulatory regimes and regulatory practices, as the various member countries map the objectives into their domestic regulatory and supervisory apparatus. Mr. Thirachai, of the Thailand Securities and Exchange Commission, added a few more challenges the emerging markets are facing: the strong outside pressure from many international bodies (WTO, FTA counterparts and international institutions in consultation) to open up their markets and the difficulty of regulating hedge fund activities.

7. The succeeding presentations in this session began to flesh out the details of the topic, focussing more directly on the challenges facing regulators in Asia, but from somewhat different perspectives. Mr. Sheng gave a thorough overview of the history of challenges for the capital markets in Asia. Mr. Sheng indicated that the capital markets in Asia are still relatively small and weak compared with the US and EU historically because of those countries' bank-dominated financial structures drawn by their unbalanced growth model with orientation toward export and industrialization. Mr Sheng outlined the basic functions of the capital market: resource allocation, price discovery, risk management and corporate governance, as areas in which Asian capital markets remain problematic and have a need for reform. Mr. Sheng stressed demographic changes of aging and globalisation as important challenges Asian countries are now facing and their need to rebalance their financial policy and structures as a whole. Mr. Sheng also stressed that each country has to consider its reform process because there is no one solution to the matter, but to make the process successful it is important to take a strategic viewpoint focusing on the 3Rs: Risks, Rewards, and Resources. In summing up, Mr. Sheng suggests that the process of reform has begun, but warns that the region is far from completing the type of financial services sector it will need in the future. For this to occur, policymakers must act.

8. Mr. Naohiko Matsuo, General Counsel and Director for Investment Services Law, Japanese Financial Services Agency, illustrated just how much work can be involved in laying the proper groundwork for the development of a sound financial services industry by introducing the Japanese experience in capital market reforms on two subjects: financial conglomerates and investment services, both of which have at present become global topics in the financial policy arena. In the context of the provision of investment services in Japan, Mr. Matsuo traced the evolution of the financial services industry in Japan, linking that evolution to changes in the legal and regulatory environment. That evolution has led to the formation of a few large financial conglomerates and Mr. Matsuo highlighted some of the challenges posed by their activities. Some risks are common to all conglomerates, while others vary depending on the mix of business activities carried out within the conglomerate structure. Mr. Matsuo first outlined the policy reforms related to financial conglomerates from the 1990s to the present, including the adoption of a financial holding company structure and of "one-stop shopping" in which various institutions, mainly banks, are allowed to sell various financial instruments. Secondly Mr. Matsuo elaborated on the "Investor Services Law" on which he is currently drafting a bill as a deregulation to widen the scope of financial activities and instruments and simplify the current fragmented securities-related laws in Japan. Finally Mr. Matsuo ended the presentation by touching on best practices of regulatory structures, noting that while recognising that it varies from country to country, Japan is adopting a universal regulatory body to achieve optimal results.

9. Dr. Stephen Grenville, Lowy Institute for International Policy, Australia, gave a presentation on financial sector regulation. According to his theory, there are two imperative points in financial regulation rule-making. One is to be parsimonious with the minimum number of rules and the other is to hold to the principle of subsidiarity, making the rules as simple and straightforward as possible. When discussing the best practice of regulatory structure of financial markets in emerging economies especially in Asia, Mr. Grenville emphasised that a unitary supervisor (e.g. a super-regulator across financial sectors) would not be appropriate, given the current level of developments in this region, as it could cause serious inefficiency and ineffectiveness, breaking the above-mentioned two principles.

10. Mr. Pratip Kar, Executive Director, Securities and Exchange Board of India, commented that it is quite important to strike a good balance of regulatory reforms while avoiding stifling market competition and innovation. Besides that, a successful coordinating system among multiple financial regulators in India has been introduced. Professor Takatoshi Ito, Faculty of Economics, University of Tokyo, raised, among others, one important question; why are Asian bank-savings still high? (Is it merely the case of their individuals' preferences or a case for regulatory reform)? It was generally agreed in the session that regulatory reforms depend on the local situation of each country's market development and there could not be a one-size-fits-all solution in regulatory responses to market changes. Thus, there could be multiple forms of regulatory and supervisory structures. The importance of solid legal infrastructures was emphasised for effective regulation and supervision. Most participants agreed that the implications of the global imbalances for capital markets in Asia need to be further discussed.

