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# SUMMARY RECORD OF

# OECD-ADBI 16TH ROUNDTABLE ON CAPITAL MARKET AND FINANCIAL REFORM IN ASIA

# ("TOKYO ROUNDTABLE")

**22-23 MARCH 2016**

**TOKYO, JAPAN**

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**OECD-ADBI 16TH 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 Roundtable benefitted from high-level participation from various backgrounds. It included high-ranking officials from finance ministries/treasuries, central banks and securities regulators from 23 non-OECD economies, including China, India, Indonesia, Malaysia, Thailand, the Philippines and Viet Nam, as well as OECD member countries, such as Australia, Canada, France, Germany, Japan, Korea, Switzerland, and Turkey. It also brought together experts from international organisations, particularly ADB, BIS and IMF, as well as private sector representatives and academics.

In addition, the meeting welcomed the attendance of financial regulators/supervisors from Asian and African regions, who took part in the seminar organised by the Japanese Financial Services Agency (JFSA) as a back-to-back event with the Tokyo Roundtable.

## Keynote presentations

Between the sessions, three keynote presentations were delivered:

***Mr. Masamichi Kono, Vice Minister for International Affairs, FSA, Japan***, shared his insights on a new strategy for growth finance in Asia. Mr Kono pointed out that doubts have been cast on the ability of the global financial system to channel sufficient funds to sustain long-term finance and called for a viable long-term growth strategy in countries and a vision for enabling sustainable finance for growth that would support such a strategy. In his view, it is a strategic priority to transform the flow of funds by strengthening channels for growth finance through the development of capital markets. Asset managers and market intermediaries should be invited to play greater roles. Mr Kono emphasized that this strategy should take on a more regional perspective, because Asian economies have become much more integrated than in the past. A more balanced financial system, with the bank channel complemented and reinforced by a liquid and orderly capital markets channel would need to be developed. He also pointed out the necessity for a comprehensive assessment of the collective and cumulative effects of reform on the performance of the financial systems and markets to channel the necessary funds[1].

***Mr. Rintaro Tamaki, Deputy Secretary General***, ***OECD***, discussed the issue of greening capital markets. The risks of carbon-intensive investment are now too evident to ignore. A low-carbon transition would render the vast majority of fossil fuel reserves “stranded assets”. There is an increasing argument that fiduciaries need to take into consideration climate-related risk factors in the investment decision-making process from a financial point of view. In order to meet future green investment needs, governments should foster the development of viable investment channels that are suitable for institutional investors. Labelled green bonds have been the subject of increasing government, investor and media interest and expectation due in part to the explosive growth in the market.

***Mr. Naoyuki Yoshino, Dean, ADBI***, provided his analysis on the economic effects of infrastructure. PPP is advocated, but bankable projects are scarce in the region, as returns from infrastructure investment rely traditionally on toll fees or train fees which are often regulated by governments to keep prices low. It is proposed that the increment of tax revenues from highways or railways which are coming from the spill-over effects of infrastructure investment should contribute a part of such tax revenues for investment in infrastructure. The spill-over effects can be calculated through the use of micro-data, as in the cases of the Southern Tagalog Arterial Road in the Philippines and the Uzbekistan railway, or of macro-data, as in the case of Kyushu Shinkansen railway in Japan.

[1]The full text of Mr. Kono’s speech can be found at: http://www.fsa.go.jp/common/conference/danwa/20160322/01.pdf

**22 MARCH 2016 (DAY 1)**

**Session 1: Capital flows in Asia – impacts and implications of the recent global economic developments and the normalization of the US monetary policy**

