Lee Hsien Loong: Seizing the opportunities

Address by Mr Lee Hsien Loong, Deputy Prime Minister of Singapore and Chairman of the Monetary Authority of Singapore, at the MAS Staff Seminar, Singapore, 18 November 2003.

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I. Introduction

We held our last Staff Seminar in October 2002 against a backdrop of weak global economic conditions and uncertainties in the Middle East. We anticipated then that MAS would have to manage within a riskier environment. And this turned out to be so. For us in Asia, the Iraq war and the SARS outbreak weakened business and consumer spending, and caused a major setback to the recovery of the regional economies. However, with the easing of geopolitical tensions and the containment of SARS, sentiments have rebounded and the outlook has brightened. We should now actively prepare ourselves to ride on the recovery and seize the opportunities that are emerging.

II. Economic and financial landscape

In the third quarter this year, the US economy expanded at a brisk annualized 7.2%, buoyed by rising productivity, strong investment and consumption. Economists are generally upbeat about US prospects for 2004. But they are concerned that in the longer term the US may not be able to drive the global economy, because of its large twin deficits, record household debt, and low personal savings.

Europe is just starting to recover from two years of very weak growth. The Japanese economy has been surprisingly robust and the market is becoming more optimistic not just at the cyclical pickup, but also at better prospects for structural improvements. Asia is improving too, supported by easy monetary and fiscal policies and the more favourable outlook in the developed economies. Asian stock markets have been buoyant, and Asian merger and acquisition activities are on the rise. Investors are regaining interest in the region, as shown by strong capital inflows, particularly into equity markets. Growth is picking up. SARS failed to dent China's growth, which is expected to reach 8% this year. South-east Asia is also looking up, especially Thailand which is expected to register 6% GDP growth this year.[1] Malaysia has also recently projected its GDP to grow by 6% per annum for the next two years.[2]

The IMF believes that the world economy has turned the corner. Economic activity is expected to pick up strongly over the next 12 months, growing 3.2% next year, up from this year's 2.3%.[3] Likewise, the World Bank expects the East Asian economies to expand by 6.1% this year and by a more robust 6.7% next year.[4]

III. Singapore's economic and financial landscape

Singapore's economic and financial outlook

In Singapore, following a dismal second quarter because of SARS, the economy rebounded strongly in the third quarter, posting a reassuring 17% quarter on quarter growth. With the improvement in the external environment, the outlook has improved considerably in the last quarter. We now expect the economy to grow between 0.5-1% this year. But we believe that in the short-term recovery will still be less vigorous, compared to previous cycles. This reflects the continuing restructuring in the Singapore economy, particularly in low-end manufacturing. However, both the manufacturing and services sectors appear poised to ride the recovery and next year we expect GDP growth to pick up to 3-5%.

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1 Source: Asian Development Bank.

2 The Business Times, 30 Oct 2003 "KL's growth will average 6% in 2004-05: Mahathir".

3 The Business Times, 24 Oct 2003 "Global economy bouncing back, says IMF".

4 The Business Times, 5 Sep 2003 "East Asia will be fastest with 6.1% growth in 2003".

In the financial services sector, stock market activity reached record levels, with fund management and corporate finance activity also growing strongly. Following several negative quarters, the financial sector started growing again in the second and third quarters. As a result, growth in the first three quarters of this year averaged about 2.5%. The sector should register moderate growth for the rest of the year, and strengthen further into 2004.

Prospects for Singapore's financial centre

What does the improved economic and financial outlook mean for Singapore's financial sector? Back in 1998, when the Financial Sector Review Group was developing strategies for growing the financial sector, we thought that Singapore could become an international financial centre for certain activities, like London. For example, we were already the fourth largest FX centre in the world. We wanted to build on our strengths as a money market and treasury centre to become the debt hub for Asia. At the same time, in other respects we hoped to emulate Zurich. We could become the premier international asset management centre for Asia. After all, our well-respected regulatory, legal and accounting systems and stable socio-economic conditions had already made Singapore a location of choice for private wealth.