III. Integration of Capital Markets in the Asian Region

11. For the introduction of Session 2, Mr. Masahiro Kawai, Head, Office for Regional Economic Integration, and Special Advisor to the President of ADB, reviewed and updated the developments of regional bond market development initiatives in the region towards integration of capital markets in Asia, mainly focused on the Asian Bond Market Initiatives (ABMI) and the Asian Bond Fund (ABF). Mr. Kawai pointed out that though these initiatives are gaining momentum and generating tangible results, there still remains much to be done with regard to liquidity, investor base, infrastructure, regulatory framework and other areas.

12. Following the presentation, Mr. Thirachai of the Thailand Securities and Exchange Commission, outlined the historical background of regional cooperation in Asia, focusing on the ABF2 which has great potential to develop by future private sector participation in the newly-created "Exchange Traded Fund" and "Pan Asian Index Fund". Mr. Thirachai stressed that all efforts need to be concentrated on domestic bond market development in this region and also called for the establishment of a united institution for bond market developments to coordinate current fragmented initiatives and to form an advisory body with a mandate of peer pressure for member economies.

13. Mr. Gordon de Brouwer, Director, Department of the Treasury, Australia, took a broad based viewpoint of regional integration. Among the important topics on financial cooperation, establishment of regional financial institution has gained the most attention since the previous financial crisis. Mr. Brouwer elaborated the importance of regional institutions for further regional development and stability and emphasized the need for the right design. For financial market integration, while mentioning many challenges ahead, three important points were raised: (1) make better and strategic use of existing fora such as ASEAN+3, EMEAP, and APEC, (2) further engage with the private sector, and (3) utilize international institutions and fora like IMF, World Bank, ADB and OECD.

14. Professor Ghon Rhee, K.J. Luke distinguished Professor of Finance, University of Hawaii, raised some thought-provoking questions on recent regional bond market developments. Professor Rhee pointed out that ABF and ABMI have had less visibility to private investors due to lack of transparency, which prevents the private sector from promoting its participation. In addition, it was indicated that Japanese investors are investing too little in Asian bond markets relative to their size. For further market developments it was pointed out that the Asian economies should think about how to make their bonds more attractive to private investors especially in Japan and the credit enhancement program in ABMI should be prioritized among others.

15. Mr. Shigeki Kimura, Director of Research Division, International Bureau, Ministry of Finance, Japan, commented on Professor Rhee's arguments pointing out that regional bond market development initiatives were introduced to address the challenges of channeling ample regional savings to regional

financial markets, not necessarily to attract foreign investments as a main purpose. Mr. Kimura also reported the current Japanese investors' active participation in securities markets and introduced an ongoing regional study on the Asian currency basket denominated bond issuance under the ABMI. In response to a question by Mr. David Cowen, Senior Economist, Regional Office for Asia and the Pacific, IMF about the difference from Pan Asian Index Fund, Mr. Kimura stressed its supply-oriented feature, designed especially to nurture mortgage backed securities instruments in this region.

16. Mr. Asela Fernando, member of Securities & Exchange Commission, and President of the Institute of Chartered Accountants of Sri Lanka, introduced the recent regional cooperation and capital market developments in South Asia and noted that the regional initiatives for capital market integration are the right steps forward for further prosperity in Asia as a whole. Dr. Ruben Lee, Managing Director, Oxford Finance Group, United Kingdom, tried to define the meaning of regional integration, which is that equality of risk adjusted rates of return is the most appropriate one. Dr. Lee insisted,, however, that in spite of its controversy, the appropriate method of achieving such a situation is promoting more competition - not taking a regional platform and adopting common standards. He also added that a single regulatory body is not needed for regional integration given the current European experiences, which triggered objections by some participants.