- ***Mr. Kenichiro Kashiwase, Economist, IMF, Regional Office for Asia and the Pacific,*** provided his analysis on international capital flows against the changing landscape of the global economy. In his view, "searching for growth and yield" has served as the major driver of international capital flows in the recent low interest rate environment in advanced economies. Since the global financial crisis, the high economic growth in emerging Asian economies has attracted strong FDI mostly from within the region and Europe, as well as large portfolio investment from US and Europe. However, the global financial market has been tightening, while the emerging markets in Asia have weathered the turmoil over the last few months. A potential risk in the region could be expansion of credit, fuelled by massive FDI and portfolio inflows. He stressed the importance of applying policy measures appropriately for demand management.
- ***Mr. Ilhyock Shim, Principal Economist, BIS***, illustrated the recent evolvement of international banking flows to emerging market economies (EMEs) and intra-regional banking in Asia-Pacific. Before the global financial crisis, cross-border banking activity had mostly taken the form of a flow of dollars mainly from the US to Europe and then to Asia-Pacific as well as back to the US, with European banks serving as the major intermediaries. Since the crisis, European banks have held back and banks from Asia-Pacific have stepped in. This new trend in Asia-Pacific banks' intra-regional lending raises some financial instability issues such as the potential for common and concentrated creditors, systemic risks involving foreign branches, liquidity risks in FX funding and an increasing share of short-term FX loans by Asia-Pacific banks.
- ***Mr. Kenji Fujita, Associate Director-General, Financial Markets Department, Bank of Japan***, shared his view on the recent changes and driving forces behind capital flows in Asia. Data on fund flows show that portfolio investment flows into EMEs began to decline in 2013. In general, EMEs in Asia are considered to be resilient against funding risks thanks to a floating exchange rate regime, an accumulation of foreign reserves and a prudent monetary policy. However, a piling-up of debts, particularly those denominated in USD, is attracting the somewhat uneasy attention of investors. A large redemption of USD-denominated corporate bonds is expected for Asian EMEs in the coming years. Re-finance does not appear to be challenging so far, as global investors have been less cautious about these economies. Mr. Fujiata pointed out, however, that signs of concern about the market functioning, for example liquidity, are looming. He also suggested that huge capital outflows from China appeared to be largely related to early redemption of USD-denominated debts and trade credits.
- ***Mr. Jae-Ha Park, Senior Fellow, Korea Institute for Finance***, pointed out the economic risks and challenges that Asian EMEs have been facing and set out some policy suggestions. These included: strengthening the economic fundamentals and resilience of each economy; pursuing the enhancement of currency cooperation among Asian countries to prevent a currency war and ensure regional financial stability; and broadening financial safety nets by strengthening the Chiang Mai Initiative Multilateralisation (CMIM) and improving the functions of the ASEAN+3 Macroeconomic Research Office (AMRO). He also described three macro-prudential measures which were introduced in Korea after the global crisis, namely: a ceiling on banks' FX derivatives positions; a tax on foreigners' fixed-income investment; and a bank levy, which have effectively curbed massive capital inflows and outflows.

- ***Mr. Roselee Shah Shaharudin, Assistant General Manager, SC Malaysia (Visiting Fellow, the Asian Financial Partnership Centre (AFPAC))***, observed that the process towards normalisation of the interest rate in the US created volatility in the Asian equity markets, while other factors including sluggish oil prices and China's weak economy were also contributory to it. He also found that different degrees of reaction towards the normalisation of the interest rate among ASEAN markets were partly attributed to different designs in their market architecture. In Malaysia, foreign investors sold their stocks in recent years, but the Government-Linked Investment Companies (GLICs) have been buying up Malaysian equities, providing deep liquidity for the market and acting as a buffer for the foreign selloffs. Thanks to the GLICs, the Malaysian equity market has continued to grow and has remained resilient despite volatility in the global equity markets. However, the GLICs have become more selective on Malaysian equities in 2015 because of the headwinds to corporate earnings growth, which may raise concern in the future.
- ***Mr. Manu Vettickan, Deputy Director, Ministry of Finance, India***, affirmed that international financial crises seem to be occurring more frequently in recent years, reflecting greater and faster capital flows across borders. He observed that the crises in emerging markets of the 1980s-1990s were mainly derived from heavy government borrowing and triggered by exchange market collapse driven by speculative attacks. In contrast, the more recent crises originated from high corporate leverage and initiated by the sudden stop of capital flows. India has recognised the importance of macro-economy stability through the experiences of other countries. Although it is difficult to predict how the next crisis could happen, the most vulnerable countries are those which have high external borrowing requirements and relatively low buffers. India stands out as a haven of stability and an outpost of opportunity. It focuses on attracting stable and risk-bearing capital to finance its growth in the long run, while avoiding being tempted by cheap finance. Under India's current strong economy and high growth rate, it is expected that capital inflows will continue in 2016.

