Heng Swee Keat: A review of Singapore's economy and financial system

Opening remarks by Mr Heng Swee Keat, Managing Director of the Monetary Authority of Singapore, at MAS' Annual Report 2008/09 Press Conference, Singapore, 16 July 2009.

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Backdrop on global financial and economic crisis

The world economy has witnessed one of the most tumultuous and challenging times. Global GDP is expected to contract in 2009, the first time in the post-War period.[1] The tremors that shook the financial markets surpassed the most extreme stress scenarios. Bank losses have now exceeded US$1.5 trillion and further writedowns are expected. In the six months following the collapse of Lehman Brothers, from September 2008 to March 2009, stock markets worldwide fell by almost 40%, wiping off about US$16 trillion in capitalisation. Singapore's Straits Times Index (STI) also fell by close to 35%. In the fixed income markets, the rally in government bonds was offset by the sell-off in the non-sovereign sectors such that global bond markets in aggregate also declined over this period. Many institutional and individual investors were affected negatively.

These shocks to the international financial system severely disrupted credit flows and led to dislocations in economic activity globally. The US – which was the epicenter of the crisis – as well as the EU and Japan, fell into a deep recession. The collapse in G3 demand, in turn, had a cascading effect on the emerging economies. As trade collapsed towards the end of 2008 and into the first few months of this year, Asia's export-reliant economies were hard-hit.

Against this external backdrop, the Singapore economy contracted sharply, as our manufacturing, transport, logistics and wholesale trade industries were closely tied to global and regional trade flows. By the first quarter this year, the economy had posted an output loss of around 10% from its peak a year ago, the steepest decline in its history.

The unprecedented global financial crisis has weighed heavily on financial markets worldwide, leading to severe declines in valuation across many asset classes amidst heightened market volatility. MAS' investments were negatively affected by the crisis. As at the close of the financial year on 31 March 2009, MAS recorded a net loss of S$9.2 billion, about 3.5% of MAS' average total assets. This compares with profits of S$7.44 billion in the previous year and S$3.85 billion in FY06. This severe crisis has therefore pared back about 80% of the gains in the preceding two years. The extent of loss has been mitigated as we raised the liquidity profile of our portfolio in the early part of 2008, in the face of greater uncertainties. With the broad based upturn in financial markets after the close of the financial year, the valuation of MAS' foreign assets has improved and more than half of the losses have been recovered.

Despite the severe global conditions, Singapore's financial system has, by and large, weathered the crisis well. In managing this crisis, MAS has focused on maintaining the strength of Singapore's financial system, based on three key pillars: first, maintaining sound financial institutions; second, ensuring well functioning markets; and third, maintaining confidence of investors. Let me touch on these in greater details.

[1] In July 2009, IMF upgraded its 2010 world GDP growth forecast from 1.9% to 2.5%. Its 2009 world GDP growth forecast was lowered slightly to -1.4% from -1.3% previously.

Strengthening resilience – what MAS has done

Given the openness of our financial system and the severe downturn in our economy, Singapore's financial system cannot be insulated. MAS focused on maintaining the **soundness of financial institutions** in Singapore. We intensified supervision of financial institutions through close monitoring of their financial soundness, holding regular discussions with the board, management, and auditors of financial institutions, and for foreign financial institutions, having constant dialogues with their home regulators and head-office auditors.

Stress testing major financial institutions is one of our supervisory tools that is used regularly even before the crisis. In this crisis, we have given stress tests an added emphasis, and the latest stress tests of banks and life insurers were conducted in Q1 2009. As the banks and insurers here were well-capitalised and financially sound, the objective of the stress test was not to ascertain what recapitalization amount was needed, because the need did not arise. Instead, the stress tests were to allow MAS to determine how resilient the banks and insurers were to highly adverse scenarios. In this regard, the stress tests revealed that while financial institutions' financial resources would be affected by lower asset values, rising credit costs and moderating earnings, they are generally resilient even under stress conditions. A second objective is to focus the financial institutions' attention on managing their risks and safeguarding the robustness of their liquidity, earnings and capital so that they remain financially sound through the economic downturn.

<u>Second</u>, we took steps to ensure **well-functioning markets**. Singapore's interbank money markets did not experience the seizure that griped the LIBOR markets. However, the openness of our markets meant we could not be immune from the global dislocations. MAS reassured financial institutions that they would have access to S$ and US$ liquidity in three ways.

We kept a higher level of liquidity in the banking system. We also expanded eligibility to the Standing Facility to all banks that participate in the MAS Electronic Payment System, MEPS+, allowing them to repurchase SGS for S$ funds with the MAS. Finally, we entered into a US$30 billion swap arrangement with the US Federal Reserve. This arrangement has been extended to 1 February 2010.