After five years of promotion and development, we have achieved some encouraging results. The debt market has grown more than 3-fold since 1998. We have attracted some foreign issuers, and our own corporates have tapped international markets from here. However, we remain largely a market with domestic focus. We therefore need to do more to make our markets deeper, more liquid and internationally established.

The prospects are good. Asian countries are now cooperating more closely to develop domestic bond markets. As corporates in our region expand their businesses to take advantage of the recovery, they will need more funding. We also see a clear trend towards more derivative products being structured here as investors look for better yields or protection. All these factors will help us to continue to grow our debt markets in size and sophistication as a major debt hub.

In the equity market, the global trend five years ago seemed to be towards cross-border alliances and linkages. This has generally not worked out, except to a limited extent in Europe. Indeed, the last few years have been very difficult for stock markets world-wide. However, this year things seem to have turned. In Singapore, stock market activity reached record levels in recent months. Activity should stay strong, because of portfolio inflows in anticipation of the economic pickup next year. The increase in interest in the SGX and in listings on the exchange, from companies having substantial operations in China has been encouraging. There is also a new interest among regional exchanges to explore alliances with each other.

We have maintained our position as a leading global FX centre, and this has opened up opportunities that were less apparent in 1998. One area is commodities trading. Financial institutions are now also major commodities players, with more financial products being structured based on commodity prices as the underlying risk. These structuring and trading teams are usually in the same business units as the FX experts, a number of whom are based in Singapore.

In investment banking, for some time all the interest seemed concentrated in North East Asia. South Korea had recovered from the Asian financial crisis faster than the rest, and China was creating great excitement. However, strong investor interest in recent deals in Southeast Asia indicates a revival of regional M&A activity. Many Singapore firms have interest in expanding overseas, possibly through an acquisition strategy. With the economic recovery firms are likely to increase their capital expenditure, while countries will invest more in infrastructure and other big-ticket projects. This should foster further pickup in the syndicated loan market and Asian Dollar Market.

One particularly successful area is wealth management, and its prospects remain good. In fund management, global mandates are now increasingly being managed out of Singapore. The industry is also expanding in breadth and depth. Beyond marketing and portfolio management, fund management firms are also locating regional functions such as trading, risk management and research in Singapore. More hedge funds are also setting up here, adding to the industry's diversity.

Private banking should continue its sterling performance, as Asia-Pacific is the fastest growing region for private banking in the world. According to Merrill Lynch, Asia-Pacific high net-worth individual wealth jumped 11% last year, supported by high savings rates and robust GDP growth in key regional economies such as China, South Korea and Australia. This figure could be an underestimate, given the low penetration of high net worth individuals in Asia by private banks. Bankers managing private wealth will be attracted to locations which enjoy political and social stability and possess well-respected regulatory, legal and accounting systems. Singapore has all these attributes and is well placed to become a premier centre for private banking business in Asia.

Reputable and well regulated regimes like Singapore can provide a location of choice for investors and financial intermediaries alike, especially with the renewed emphasis on corporate governance and integrity after the excesses of the dotcom era. We can exploit this advantage to become a regional risk mitigation centre, for instance in the areas of clearing & settling OTC and exchange-traded products.

The current outsourcing and off-shoring trend would also present opportunities for us. One estimate is that two million jobs would be created in lower-cost locations like India and China over the next 5 years. While we cannot compete with India and China on cost, we can compete for processing activities which are mission critical and of higher value-added. In the past year, major financial institutions have relocated higher-end middle and back-office operations here. These institutions take the view that Singapore's developed infrastructure, reliability, and skilled manpower make us more suitable for these time-sensitive and mission-critical functions.