Discussion

Various comments and views were exchanged on the recent developments in international capital flows and global economic environment. Among other factors, the increasing corporate debt and rapid growth in USD lending were currently emerging as the biggest risk in Asian economies. It was pointed out that recent global experience has shown that a financial crisis may happen in the form of a sudden liquidity dry-up, possibly triggered by a default of a major corporate bond. One participant argued that financial crises have been following the same pattern, starting with a recession in the advanced economies, which induces monetary policy easing resulting in creation of liquidity, which causes in turn significant capital inflows to EMEs. We might now be seeing such capital flows ending. Responding to a question on whether a Korea-type macro-prudential policy would be recommendable to other EMEs, some panellists maintained that such a policy may indeed work effectively to restrain short-term foreign debt, which is the major cause of financial crises. Another participant asked if the advanced countries should take global market stability into consideration in determining their macro-economic policy. One of the panellists replied that the central banks should take into account the international impacts of their policy decisions, although this may be beyond their mandate. Discussion also covered the immediate and medium-term effects of the negative interest rate policy just introduced in Japan.

**Session 2: Bond market development in Asia**

- ***Mr. Serdar Celik, Economist, Corporate Affairs Division, OECD,*** illustrated the importance of growth companies which contribute in their own right to innovation and net job creation but also by challenging incumbent companies and forcing them to be more creative. What growth companies need is access to capital, in particular equity capital, which is of particular importance for their long-term investment and growth. Eventually growth companies need to tap public equity markets by IPO, although small company IPOs are declining in advanced economies. Once they pass the IPO threshold, their access to markets, both equity and bond, should improve significantly. In order to be successful in IPO, growth companies need to meet investor expectations with respect not only to financial performance but also non-financial aspects such as the quality of corporate governance practices, disclosure routines and the board of directors.
- ***Mr. Noritaka Akamatsu, Senior Advisor, ADB,*** provided an analysis of the infrastructure investment need in Asia which is estimated to reach USD 8 trillion during the period 2010–2020, or USD 750 billion per year, although China's Belt & Road Initiative may push it up. A particular challenge for Asia is that the region has high savings but not high long-term savings due to the bank-centric financial system. It is therefore necessary to promote contractual savings, in particular pension funds, in the region to expand domestic long-term savings. Moreover, local currency bond markets should be developed, in which contractual savings can be invested and infrastructure projects can obtain access to finance. The Credit Guarantee and Investment Facility (CGIF) under the Asian Bond Market Initiative of ASEAN+3 supports the development of local currency bond markets and their harmonization in the region.
- ***Mr. Ephyro Luis Amatong, Commissioner, Securities and Exchange Commission, the Philippines***, explained that the Philippines is committed to investing in infrastructure through its robust public-private partnership (PPP) program. It is estimated, however, that the government's programmed infrastructure projects alone will require over USD 43 billion in private financing. As bank financing becomes more limited due to the regulation which restricts the exposure to a single borrower as well as Basel III capital requirements, the bond market is attracting attention. Although it has grown rapidly over the past 10 years, the Philippine market still remains smaller than other ASEAN markets. Huge room for growth exists in Philippine corporate bond issuances, as they account for only 17% of the total bond outstanding. The major challenges for development of the corporate bond market in the Philippines include: the need to develop more robust credit ratings; unfavourable regulation on insurance companies; and withholding taxes on bond coupon payments impeding active trading.
- ***Ms. Naoko Nemoto, Vice President, S&P Japan***, observed that in Asia, private debt issuances have increased amid the low interest rate environment and that banks are expected to increase issuance of Basel III-compliant hybrid securities such as preferred equities. Although bond markets seem relatively stable compared to equity markets in the region, global market volatility may adversely impact regional financial markets, which poses the challenge of refinancing risk for low-rating issuers when investor sentiment is in decline. According to S&P's assessment, the economic and industry risk scores of the Asia-Pacific banking sectors are dispersed, and show that the institutional framework in some countries trail global standards. The Japanese debt market may need to improve its liquidity and depth and may apply this policy to encourage a shift of funds from deposits to other financial assets such as pension and mutual funds. China still has a bank-heavy financial system, although the bond market is growing.
- ***Mr. David Fernandez, Head of FICC Research, Asia-Pacific, Barclays Bank***, presented his views on recent developments and possible scenarios for China's bond market which is currently standing at a