Third, measures were put in place to **maintain confidence of investors** in Singapore as an international financial centre. In response to announcements by jurisdictions in the region of blanket government guarantee on deposits, the Singapore Government announced on 16 October 2008 a guarantee on deposits of individuals and non-bank customers of banks licensed in Singapore. This was aimed at ensuring a level international playing field for banks in Singapore and demonstrated the Government's confidence in the soundness of the financial system. It has also had the effect of maintaining the confidence of investors and depositors in our banking system.

State of the financial System

The measures taken around the three pillars of maintaining **sound financial institutions, ensuring well functioning markets and maintaining confidence of investors**, as well as the way in which institutions and market players responded to the crisis, have helped our financial sector weather the crisis. A healthy and functioning financial system has continued to support credit and capital intermediation to the economy. Compared to the Asian Financial Crisis, the moderation in bank lending has been milder. While credit conditions have tightened, there has not been disruption of credit flows to corporates. A total of S$9.6 billion[2] was raised by SGX listed companies in the first half of 2009, which accounted for 65% of

[2] Source: SGX & Thomson Reuters.

total rights offerings in Asia in this period. More than 7,300 Government-backed loans amounting to S$4 billion have since been approved in the first half of 2009.

In the first quarter of this year, the financial sector grew by 7.7% quarter-on-quarter on a seasonally-adjusted annualized basis. Financial services employment has also held up reasonably well. Employment stock continued to increase in Q4 2008 and fell by 1,900 or 1.1% in Q1 2009. A recent poll[3] showed that the banking and financial services sector reported the biggest jump in hiring intentions, 32% this quarter, up from 19% in Q2.

Strengthening resilience – new measures

Going forward, we will remain vigilant and continue to focus on the three key pillars of resilience of our financial system. The main focus would be on shaping and adopting new international regulatory standards, strengthening the corporate governance of financial institutions, enhancing the Standing Facility and strengthening the Singapore Government Securities auction system, and bolstering investors' confidence in our financial system.

Reforming the regulatory framework has become a major issue internationally, and the emerging consensus is towards more stringent regulation. Under the first pillar of **sound financial institutions**, MAS is contributing to and helping to shape new regulatory standards being discussed at the Financial Stability Board, the Basel Committee on Banking Supervision and other international standard-setting bodies. For example, discussions on liquidity risk management standards and the capital framework for banks are at an advanced stage. Over the course of the next one to two years, we will be implementing changes to our regulatory framework to adopt these new standards. As MAS' regulatory framework has generally been regarded as conservative, we are in a good position to adopt these standards. We are mindful of maintaining a balanced approach and not over-swinging the regulatory pendulum. We will work closely with and consult the industry and the public.

In the area of regulatory standards, we will review the Corporate Governance Regulations and Guidelines for locally incorporated banks and significant life insurance companies, introduced in 2005 and which were implemented in 2007. MAS' review will focus on the effectiveness of risk management at the Board level, including the role played by Boards in safeguarding the safety and soundness of their institutions and in addressing market conduct risks. This would include a review of the Board's role in setting remuneration policies to manage risks effectively.

Giving further impetus to risk management, the locally incorporated banks are conducting more detailed stress tests internally as part of their Basel II implementation process and the results will be used in their capital planning. For foreign banks, MAS is continuing our close cooperation with home supervisors through regular discussions as well as participation in supervisory colleges.

In the <u>second</u> area of ensuring **well-functioning markets**, several new measures, to **enhance the MAS Standing Facility** and **strengthen the SGS primary auction system**, will be implemented.

The **MAS Standing Facility** has been a key channel of providing liquidity to financial institutions. To further enhance this facility, with immediate effect:

a) We will accept AAA-rated S$ debt securities issued by sovereigns, supranationals and sovereign-backed corporates as collateral in the Standing Facility in addition to SGS. Given this change, we will also permit banks to treat these securities as Tier 2

[3] Conducted US-based recruitment firm Hudson.

liquid assets, with the same zero risk weighting as SGS. This will help banks to better manage their risks and liquidity profiles.

b) We will also enter into cross-border collateral arrangements with other central banks to accept well-rated foreign currencies and government debt securities as collateral in the Standing Facility. Last month, I signed an MOU with the Governor of De Nederlandsche Bank N.V., the Dutch Central Bank. Discussions are ongoing with several other central banks.