In the banking sector, we have gone from 7 local banks to 3 over the last 5 years. Singapore banks have grown larger and stronger, and they are continuing to build up their regional footprints. As a regulator, MAS is happy that they have made progress strengthening management teams and building up risk management systems. Last year, one rating agency even ranked Singapore banks as being among the strongest not only in Asia but in the whole world.[5]

However, by international standards, the three local banking groups are still rather small, despite having made some regional acquisitions and undergone domestic consolidation. The largest of them, DBS Group, ranks only 96th in the world in terms of assets. The banks are also mainly Singapore banks, rather than regional players with strong presence in several countries. Possibilities for domestic growth are limited, other than by further consolidation. But countries in the region like India and Korea are opening up their financial sectors to foreign participation, and other regional and global players are starting to explore these opportunities. The local banks would be conscious of these industry trends.

Does size matter to the local banks? There are differing views. One view is that it does, because economy of scale is increasingly important. The pursuit of size in the global financial industry has been underway for several years, and despite some less-than-successful mergers overseas, is still on-going. The most recent merger between Bank of America and FleetBoston Financial would create the second largest US bank with total assets of nearly US$1 trillion and operations across 34 countries.

In this view, size also enables a bank to diversify across geography and products, which gives it a much stronger base. This is the way the industry is moving. If Singapore banks do not make it to be significant regional players, at least, then they risk being marginalised, and perhaps eventually being absorbed by other players.

However, there are others who maintain the contrary view. They hold that size is not essential for banking or financial industry success. There exist successful smaller players who excel in particular markets or specialised areas of expertise, and Singapore banks can be among these. Furthermore, banks can only expand as fast as they can grow their business or assimilate new acquisitions. Over-rapid expansion can result in weaknesses and mistakes, and turn a small but strong operation into a large but vulnerable one.

It is up to the Singapore banks and their shareholders to consider these opposing arguments and continually reassess their strategies. They will need to decide whether they need further scale to compete effectively, and if so whether it should be achieved through consolidation at home, expansion and acquisition abroad, or a combination of both. MAS cannot make this judgment for them, though the continued strength of our banking system depends on their making the right judgment call. Whatever the outcome, we need a core of strong local banks, as the stability of our financial system hinges on that.

Overall, the prospects for our financial centre look good. Last year, employment fell slightly because of mergers, consolidation and the general economic weakness, but the worst seems to be behind us. More jobs are being created by the new activities that are being attracted here and by expansion in

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[5] FitchRatings, The Singapore Banking System, 19 Apr 2002.

established areas like wealth management. The financial sector will continue to be an important contributor to economic growth.

IV. Progress review of MAS' 2003 business priorities

Let us now briefly review how well MAS has achieved its business priorities over the past year before we focus on what we must do to grasp the opportunities arising from the financial services upturn.

Managing within a riskier environment

First, managing within a riskier environment. The financial industry is ever-changing - risk management practices are constantly being tested and challenged by new business models and financial products. The impact of these innovations on the safety and soundness of financial institutions, and on the resilience of the financial system is not always obvious. Regulators must continually seek to identify and manage new and evolving risks, without inhibiting the creativity and dynamism of the markets.

As we continued to shift from one-size-fits-all to risk-focused supervision, we modified, adapted and updated specific supervisory practices and methodologies in line with industry developments. In the last year, we have taken steps to more clearly define (1) the objectives or desired outcomes of supervision, (2) the functions MAS performs directly or facilitates indirectly to achieve these outcomes, and (3) the principles that guide our supervisory approach. This will help us to steer through the environment of continuous change and greater uncertainty. We intend to publish the framework of our ideas on these issues.

In all areas of supervision, we continue to build up our institutional knowledge. This includes understanding the key risk areas of individual institutions, and how they manage risks. We keep asking this fundamental question: What could go wrong with each institution that we supervise? Then we allocate appropriate supervisory resources, depending on the probability and potential impact of different mishaps.

We are also making progress implementing risk-based capital requirements. The risk-based capital requirements for SGX member companies have taken effect in October. The models for insurers have been rigorously tested and will be implemented next year. In banking, where international risk-based capital standards already exist, MAS is working with local banks to prepare for Basel II. We are not going to prescribe the approaches for our banks to adopt, but we have encouraged them to put in place the more advanced risk management practices that would enable them to move to the internal ratings-based approaches if they chose to do so. To enhance risk management capabilities in institutions, we have also issued comprehensive guidelines on international best practices.