17. Mr. Atsushi Takeuchi, Section Director, International Department, Bank of Japan, responding to Professor Rhee's arguments on ABF, argued that though the transparency issue is somewhat sensitive to handle because of the nature of financial instruments, the most notable point is the successful initiation of the index of Asian bonds which have currently received great attention from intra-extra regional investors. Ms. Cathy Quinn, Commission Member, New Zealand Securities Commission, and Dr. Zana Rina Zahari, Chief Executive Officer, RHB Securities SDN BHD, Malaysia, presented their regulators' efforts to encourage companies and investors to participate again in the securities markets after the loss of confidence.

18. Through these discussions, participants did not agree on which approach (harmonization or mutual recognition) Asian economies should take for regional integration, however, the importance of continuing regional capital market development initiatives with more private sector perspective was highly valued and recognized among all participants.

IV. Investor Education

19. Ms. Barbara Smith, Principal Analyst (Financial Education) of the OECD, discussed the OECD study on financial education in OECD countries, focusing on individual investors. She noted that many countries have seen an increase in the number of individual investors and a transfer of risk from institutions to households. These changes are due in part to an increase in the number and complexity of financial products, the baby boom and the increase in life expectancy, and changes in pension arrangements leading to increased personal responsibility. Ms. Smith also described some of the findings of the OECD study on financial education: financial literacy rates are low even in OECD countries; demographic, economic and behavioural factors influence the response of consumers to financial education programmes; and where evaluated, financial education programmes have been found to be effective.

20. Ms. Christina Tan, Deputy Director and Head of Consumer Issues Division, Monetary Authority of Singapore, presented Singapore's nationwide program of financial education. The driving factor which converted some industry's initiatives into a nationwide one was the consequence of poor financial decisions by individual investors who needed to be financially well-informed. Ms. Tan also introduced the financial literacy survey in Singapore of which the outcomes were generally encouraging but had some areas for improvement such as inadequate savings for emergencies and retirement planning. Ms. Tan

stressed the importance of keeping the process sustainable by paying attention to the various needs through the concerted efforts of program providers.

21. Mr. Toshitsugu Shimizu, Executive Officer, Tokyo Stock Exchange, introduced the Japanese experiences on investor education. Although in Japan individuals' financial assets have traditionally been mainly tied up in cash and deposit accounts, this tendency is drastically changing and asset shifting is taking place as Japanese social systems such as finance, labour, and welfare areas are making changes. The Tokyo Stock Exchange (TSE) Academy was established in 2004 to meet these increasing demands. Its targets are focused on school teachers and students as well as individuals because they generally lack financial knowledge partly due to virtually no curriculum on economic and financial planning in the Japanese school education system.

22. The following presenters introduced their capital market developments and related investor education programs. Professor Berna Collier, Commissioner, Australian Securities and Investors Commission, outlined their efforts towards raising the standards of licensed financial advisers and simplifying financial documents and pointed out the significance of the government's role in program coordination. Dr. Darmin Nasution, Chairman, Indonesia Capital Market Supervisory Agency, stated that his authority regards investor protection as the main purpose of investor education given the current rapid growth of mutual funds and subsequent retail investor participation in the securities market in Indonesia. Dr. Azizul Islam, Chairman, Securities & Exchange Commission, Bangladesh, outlined his authority's three main points of financial education to help investors understand: (1) risk, return and liquidity character, (2) operation of market actors, and (3) potential market misconduct. Other participants from Pakistan, China, Korea, and the Philippines also joined the discussion by informing participants of their current experiences in capital market developments. All the participants agreed on the importance of financial education for developing sound and efficient capital markets.

23. The OECD study "Improving Financial Literacy: Analysis of Issues and Policies" was due to be published in November 2005 and a Recommendation on Principles and Good Practices for Financial Education and Awareness was approved by the OECD Council in June 2005.

V. Developments in Venture Capital and Private Equity since the end of "Tech Bubble"

24. Venture capital and private equities are key financial sources for emerging industries in Asia. Mr. John Thompson, Financial Counsellor of the OECD, provided an overview of recent developments in venture capital and private equities markets, focusing on the US and the EU which indicate the contrasting performance between them. Mr Thompson defined venture capital as investment of equity nature to high growth companies especially technology-oriented ones and subsets of private equities. Such emerging companies with dynamic growth are considered important, not only because they can generate employment but also help maintain their strategic position and international competence in their economies. There is, however, a striking difference in market developments between the US and the EU. The US has established well-developed markets earning high returns, whereas the EU is lagging behind with much less return. This trend has been consistent for about 30 years due to many structural factors such as cultural values, corporate laws, financial market, taxation, science-industry linkage, as well as informal equity investment. Though the cyclical trend of venture capital has been heading upward since 2004 after the slump caused by the bubble burst, market reforms and competition in the EU have been heating up, and the US-dominant situation still remains unchanged.

