

ISSUES



PACIFIC ECONOMIC COOPERATION COUNCIL



**Strengthening Domestic Financial Systems in APEC:**  
**Recommendation of Launching an APEC Peer Review Process**  
**Assessing Progress on Domestic Reform**

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**ISSUES@PECC** presents the current work of PECC's three Forums on Trade, Finance and Community Building and collaborative work with other groups. Complimentary copies are available upon request from the PECC International Secretariat. It is also available on line at <http://www.pecc.org>.

### **About this Issue**

This **ISSUES@PECC** summarizes the findings from the discussion on *The Unfinished Business of Strengthening the Domestic Financial Systems: How Much Unfinished and How to Help Finish*, at the 3rd Annual Conference of the PECC Finance Forum held in Santiago, Chile, on June 20-21, 2004.

The PECC Finance Forum serves as an open forum for a tri-partite dialogue among the academia, government and business sector, on the financial policy issues facing the Asia-Pacific region. The purpose of the dialogue is to assess the international environment for financial stability and development in the region, the progress in the promotion of financial reforms, integration and cooperation in the region, and to develop the desired vision of regional financial and monetary cooperation. For the purpose of these assessments, the Finance Forum undertakes survey-based task force studies on specific issues as well as convenes an annual conference of experts drawn from the member economies and international financial institutions.

For more information, visit <http://www.pecc.org/finance>.

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**The Pacific Economic Cooperation Council (PECC)** was founded in 1980 to serve as a forum to discuss cooperation and policy coordination in the Pacific Region. PECC's expert networks composed of analysts, officials and businessmen provide practical policy advice on trade, finance, and sectoral issues to the region's governments. PECC is the only non-government official observer of the APEC process. See: <http://www.pecc.org> for more details.

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## INTRODUCTION

Strong and diversified domestic financial system is an indispensable element of a strategy to achieve a wealthy and dynamic APEC economy by 2020 that is integrated into the world economy. This report recommends that Finance Ministers initiate an APEC process that monitors and evaluates the progress made by APEC member economies to strengthen and diversify their domestic financial systems.

The PECC Finance Forum posed the question of whether the task of assessing progress on domestic financial reform and strengthening is a useful one. For two reasons, the answer was positive. First, such assessments are guides to what can be done, what works and provide information that can be shared among officials and market participants so that the maximum benefits of reform can be obtained. Second, the process of assessment can be used to identify what remains to be done-- and where--in order to encourage persistent efforts and help to overcome obstacles to reform and modernization.

The PECC Finance Forum believes that an APEC work program as an agent of change can best be achieved through a

process that encourages voluntary participation, provides information that is useable by governments and private sector participants and builds a process of peer pressure for change.

## WHAT NEEDS TO BE ASSESSED?

The focus of such assessments should be the domestic financial system - which is still bank-dominated in many countries - not only to assess progress towards sounder banking systems, but also to diversify domestic financial systems to include sound capital markets and a greater diversity of financial instruments to finance innovation and development. Thus, assessments should focus on financial intermediaries such as banks and other savings institutions, securities markets, payments systems, asset and wealth managers, foreign exchange markets, as well as governance practices. All of these areas are inter-related, but the work program needs to be selective to be manageable.

## HOW CAN SUCH ASSESSMENTS BE MADE?

The PECC Finance Forum considered several alternative approaches recognizing



that some will depend on the availability of data:

- **Scorecards:** A scorecard that ranks and compares countries' financial sectors and supervision with international best practice is one possible approach. A scorecard has the advantage of providing fairly compressed comparative summaries, but also the disadvantage of compression that over-simplifies complex information and processes so as to be misleading.
  - **Checklists:** Another approach is to prepare check lists to be used to compare the status quo with best practice. By 2004, criteria for such checklists can be constructed from principles of and guidelines for best practice that are available from supervisors working in global coordinating bodies in all sectors of the financial services industry.
  - **Modelling:** Current indicators of financial performance can be modeled with respect to key structural variables by modeling base case scenarios against alternative scenarios in which the structural variables are changed.
- Such comparative scenario exercises would illustrate how outcomes could be improved (or could deteriorate) under different assumptions. A consistent conceptual model of financial sector relationships would be essential. Much data would be required on each economy and careful attention would have to be paid to sequencing and the speed of change in the institutional environment.
- **Qualitative country studies:** A more qualitative process is also possible that promotes peer review and information exchange based on country representatives completing questionnaires that are reviewed by third parties. This process would be analogous to that being used for peer review of corporate governance in banking.

## WHAT CAN APEC DO?

The research task could be an enormous one, potentially involving comparisons of evaluations of performance in each APEC economy using multiple attributes of best international practice in financial institution performance and oversight. Further, such a project would have little value unless it

had continuity (rather than being a one-off approach).

PECC is one organization that might be able to do the necessary research but it does not have the governance or accountability structure to raise the potentially-large amount of funding that would be required.

A more focused approach is possible, however, based on the fourth option above. Based on papers presented at the Forum, the scorecard approach was rejected as too simplistic and potentially confrontational. Desirable principles to follow in assessment include: comparison of domestic financial performance and supervision with international best practice; objective third party assessment; and complete coverage of the APEC economies.

Data for banking systems and supervision have been collected by the World Bank. This database provides fairly complete country coverage, but the data reported rely exclusively on authorities' self assessments. The data are not subject to third party appraisal. Alternatively, Financial Sector Assessment Programs (FSAPs) meet the first two criteria. These assessments cover all aspects of a

country's financial system and supervision as well as corporate governance. Domestic authorities' self-assessments are subjected to expert third party appraisals. The main problem with FSAPs is their incomplete country coverage. Of the Latin American and 10+3 members of APEC, only five countries have completed and published FSAPS (Hong Kong, Japan, Korea, Mexico and Singapore). But the completed reports provide a useful starting point.

## RECOMMENDATION

APEC Finance Ministers should highlight the importance of continued attention to stronger and more diverse domestic financial systems and encourage the use of peer pressure for reform through a mix of formal recommendations, informal dialogue, public scrutiny and comparison and ranking of countries. The PECC Finance Forum could team with the Technical Working Group, and possibly with the Asian Bankers Association (ABA) and/or the APEC Business Advisory Council (ABAC) to initiate such a process that focuses on domestic financial sector strengthening and modernization. This process would regularly assess progress towards (a) sound banking systems and (b) development of sound capital markets.



The process can be based on comparison with best international practices along the lines applied in FSAPs. Economies could voluntarily undertake self-assessments based on a PECC-created questionnaire and review these assessments with participants drawn from academe (the Finance Forum members), other governments (the TWG) and members of the private sector (ABA, ABAC). Each economy can proceed at its own pace, but the objective of monitoring and evaluation within APEC is to encourage similar frameworks, and over time, convergence in performance.

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*ISBN: 981-05-1744-0*

*Published by the PECC International Secretariat*

*Layout and Printing by Nest Communications Pte Ltd*

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