critical crossroad. China's onshore bond market has grown rapidly, outpacing the GDP growth, which is partly attributed to the local government swap programme. Although already developed significantly to date, the Chinese government's bond market has a high potential for further growth. China is opening its door to foreign investors in domestic markets earlier than expected, although actual investment remains limited so far. The dim sum (offshore RMB bond) market has been slowing its growth, resulting from a declining demand for RMB assets which reflects a prospect for currency depreciation which is likely to continue. However, a wide range of funding needs still exists in the dim sum market. The market could be revived if the foreign exchange forecast becomes stable and currency hedging costs normalised.

Discussion

Discussion focused upon the ways and means of forging ahead with the development of bond markets in Asia. The view was broadly shared that developing local currency bond markets should contribute to financial stability as well as address key areas of financial gaps in the region, SME and infrastructure. One of the recommendations made for capital market development in Asia was to enhance corporate disclosure as close relations between group companies and high ownership concentration were prevalent in the region. Collaboration between local and international rating agencies would be a practical step for improvement. The success of the Philippines' PPP was recognized, which came after learning from mistakes in the 1990s. The keys for successful PPP operations may include ensuring public components and providing regulatory risk insurance. The Credit Guarantee and Investment Facility (CGIF) was referred to by a few participants as an important support measure for corporate bond issuing in the region, although one panellist suggested that this facility has played a limited role due to its capacity constraint and it is therefore necessary to increase the capital to support more greenfield bonds at the construction stage of infrastructure projects. One participant pointed out that the recent challenges may derive from the Basel III implementation, which is in fact not friendly to corporate bond markets. Other comments during the discussion included: in China less attention has been drawn to bond markets dominated by banks than to equity markets where massive retail investors participate; and given the huge funding gap for infrastructure in Asia, the AIIB should play a role.

## 23 MARCH 2016 (DAY 2)

### Session 3: Effective and efficient support for SME finance in Asia

- ***Mr. Naoyuki Yoshino, Dean, ADBI and Mr. Farhad Taghizadeh-Hesary, Faculty Member, Keio University and Visiting Professor, The University of Tokyo***, highlighted first the importance of SMEs in Asian economies and the challenges they face in raising money. By alleviating the financing difficulties of SMEs, credit guarantee schemes (CGSs) contribute to their efforts to maintain, establish and develop operations. The CGS in Japan has a long history and is the largest in its scale compared with GDP. Other Asian countries, including Indonesia, the Philippines and Thailand, have established CGSs, which expanded their operations significantly after the recent global crisis. A model analysis revealed that where the policy objectives (increase in SME loans and non-performing loan ratio) are given, the optimal credit guarantee ratio can be calculated and is different depending on the soundness of lending institutions.