Globally, government bond issuance is rising while banks' balance sheets which are typically used to underwrite these issuances are shrinking. We have seen in some jurisdictions several instances of poor or even failed auctions of government bonds due to unexpectedly weak sentiment or concerns about ballooning government debt and fiscal deficits. Singapore is different. The Government does not issue bonds to finance its budget deficit. Investors understand that the Government issues SGS for the sole purpose of building a risk-free yield curve for the corporate sector to price its debt. But the SGS market can be affected by contagion of weak sentiment spilling over from other markets. We have therefore worked with the Government on two measures to enhance the resilience of the SGS market.

MAS will be empowered to either adjust the issuance size or vary its subscription amount to stabilise an auction. This will mitigate the risk of disorderly trading in specific securities or further volatility in the secondary market. In the event of extreme market conditions or disruption, MAS will be empowered to cancel an auction.

In ensuring stability and resilience of the financial sector, a key anchor is a central bank backed by a strong balance sheet. We have increased our total capital and reserves to S$28.74 billion, representing close to 11% of MAS' total assets of S$264.75 billion. This will position us well to navigate through a potentially volatile financial market environment, and allow us to implement a broader range of measures to stabilize the Singapore financial system should the need ever arise.

While local institutions withstood the crisis and remained sound, a large number of local investors were adversely affected when the credit-linked structured notes they bought defaulted or were redeemed early. Although the defaults were triggered by an unprecedented financial crisis, it has been a painful experience for affected investors. MAS has responded by taking prompt measures to require affected financial institutions to review complaints rigorously. MAS' approach was for financial institutions to review complaints on a case-by-case basis. Settlement offers are made by the financial institutions taking into account the particular facts and circumstances of each transaction. We also completed our investigations into the sale and marketing of structured notes linked to Lehman Brothers by these financial institutions. Our investigation found that the nature and extent of failings identified and their potential impact on the sales process and customers differed for each institution.

It is clear from our investigation findings that an across-the-board general settlement for all investors would not have been justifiable. We understand that not everyone agrees with the case-by-case approach. However, we believe it is the correct approach that is fair to all parties concerned.

There are lessons from this episode for financial institutions, investors and MAS. Thus, in the <u>third</u> area of **enhancing confidence in our financial system**, we have to review the roles undertaken by all parties. MAS has reviewed the sale and marketing of structured products, and in March 2009 put out for consultation a set of proposals to further safeguard consumers' interests and promote higher industry standards for the sale and marketing of unlisted investment products. For financial institutions, the Board and senior management must take immediate steps to win back the trust and confidence of their customers. MAS' Fair Dealing guidelines reiterate that the Board and senior management of financial institutions are responsible for achieving fair dealing outcomes by their institutions. They will need to go beyond just addressing the failings identified in MAS' investigations. One immediate area for attention is staff training.

To this end, MAS has proposed a new Capital Markets and Financial Advisory Services (CMFAS) examination module on product knowledge for representatives who want to sell "complex investment products". MAS has been working with representatives from various industry associations and The Institute of Banking and Finance to develop this CMFAS examination module. But in addition, financial institutions must ensure that their representatives keep up to date with market developments.

MAS will review and intensify our supervision of financial institutions in the sale of investment products, and commit more resources to this. We will continue to use thematic and ad-hoc inspections to review compliance policies, procedures and controls of financial institutions. MAS' supervision cannot replace the primary role of the Board and senior management to ensure that controls and processes are implemented robustly by all their staff in all dealings with customers, at all locations. We will therefore scrutinise the steps being taken by Board and senior management to ensure fair dealing by the financial institution with its customers. This will include areas such as product approval due diligence, as well as the pay and incentive structures for sales and advisory staff, and their training and supervision. Downstream, we will increase the use mystery shopping to complement inspections and other supervisory tools to help us identify specific areas where financial institutions are falling short.

While this means that MAS will be more probing in our supervision and dealings with financial institutions than in the past, we will need to be careful that this does not create an overly legalistic and combative relationship with the regulated entities. We share a common objective in having a regime that encourages growth based on sound and ethical business practices, and adherence to the spirit and letter of MAS' standards, so that consumers can be well served.

Consumers too have to play their part. The recent crisis reinforces the importance of investing only in products that they understand and taking steps to better safeguard their interests when making investment decisions. Although these points have been highlighted in various MoneySENSE guides and seminars, in times of rising asset markets, outreach efforts had not been easy, but we must persist.

To help investors understand common financial products, we launched the MyMoney programme, in partnership with ABS, the Securities Investors Association (SIAS) and the Singapore Management University's Sim Kee Boon Institute for Financial Economics. Speakers shared facts on the risks in investment products such as structured deposits, unit trusts, bonds and investment linked policies, highlighting risk-return trade-offs, and key issues consumers should consider before deciding whether to purchase a product.

