Heng Swee Keat: Achieving good regulatory outcomes – the way forward

Welcome speech by Mr Heng Swee Keat, Managing Director of the Monetary Authority of Singapore, at the 16th International Conference of Banking Supervisors, Singapore, 22 September 2010.

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1. Good morning. My colleagues and I at the Monetary Authority of Singapore are delighted to welcome you to Singapore, and to the 16th International Conference of Banking Supervisors (ICBS). We are honoured to join the Basel Committee on Banking Supervision (BCBS) as organisers of the conference.

Looking back on the crisis

2. When we last met in Brussels in September 2008, the collapse of Lehman Brothers triggered a tail-spin in the global financial system. The global economic outlook was then grim. Decisive policy action has averted the worst scenarios of the crises, and the overall situation has improved significantly. Still, financial vulnerabilities and uncertainty over the pace of global economic recovery remain.

3. This year's ICBS comes at a critical juncture. In the last two years, all of us, as national financial authorities, have undertaken extensive reviews to enhance the resilience of our financial systems. Globally, the FSB and IMF have been working to forge agreement on measures to prevent and mitigate a crisis of such systemic proportions. In particular, the Basel Committee under the leadership of Governor Nout Wellink has been at the forefront of devising a new regulatory framework that underpins and fosters a more resilient global banking system.

4. By bringing together senior officials from central banks and supervisory agencies from over 100 countries, this year's meeting will provide the platform for us to move ahead on the core of the regulatory changes, and to chart the direction for the remaining areas of work.

5. The two themes for this year's conference – building a more resilient banking system, and creating a stable financial environment for sustained economic growth underscore two key principles. First, the financial system needs to be resilient to avoid destabilizing the economy. Second, beyond resilience, rebuilding the nexus between the financial sector and the real sector is critical to supporting growth and development. This is particularly important in many emerging economies where the pace of financial sector development has not caught up with that of the real economy.

6. Let me now share some reflections on three themes that permeate discussion on financial resilience – microprudential regulations, macroprudential regulations, and supervisory approach.

The Basel Committee's reforms

7. Many banks entered the crisis with too much leverage, too little capital and inadequate liquidity buffers. We need better micro-prudential regulations. Banks need to reduce leverage, have higher quality and quantity of capital to absorb losses, and maintain a higher proportion of liquid assets to withstand shocks in the funding markets.

8. The Basel Committee has agreed on the need for standards relating to capital, liquidity and leverage. These first set of parameters for core capital has been carefully calibrated after considering the conditions in the various economies, as well as the results of

the bottom-up Quantitative Impact Studies and the top-down macroeconomic impact of the proposed changes. The phase-in arrangement for the new benchmarks strikes an important balance between strengthening the financial system and supporting economic recovery. Singapore supports the Basel Committee's reforms, and the further work to be done.

9. Going forward, our key challenge is to ensure robust implementation of these new capital standards. In an interconnected global system, major problems in one part of the system will eventually affect us directly or indirectly, through various channels. All economies, whether advanced or emerging, and whether they had a direct banking crisis or not, have therefore a shared interest in strengthening the resilience of the global financial system.

10. However, as we phase-in these measures, we need to be vigilant that these do not have unintended consequences on credit availability and economic growth, or in reducing diversity in the financial system.

11. In striving towards a convergence in regulatory standards in order to preserve a level playing field across jurisdictions, we should be cognizant that the starting conditions and future challenges of countries differ. For many emerging economies, their priority lies not in re-capitalising banks or reducing leverage, but in continuing the reform of the banking system and in developing deeper capital markets to support future economic expansion. Moreover, banks in emerging markets vary in size, sophistication and systemic significance – some are small and domestically focused, while others have sizeable regional footprints. Most emerging economies are also hosts to global banks, and rely on them to provide trade and project finance, and cross border remittances. Let me emphasise that these differences do not detract from the need to have higher regulatory standards. However, it does mean that in calibrating the details of the rules, we have to take into account these differences, so that financial intermediation is not adversely affected.

The Macroprudential dimension

12. Let me now say a few words about macroprudential regulations. Macroprudential regulations relate to the use of prudential tools to promote the stability of the financial system as a whole, and not just that of individual institutions. It recognizes that there are two sources of systemic risks. One, at any point in time, interlinkages and common exposures across institutions can multiply aggregate risks. Two, over time, boom/bust cycles can be amplified and destabilize the entire system. In good times, low volatility and low risk premia induce excessive credit creation and rising asset prices in a process which then feeds on itself. When confidence turns, the credit excesses and asset bubbles unwind quickly, with prices overshooting as they head down, feeding a downward spiral.

13. While macroprudential regulation is not new, the financial crisis has triggered a renewed interest in it. Various ideas are being explored – such as systemic surcharges and counter-cyclical capital buffers, and the viability of a more structured and rule-based framework for such measures. We should certainly explore new approaches and better tools. But let me make a few points on this.

14. First, unlike monetary policy, research on macroprudential tools of a more structured, rules-based nature is at an early stage. There are no simple targets like an inflation target, or clear measures of success built on detailed analysis of a long data series, since tail risks do not, by definition, materalise frequently. This makes the task inherently harder. Nor are there many rule-based tools that have proven their efficacy at the global level. Much more analytical work is needed.

15. Second, we now have a better understanding that the systemic risk posed by a bank depends on its size, interconnectedness and substitutability. It does not come from just "too-big-to-fail", though sometimes these terms are used interchangeably. Many small banks

pursuing similar business models can build up large correlated positions. There can be systemic impact if these banks unwind their positions at the same time.