25. Following his presentation, Mr. Hanson Cheah, Managing Partner, AsiaTech Ventures Limited, Hong Kong, outlined the trend of venture capital developments in Asia from the time before the tech bubble. Asian private equity amounts to US\$100 billion under management and investment amounts to US\$ four billion every year. Hong Kong is the largest financial centre with US\$ 30 billion and 200 private

equity firms in this region. Private equity markets were remarkably developed by the active support from governments and strong demand due to the tech bubble. Among others the KOSDAQ Korea and the OTC Taiwan have been the most successful markets in terms of return. Private equity funds are financed mainly by US and European institutions while many Asian economies' institutions are still restricted to investing in private equity. Though there remain many challenges to be addressed in legal, regulatory, infrastructure and personnel areas, Mr. Cheah stressed that the future looks brighter against the current background of diversification of capitals and exits, as well as upgraded skills and the surge in economic growth in China and India.

26. Mr. Chang Sun, Managing Director, Warburg Pincus Asia LLC, Hong Kong, gave an overview of the developments in venture capital and private equity in China. Private equity in China began just 5 years after the foundation of the Shanghai Stock Exchange and that caused a great number of challenges in the immature ex-socialist market. Nevertheless, venture capital investments have been increasing to meet the robust demand along with the rapidly growing economy. As the exits are becoming easier, IPOs and strategic sales are on the rise. Mr. Sun stressed that private equity growth will benefit both companies and financial markets. Private equity tends to pay extra attention to companies' corporate governance and push them to comply with regulatory requirements because their reputation is the most important stake for private equity. Besides that, emerging SMEs will help correct the over-dominance of financial markets by large companies and conglomerates.

27. Professor Dosoung Choi, President, Korea Securities Research Institute, introduced the current situation of venture capital and private equity in Korea. In Korea, although the size of stock markets is relatively small because of its bank-centred financial system, the size of venture capital market is the 7th largest among the OECD countries. Korean venture capital expanded from 1986 to 1998 partly with government support, then overshot in 2000, and after the IT bubble burst, is now at the stage of consolidation and restructuring in which the number of venture capitals decreased to 105 in 2004. One of the big differences between the Korean and the US market is that most exits (about 91%) are through IPOs whereas M&A is prevalent in the US. The Korean government introduced buyout funds (PEFs) in 2004 to boost the M&A finance, however, most important, according to Professor Dosoung, is to regain investors' trust lost in the dotcom clash by strengthening investor protection, enhancing integrity, transparency and accountability, and galvanizing synergy between venture capital and venture entrepreneur.

28. Mr. Shimizu of the Tokyo Stock Exchange introduced the Japanese venture stock market "Mothers." while Mr. Michael Buxton, Co CEO, Ernst & Young, Tokyo, reported on the current regulatory reforms and active private equity movements in Japan. It was agreed that enhancing the quality of companies and sponsors is crucial for successful venture capital market development and therefore regulators should do their utmost to monitor governance and maintain substantial value of markets.

VI. Governance Issues Related to Securities Markets

29. This topic relates to the current global controversial issue on how to govern stock exchanges which are being demutualised with some regulatory functions retained within them. Governance issues on market infrastructure institutions are controversial and crucially important for regulators to address because it is still difficult to pinpoint the appropriate governance structures to resolve conflicts of interest problem. Dr. Lee of Oxford Finance Group tried to resolve this controversial issue by examining the characteristics of the market structure (exchanges, Central Counter Parties-CCPs and Central Settlement Depositories-CSDs). Dr Lee stated that demutualization has been a growing trend on a global basis, but it has not necessarily been viewed as the optimal solution. Though there are many benefits to be expected by adopting? demutualization, e.g.: more responsiveness to customers, modernization of technology, more flexible governance structure and avoidance of concentration of ownership, these benefits have not been

realized in practice. On the other hand, demutualization has a potential risk of becoming a natural monopoly with the existence of profit-seeking owners. Besides that, the industry structure, which is characterized by liquidity externality, switching cost and netting benefits as well as vertical integration among exchanges, CCPs and CSDs, tends to hamper competition with newcomers and causes anti-competitive behaviour. Dr. Lee concluded that elimination of conflicts of interest is not recommended as commercial and regulatory benefits are closely linked. Conflicts of interest should be managed appropriately, however optimal solutions have not yet been found.