We have recently completed the IMF/World Bank's Financial Sector Assessment Program (FSAP). According to the preliminary findings, the assessors have concluded that Singapore's financial sector is robust with few short-term vulnerabilities. While we can take heart from the positive FSAP findings, we must not be complacent. We must remain vigilant to ensure continued confidence in our financial system.

Strengthening partnership with industry

Second, strengthening partnership with the industry. MAS has collaborated with the industry in several areas. We have embarked on a joint initiative with SGX to cultivate a stronger research-oriented environment in the stock-broking industry. We have also partnered banks to establish a cheque truncation system, and to include the Singapore Dollar as one of 11 global currencies in CLS (Continuous Linked Settlement). The participation in CLS eliminates FX settlement risk, and further consolidates Singapore's position as a leading FX trading centre and a key node in the global financial system.

Last year we formally adopted a policy of extensively consulting industry on new regulatory changes. Since January 2003, we have issued 17 consultation papers. The feedback from industry both here and abroad, has been useful in helping us formulate these changes.

Deepening talent pool

Third, deepening Singapore's talent pool. As we move towards providing higher value-added services, we will face more intense competition for talent. We need to deepen our talent pool by training the local workforce whilst stepping up efforts to attract foreign talent with the requisite specialist skills.

The industry needs professionals with market experience and skills to deal with the increasingly complex and volatile financial markets. To meet this demand, we need to enhance our training and development initiatives. Besides co-funding financial skills training under the Financial Sector Development Fund, we are actively promoting Singapore as a financial training hub. Discussions are now on-going with the newly established Wealth Management Institute and INSEAD as well as major institutions to develop corporate training centres and corporate universities.

We would also like to build up Singapore's financial research capabilities with an Asian and emerging market focus. We are currently exploring the possibility of establishing a financial research institute, in partnership with established financial research institutes worldwide.

Enhancing market discipline

To enhance market discipline, we have facilitated the establishment of industry-sponsored but independently-run complaints-handling processes and mechanisms for customers to settle disputes with banks and insurers. The banking industry now has a Consumer Mediation Unit and the insurance industry the Insurance Disputes Resolution Organisation (IDRO). Presently, we are working with the securities industry to study the feasibility of an industry-based dispute resolution scheme for the capital markets.

Together with other government agencies, we launched a national financial education programme "MoneySENSE", aimed at improving the basic financial literacy of consumers. The "For the Consumer" portal on MAS' website provides a one-stop access to financial education materials, including consumer guides.

V. MAS workplan for 2004

The past year has been a challenging one on many fronts, but MAS has made good progress in meeting its business priorities. With the global and regional economic recovery, many new opportunities will emerge. To capitalise on these opportunities, we have identified three key thrusts for our 2004 workplan.

Enhancing our competitive operating environment

The first thrust is to enhance our competitive operating environment. We aim to do so in the following areas.

We will enhance the transparency of supervisory initiatives and policies. To improve financial institutions' understanding of their statutory responsibilities, MAS will articulate more explicitly and systematically the intent of significant changes in legislation and regulation. We also intend to share best practices for compliance.

We will also be reviewing our process for conducting monetary policy in light of the ongoing structural changes in the economy. We will be looking at how we make decisions, how we communicate the Monetary Policy Statement, how we implement the policy, as well as studying the transmission mechanism through which the exchange rate affects the real economy.

Next, we will seek a judicious cost-benefit balance in our regulatory and supervisory work. MAS will not compromise the safety and soundness of individual institutions or systemic stability. But it will strive to supervise institutions without placing unnecessary regulatory burdens on well-managed individual institutions or inhibiting the innovation and dynamism of the financial sector. Compliance costs of supervisory actions will be commensurate with the risks posed by the individual institutions.