- ***Mr. Sebastian Schich, Principal Economist, Financial Affairs Division, OECD***, provided some background to the OECD/EC survey on evaluating publicly-supported financial guarantee programmes for SMEs and invited ADB and Asian economies to participate in this survey. Its purpose is to collect information on the assessment of costs and benefits of SMEs' CGSs. The survey also aims to identify approaches to their evaluation that are widely used as well as those that are less widely used but innovative and effective. A specific focus will be placed on identifying effective approaches to detecting situations in which the benefits of publicly-supported financial guarantee programmes for SMEs clearly outweigh the costs or, on the contrary, the costs exceed the benefits by keeping so-called "zombie companies" alive.
- ***Mr. Eric Vermeulen, Professor, Tilburg University***, discussed public CGSs, which are regarded as important to support SMEs facing difficulty in accessing finance, in particular start-ups in the middle of the "valley of death". However, what is necessary for start-ups is mostly equity capital, not loans, and equity finance to early stage companies is growing rapidly in Asia. In contrast, more attention should be given to later stage companies that can make use of debt capital for scaling up their business. In designing a public CGS, the eligibility and qualification criteria for SMEs and lenders should be clearly defined, as otherwise the scheme would run in an inefficient and costly manner. What rapidly growing SMEs need is a real partner creditor who provides not only finance for growth but also inputs and advice. An example is Silicon Valley Bank.
- ***Ms. Karunajothi Kandasamy, Deputy CEO, SME Corporation Malaysia***, described how the central agency for SME development in Malaysia, SME Corp., aims to promote development of dynamic, competitive and resilient SMEs. In the last decade, SMEs in Malaysia have shown impressive growth, but their contribution to GDP is still lagging compared to high income nations. The SME Master-plan (2012-2020) addresses the gap at start-up and early stages. It includes the SME Investment Partner Programme to tackle untapped issues such as lack of access to financing and market access. Public guarantee schemes are increasingly used by SMEs, with the result that banks now lend more without collateral.
- ***Ms. Sujaree Monchon, Director, Examination Department, Bank of Thailand***, explained that In Thailand, SME loans continued to grow in 2015, reflecting the fact that banks recognise it as a profitable income resource. The non-performing loans ratio went up in 2015, but remained at an acceptable level of around 3.5% at the end of the year. As one of the SME supporting measures focusing on their financing constraints, Thai Credit Guarantee Corporation (TCG) has been established, which is supported and supervised by the Bank of Thailand. The future challenges include coordination of support for SMEs provided by various agencies, development of an SME database and diversification of funding channels for SMEs, such as crowdfunding and venture capital.

Discussion

Various comments were made by participants during the discussion on the role of credit guarantee schemes. Many participants agreed on the importance of loss sharing with lenders for CGSs, and discussed further the fact that too high a guarantee ratio of the public CGSs would distort credit markets, give wrong incentive to banks, weaken their commitment to strengthening credit assessment and monitoring skills in relation to SMEs and result in waste of taxpayers' money. Views varied on whether the public CGSs should be profitable or not. While the TCG is profitable due to its selective and efficient operations, some argued that given its nature - being a public policy measure where private initiatives are considered not to be forthcoming - CGSs should normally not be expected to be profitable. Others suggested that CGS should be designed to break even in the long run. The appropriate objective of public CGSs was another issue that was discussed. A question was raised about whether it is reasonable to accommodate bank loans to start-ups within the "valley of death" of the corporate lifecycle model, as equity finance may be a more suitable form of finance for these entities. One participant also doubted whether public CGSs could deal with innovative companies. Another participant suggested that public CGSs can be helpful to support the operations of SMEs during recessions, but admitted that choosing viable enterprises that would be likely to recover, as opposed to non-viable ones that could become "zombie firms" is easy ex-post, but difficult ex-ante. The invitation by the OECD to Asian economies to participate in the OECD/EC survey exercise was considered a very helpful suggestion by participants.