30. Mr. Noritaka Akamatsu, Lead Financial Economist, Financial Sector Operations & Policy Department, The World Bank, discussed governing issues on clearing and settlement (C&S) institutions. Integration of C&S institutions has the merit of economy of scope and scale. However, the strength of concentration also has shortcomings as it prevents competition with new entrants and leads to a monopolistic structure. Mr. Akamatsu outlined the importance of good governance and access criteria citing the CPSS-IOSCO Recommendations for Securities and Settlement System. Governance arrangements should be balanced among three stakeholders (owner, user, and regulator) and Access criteria should also be balanced against potential risk brought by accepting different types of participants. Mr. Akamatsu also pointed out the CSD's delicate relationship in the real market with institutions like the stock exchange, central bank, (global) custodian, International CSD and registry.

31. Ms. Fe Barin, Chairperson, Securities and Exchange Commission of the Philippines, introduced the experiences of the Philippines. In the Philippines there have been merits rather than problems in demutualization partly because of the appropriate (dynamic and static) prescriptions in the law and the regulator's efforts to identify and address pitfalls in this system. The SEC is also monitoring self regulatory organizations to check and balance its authorized delegated power. For clearing and settlement, the SEC is taking measures to integrate the clearing system for bonds and equities, while mitigating investors' risk by shortening the settlement period and forcing the CCP to impose stringent criteria for market participant entry. Mr. Toru Shikibu, Deputy Commissioner for International Affairs, Financial Services Agency of Japan, presented Japan's own specific issues on governance of stock exchanges which are currently being debated at a political level: (1) on the debates on SRO function of Tokyo Stock Exchange, it has recently been proposed that the SRO function, unlike at the London Stock Exchange (LSE), be delegated to the chief regulatory officer under the supervision of a committee within the board of directors. This proposal will be deliberated by the FSA. (2) Regarding the debates on authorization of major share holding of Osaka Stock Exchange, FSA decided not to allow the equity fund to acquire more than 25% of all stocks in order to strike a balance in the conflict of interest issue. Dr. Zana Rina Zahari of RHB Securities introduced the Malaysian experiences. Bursa Malaysia, established by the integration of six exchanges and two clearing houses in Malaysia, was demutualized in 2004 following the regional trend of the Singapore Stock Exchange (SGX) and the Hong Kong Stock Exchange (HKEx) to create new product lines and attract new brains. While the governance issue is still under discussion in government, SRO has been considering one option. The process of establishing SRO has been taking shape, however the issue still remains of how to acknowledge the opinions of participating organizations (stock-broking companies)..

32. One notable question on the possibility of "Asia Clear" in this region has been raised, but it received cautious responses from the two main speakers. Dr. Lee highlighted experiences by the London Clearing House and the Clearnet, mentioning that they caused a great number of problems in balancing the interests of different competing users. Mr. Akamatsu raised two major reasons (conflicts of law and small trading volume) and indicated that it is not the right time for that. Mr. Sheng, Chairperson, wrapped up the session, emphasising two crucial points on this complex issue: (1) Once exchange becomes demutualized, it would become a natural monopoly. Then its interest would divert from the interest of country or state. (2) Demutualized exchange tends not to take enforcement action given it is risk-averse to potential stock price decline.

VI. Conclusion

33. The Round Table was successfully concluded and very much appreciated by all participants thanks to the frank and open discussion of a wide range of issues from macro to micro regarding capital market reform in Asia. Mr. Sheng's excellent chairpersonship should be noted as a key factor in the success of the Round Table. Finally, it was suggested that the next Round Table be held some time next autumn.