We will seek consistency in applying equivalent prudential and market conduct standards to financial institutions conducting similar business activities that are subject to the same risks. Harmonising and integrating regulations and supervisory practices across financial activities will reduce opportunities for regulatory arbitrage.

Working towards more win-win outcomes for Singapore and the region

Second, we must work towards more win-win outcomes for Singapore and the region.

The growth and development of Singapore depends on the health of the world economy, and the well-being of our neighbours and trading partners. As a hub and gateway in this region, Singapore benefits if the region is competitive and attractive to investors and new businesses. Southeast Asia must work together to make itself more attractive, especially with new opportunities and competition arising in North East Asia. Last month, ASEAN leaders agreed in Bali to build an ASEAN Economic Community by 2020 - a single market and production base with free flow of goods, services, investments, capital and skilled labour.

Asian countries need to foster closer cooperation and integration between financial systems and markets in the region. This will facilitate the financing, and payment and settlement of intra-regional trade. It will also improve the working of capital markets, so that the businesses can raise the capital they need more conveniently and at lower cost. Asian countries are now making greater efforts in regional financial cooperation. When these succeed, they will hopefully spur countries to go further. They recently launched a USD Asian Bond Fund. Although this did not lead to any big bang, it underscored the interest among Asian economies to develop their capital markets. In consultation with the private sector, regional central banks are now working on a local currency ABF.

As a financial centre, Singapore is well placed to seize opportunities as regional markets integrate. We will pursue a two-pronged strategy.

First, we will actively participate in regional initiatives with the objective of making Singapore a key “interchange” in regional financial flows. Within ASEAN and ASEAN+3, Singapore is leading initiatives to strengthen capital market capacity-building efforts and foster greater cross-border collaboration among regional capital markets. We are advocating the adoption of international capital market standards and practices in ASEAN as an essential market foundation.

We are realistic that the regional market will take some time to develop and accept that we cannot force the pace. But we need to stay engaged and strengthen our linkages with the major economies and emerging regions, to offer high value-added activities and secure our place as a key node in the region. On our own, we are already working to establish exchange linkages with major markets to enlarge market coverage out of Singapore.

Second, we will work to take full advantage of the new FTAs currently being negotiated to create greater financial flows into Singapore, and to enable our financial institutions to access these markets.

In our Comprehensive Economic Cooperation Agreement (CECA) with India, we are exploring closer integration of our financial markets. Both countries stand to benefit if our financial sector players can operate seamlessly between the two markets. While there are many regulatory and other issues to be addressed, we see this as a unique opportunity for both India and Singapore.

Empowering consumers to achieve fair dealing

Third, we must empower consumers to achieve fair dealing. This will help us to develop a more informed and savvy consumer market, which is necessary to grow a vibrant financial sector.

With liberalisation, there are now more channels for savings that entice investors with higher yields, such as bonds, equities, unit trusts, hedge funds, and insurance and annuity products. These products also carry higher risk. Has consumer sophistication risen in line with the complexity of financial products? As consumers seize new investment opportunities, how far should MAS safeguard their interests?

MAS no longer practises merit-based regulation of products. It is neither feasible nor desirable for MAS to prescribe what consumers can or cannot invest in, how these products should be priced, or what terms and conditions should govern transactions. This would inhibit business enterprise, restrict consumer choice, and raise compliance costs. MAS cannot intervene in commercial disputes with individual institutions or arbitrate on contractual matters. Therefore, in 1997, we stated the rule should be “Caveat Emptor” - let the buyer beware, and watch out for his own interests.

However, we have not left consumers entirely alone to fend for themselves. There may be an imbalance of power between consumers and financial institutions. Consumers may lack information and resources to participate confidently and knowledgeably in the marketplace. Thus, MAS has helped to empower consumers and to promote fair dealing by establishing a regulatory framework for increased information disclosure and sound market and business conduct standards. This regulatory regime requires offerors of investments to provide full, timely, accurate and meaningful disclosure of information to consumers, on a continuous basis. The intent is for consumers to make their own informed decisions. One objective of the “Money-SENSE” financial education programme is to equip consumers with the skills and tools to evaluate financial products, judge the risks involved and take responsibility for their actions.