Going forward, we need to focus on new products when they are launched. We would like to see financial institutions organise educational initiatives in partnership with independent experts, when they launch products with features or structures that are new to the market.

A major piece of work for us in this area in the coming year will be to develop a financial literacy core competency framework. Building on the three tiers of financial literacy in the MoneySENSE programme, the framework will set out the basic knowledge and life skills individuals would need to make informed financial decisions at key life stages, starting at an early age, continuing through working life and into retirement. These decisions include managing budgets, setting aside adequate funds for emergencies, managing CPF savings prudently for retirement, assessing affordability when buying a property, and understanding and evaluating risks when investing in particular products.

The Financial Sector Development Fund has set aside $10 million to fund financial educational programmes for the next three years. Going forward, we will invite the public to contribute new and imaginative ideas on how financial education can be delivered more effectively. Consumer education requires sustained efforts by each and everyone in the community. We will fund proposals that can best support the delivery of the knowledge and skills in the financial literacy competency framework.

Our next measure to **maintain confidence** is a review of the deposit insurance (DI) scheme in Singapore. As part of MAS' continual efforts to enhance the regulatory framework in Singapore, we are reviewing the DI scheme to ensure it remains relevant, provides adequate protection to depositors and is in line with international practice. When the DI Scheme was started in April 2006, it targeted to fully insure the deposits of 80-90% of individual depositors. In line with this, a limit of $20,000 per individual depositor per institution was set, allowing 87% of individual depositors to be fully insured.

This coverage ratio has now come down to 83%, the lower end of our targeted range. MAS is considering raising the DI coverage limit above $20,000 to achieve a better coverage ratio and provide a better level of protection to depositors. We are mindful that this should not substantially increase the cost to the industry and indirectly to customers. We are targeting to conduct our review and consult the industry and public on the proposed changes over the next six to nine months, and will seek to implement the revisions to the deposit insurance scheme in 2010.

Strengthening research capabilities

Even as we deal with the immediate effects of the global crisis, we also continue to have our eye on building up capabilities in the longer term. The Economic Policy Department in MAS has run a successful visiting scholar programme since 2002. To support and strengthen research in finance and economics on a wider scale, MAS announced today that it will sponsor a professorship in economics and finance at the National University of Singapore (NUS) for the next five years. This Professorship also signifies MAS' desire to strengthen collaboration between academia, industry and the public sector. Together with NUS, we will engage internationally renowned academics to lead and conduct research in Singapore in the areas of finance, international economics, monetary economics or public finance.

Economic outlook

Finally, on the economic outlook. More recent data, including the advanced estimates released by MTI, showed that the Singapore economy had rebounded strongly in the second quarter. This recovery has to be seen in the context of the sharp retraction in economic activity which took place during Q4 2008 and Q1 2009. As such, businesses have started to rebuild inventories to levels that are more sustainable and consistent with underlying demand, which has stabilized somewhat amidst easing financial conditions. In the domestic financial sector, several areas of activities posted gains in the second quarter. Improved sentiment has buoyed stock market turnover, while the latest figures for May showed that domestic non-bank loans remained firm.

Nevertheless, much still depends on the strength of final demand in the G3. Given that there remain stresses in the global financial system and job markets in the major economies continue to weaken, the domestic economy is likely to witness slow and uneven growth, rather than sharp and decisive recovery. For the economy as a whole, MTI has revised the official growth forecast for 2009 to between -6% and -4%.

In tandem with the weak demand and easing domestic costs, consumer price increases are expected to be muted. For the whole of 2009, CPI inflation is now expected to come in between -0.5% and 0.5%. This revision takes into account the recent developments in global commodity prices.

Monetary policy

In October last year, in light of the weak economic environment and easing inflationary pressures, MAS shifted to a 0% appreciation of the S$NEER policy band. This was followed by a re-centring of the policy band to the prevailing level of the S$NEER in April 2009, while keeping the 0% appreciation path. At this juncture, notwithstanding the sharp rebound in the economy in Q2 2009, growth remains below trend and inflationary pressures continue to be muted. We assess that the current policy stance remains appropriate to support the economic recovery and ensure medium-term price stability, which in turn underpins confidence in the Singapore dollar. Our next monetary policy review will take place as scheduled in October.

Conclusion

Going forward, it will be important for central banks and regulators around the world to remain vigilant and to continue addressing financial system risks as the markets remain fragile and uncertainty remains. Singapore is not insulated from pressures in other parts of the world. We need to understand the changes and anticipate how they would affect us in order to take the right actions. MAS will continue to build on our key pillars of having sound financial institutions, ensuring well functioning markets and maintaining confidence of investors. Building on such strong fundamentals and adapting to new challenges, we can ensure we emerge stronger.

Thank you.