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

- ***Mr. Stephen Lumpkin, Senior Economist, Financial Affairs Division, OECD***, discussed savings and investments by individuals which are important not only for their own personal financial well-being but also for economic growth. In addition to the basic legal and regulatory infrastructure, a combination of prudential regulation of service providers and consumer protection rules, financial and tax incentives, as well as financial education and awareness initiatives, is necessary to mobilise savings by individuals. Institutional investors are long-term saving vehicles designed to provide increased retirement income for an aging population. They promote the development of an equity culture and make risk capital available to new or innovative enterprises. They also contribute to the increase of choices available to investors and firms, and to more efficient financial intermediation and more effective systems of corporate governance.
- ***Mr. Mark Moseley, Senior Director, Global Infrastructure Hub (GIH)***, explained that the future demand for infrastructure is enormous, particularly in emerging economies, and given the limits to public financing there will be an increasing need for longer-term private capital. While the supply of private capital is also growing with an increasing preference by investors for infrastructure, capital markets - especially pension funds - are still an untapped resource. Infrastructure has potential attractiveness for institutional investors, due to its long-term nature, higher yields, low default rates and low correlation of risk with other asset classes. In order to unlock capital market-based financing for infrastructure, one solution may be a measure to enhance the credit of project bonds, such as the EIB Unfunded PBCE instrument.
- ***Ms. Etty Retno Wulandari, Deputy Commissioner, OJK, Indonesia***, argued that like in other EMEs, the financial sector in Indonesia is dominated by banks that have a short-term fund structure and are exposed to a mismatch risk with long-term investment. "Indonesian Financial Services Sector Master Plan 2015-2019" was launched to promote a shift to market-based financing. On the supply side, capital-raising through markets is encouraged, for example by education and socialisation to potential issuers. More accessible and affordable capital market products are being developed. On the demand side, a gradual shift from short-term bank deposits to longer-term investment products is necessary. Towards financially-literate Indonesians, a wide array of initiatives to educate the public is being undertaken by OJK.
- ***Mr. Fan Zhai, Managing Director, China Investment Corporation***, observed that China's financial system is heavily bank-based and also largely state-dominated. A shadow banking system is rapidly

expanding as a result of financial repression and regulation arbitrage, but it holds deep connections with banks. Although the third largest in the world, the bond market is still small compared with GDP and is not liquid due to heavy holding by banks. The equity market is smaller but highly liquid and volatile. The traditional over-banked financial system in China may reflect the government's intention to control the economy using a state-dominated bank system, and has been consistent with relatively weak institutional and regulatory environment. An optimal financial structure with a balance of bank-based and market-based financing, could be nurtured under a sound legal and institutional environment. An immediate risk is the policy temptation to speed up the capital account liberalisation to foster financial development.

- ***Ms. Vanessa Wang, Managing Director and Asia Pacific Head of Pensions, Citigroup, Member of Asia-Pacific Financial Forum (APFF)***, stressed the importance of insurers and pension funds which, on the liability side, ensure long-term returns for consumers, providing retirement income and longevity solutions in response to the needs of an aging population. On the asset side, they supply long-term investments through capital markets contributing to infrastructure projects and disaster risk financing. Compared with the huge size of financing demand for infrastructure, investment by foreign pension funds remains tiny and local pension funds are yet to develop although pension reforms are on-going in many Asian countries. The regulation and accounting rules tend to help avoid short-term risks, and thereby turn out not to be supportive for long-term capital investment by pension funds. The APFF has lobbied for a better regulatory, accounting and tax environment for long-term investment.

<u>Discussion</u>

The discussion centred in particular on how to encourage institutional investors, such as pension funds and life insurance companies, to invest more in infrastructure. One discussant argued that institutional investors have reserves available for infrastructure investment, but bankable projects are scarce in spite of huge infrastructure needs in the region. Innovative financial techniques should be employed to design appropriate investment products to meet the different risk appetites of investors. While larger funds tend to invest more aggressively according to the OECD survey, one discussant pointed out that the regulation to levy a high capital charge on riskier assets could curb long term investment by such institutional investors. Financial regulation is prone to focus on the banking sector, and is often short-sighted. The capital requirement regulation is important to ensure the soundness of financial institutions, but should not penalise too much the riskier, long term investment for future growth. A few participants identified a major impediment for long term investment by international and local funds as a lack of adequate hedging tools for such investment, for which MDBs may be able to offer innovative solutions. Moreover, some participants stressed that in order for institutional investors to undertake long term investment, long term saving products that bring to them stable, patient money to invest are indispensable.