To address the issue of mis-selling and misrepresentation by financial intermediaries, MAS has facilitated the setting up of affordable and efficient channels for aggrieved consumers to seek recourse. This is necessary if market discipline is to work, and consumers are to receive fair dealing. With these channels in place, we aim to develop consumer self-reliance. Let me now illustrate these principles with two examples.

My first example is the AIA Critical Year issue. This was a commercial dispute between AIA and policyholders, which had to be resolved bilaterally between them, whether through negotiations, industry-based dispute resolution mechanisms or the courts as a last resort. MAS could not intervene. But MAS had a responsibility to ensure that policyholders had full information of what AIA was offering them, what this was worth, and what other alternatives they had. MAS also had a strong interest in seeing IDRO, the industry based dispute resolution mechanism, work.

Thus what MAS did was to ensure that information was disseminated promptly, accurately and adequately, so that policyholders could make a considered decision. We issued a policyholders’ guide to help affected policyholders understand their own policies and the options available to them. AIA was asked to issue a public statement to explain fully and clearly its support package and adjudication process.

MAS also made it clear to the industry that if any dispute arose over the jurisdiction or authority of IDRO, it would have had to contemplate introducing statutory and regulatory mechanisms for dispute resolution. Full disclosure and working dispute resolution mechanisms are preconditions for a disclosure-based regime and self-reliance to work.

The AIA dispute simmered for many months. Eventually AIA responded to the concerns of policyholders, including those raised by CASE on their behalf, by revising and substantially improving its offer. As this offer addressed many of the earlier concerns, MAS welcomed it publicly. This is one instructive example of how consumer or investor bodies, such as CASE, can play a useful role bringing together and articulating the common concerns of consumers.

The second example is structured deposits. Structured deposits have become a popular new investment instrument providing the chance of higher returns than conventional fixed deposits, in exchange for the risk of lower returns if the bet turns out wrong. However, the calculation of returns and risks on such products may be complex. The average retail investor may not understand what the outcome depends on, much less judge the odds of things working out in his favour. Investors may also be misled by the assumption that, being deposits, such products are very safe.

Nevertheless, MAS has not prohibited such structured deposits, because that would restrict investor choices and would benefit neither the industry nor the consumers. But under our disclosure-based philosophy, it is important that consumers understand exactly what they are buying. So MAS has proposed guidelines for full and meaningful disclosure of the risks involved, including reasonable illustrations of potential benefits, and clear explanations of any limits on returns. We have also required banks distributing such products to treat these as investment products rather than deposits which can be sold over-the-counter by bank tellers. These guidelines are currently under consultation. MAS will monitor how the market develops to see if further action is required. Going forward, we will produce educational materials to help consumers understand these products better.

VI. Conclusion

We stand on the threshold of a cyclical economic recovery amid profound structural changes to the global economy. For the first time, emerging economic powers, China and India, are thrusting themselves into the global economy. They are forcing a major reordering of the economic landscape, whether in terms of new competition for investments and exports, or new markets for products. Despite all the problems and complexities that Asia faces, this is the most dynamic region in the world.

We need to continue to restructure the Singapore economy and move up the value chain of economic activities. Singapore will continue its role as an important financial centre despite the changing environment and challenges posed by China and India, and must find ways to benefit from these developments. Financial services will continue to be an area in which we have a competitive advantage.

The economic recovery presents great growth potential. We need to position ourselves to capitalise on the opportunities. Market players must seek out and seize the business opportunities as they arise. They must continually reassess their strategies to remain competitive in this changing world, and more importantly, implement the good strategies vigorously to create new opportunities for themselves.

MAS will continue to ensure the integrity of the financial sector, so that Singapore remains an attractive regional hub for financial sector activities. It will also adapt and respond to market developments to facilitate a more competitive operating environment. Together, MAS and the financial industry will navigate the winds of economic change and strengthen our position as a premier international financial centre.