16. In the coming years, we will be focusing on some new tools such as countercyclical capital. Their effectiveness will need to be assessed over time, and against other options. We need to agree on the right set of policy tools to deal with systemic risks with the least unintended consequences.

17. The test of resilience of a bank or a system lies in its ability to absorb losses when a shock occurs – that is, its loss absorption capacity. For an individual bank, various tools, apart from surcharges or levies, should be considered. At the system level, adopting similar rules across institutions to prevent regulatory arbitrage should not inadvertently reduce the diversity in the global financial system. A variety of business models and investors with different risk appetites and liability-matching requirements may make for a more resilient system.

18. In the same vein, national regulators should explore a variety of approaches that are best suited to their conditions. Indeed, many emerging economies have banks that are systemic only in their local context, and national regulators need to consider how best to deal with these, even as we work together on global banks of systemic significance.

19. Third, post financial crisis, there is an understandable distrust of markets and supervisory judgment, and a preference to "hard-wire" most measures under Pillar 1 on capital. But we must not swing too far. Supervisors need to regain confidence and be prepared to exercise supervisory judgment – many economies have used macroprudential tools with some success by applying discretion. There is also scope for greater disclosure and market discipline under Pillar 3. Indeed, in the proposals relating to contingent capital – whether convertible bonds or bail-in arrangements, an understanding of the market dynamics relating to these instruments is crucial to their success.

20. Fourth, a sophisticated approach is not necessarily superior. Several economies have been using basic tools such as loan-to-value ratios and concentration limits on particular sectors. These tools are simple to understand and enforce. While their application to only particular sectors appears ad hoc, and a broader counter-cyclical capital buffer to reduce credit growth across the board might seem more appealing, the experience has been that an approach that is targeted towards sectors such as a real estate has the merit of not reducing credit to other sectors such as the corporate and SME sectors. Their efficacy probably stems from simplicity and consistent applications, which condition expectations in the market.

21. Fifth, the term "macroprudential" suggests that these are essentially prudential tools, but with a "macro-orientation". Indeed, many tools that are "microprudential" in nature also serve the macro-needs as well. Loan-to-value ratios not only raise the buffer for losses but can also constrain credit growth in the economy. Similarly, macro-measures such as the tightening of interest rates can also lean against the build-up of asset prices and serve a microprudential purpose. Pursuing macroprudential objectives therefore does not mean that we have to have a narrow box of tools, each dedicated to a specific purpose. In fact, the interaction of various tools is significant – they can work in the same or opposite directions, and their cumulative impact may be greater or smaller than we anticipate. It is probably more appropriate for us to take an eclectic and holistic approach.

22. Finally, as a corollary of the above, micro- and macro-supervision should not be done in silo. In fact, we need to bring together the perspectives and tools from different stakeholders – central banks and financial supervisors, as well as government agencies that can contribute to financial stability. The property sector cooling measures introduced in Singapore and a number of Asian countries recently, involved close cross-agency cooperation and coordination amongst financial regulators, fiscal authorities and the land

offices of the respective countries. Bringing together the various agencies expands the policy options to deal with systemic risks. Different countries have different institutional arrangements, so each country will need to decide on the optimal arrangements.

Achieving regulatory outcomes through effective supervision and shared responsibility with industry

23. Let me now say a few words on achieving regulatory outcomes, beyond good rules. Perhaps the most striking area is the critical need for all of us to strengthen supervision. Effective supervision is unapologetically firm and intense, grounded on a good understanding of the nature of the institutions and the financial system. Supervisors must think independently, avoid regulatory capture and be willing to enforce out-of-bound markers rigorously. In this regard, I welcome the efforts of FSB and standard setters in developing recommendations for more effective supervision of complex and systemic institutions.

24. Effective supervision requires talented and trained staff, who can understand and respond constantly to new markets, new services, and new risks. The need for talent is particularly acute for supervisors in emerging economies, as the banking system grows rapidly. With the growing demand for risk managers, some supervisors are facing higher attrition. We have to significantly expand the talent pool, and work with international and regional bodies like the FSI, the World Bank and IMF to step up our efforts.

25. Finally, supervisors should not be acting alone in achieving the desired regulatory outcomes. Good outcomes cannot depend on a "cat-and-mouse" game of supervisors prescribing rules and then checking for compliance. The primary responsibility of having a sound bank must rest with the Board and senior management of the bank. They need to take ownership of and responsibility for managing risks, and to have the requisite knowledge, skills and experience to discharge their responsibilities effectively.

26. In this regard, MAS recently proposed a number of enhancements to the corporate governance framework for locally incorporated banks. We welcome the Basel Committee's present initiative to revisit its 2006 corporate governance guidance, and to address weaknesses identified during the crisis.

27. In promoting shared outcomes, political support is crucial in various areas. It is difficult to build a strong banking system on weak macro-economic foundations. Supervisors in all countries, but more so in emerging economies, are sometimes under political pressure to tilt credit growth in certain directions, or to exercise forbearance. While the financial system has to be responsive to the needs of the economy, a politicised supervisory process will almost certainly bring adverse consequences down the road.

Conclusion

28. In conclusion, as we embark on financial reforms, we have to be forward looking, to ensure that we do not just have a resilient global financial system, but also one that can support sustainable economic growth. We need better regulations, better appreciation of the macro-financial linkages, and firmer supervision. Globally coordinated efforts and strong cross border cooperation in some areas, as well as local efforts that are context-specific are both needed to achieve the desired regulatory outcomes.

29. Singapore is honoured to host the 16th ICBS on our common supervisory journey. I wish you a meaningful and fruitful discussion, as well as a pleasant and memorable stay here in Singapore. Thank you.