Heng Swee Keat: Dealing with the implications of the crisis and implementing policy reforms

Keynote address by Mr Heng Swee Keat, Managing Director of the Monetary Authority of Singapore, at the Opening of EDHEC-Risk Institute, Asia, Singapore, 21 January 2011.

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Ladies and gentlemen

Introduction

1. Good morning. I am very pleased to join you today at the grand opening of EDHEC-Risk Institute's Asian centre in Singapore.

Key observations from the crisis

2. The financial crisis has fundamentally changed the way we perceive and manage risks and uncertainty. Assumptions and models that had been taken for granted are being challenged, and new developments are changing the risk landscape. Let me share three observations about risks.

3. First, the growing complexity and interconnectedness within the financial system, and between the financial and economic systems have multiplied risks significantly. There are now many more potential sources of failures and the transmission of shocks from one market to another have become faster and more unpredictable.

4. Prior to the crisis, financial and capital intermediation had increasingly shifted to relatively unregulated non-bank financial institutions. Complex securitisation structures and off-balance vehicles that were thought to disperse risks led instead to concentration of risks and excessive leverage. The crisis highlighted the complex webs of inter-linkages between financial institutions, financial instruments and financial markets. As liquidity and confidence evaporated and the financial accelerator kicked in, credit markets and financial institutions experienced severe stresses. This in turn dragged down the real economy, and world trade collapsed. With globalisation, even though financial markets in emerging markets did not suffer the same problems, the collapse of trade and investors' confidence, exacerbated by credit cutbacks, brought most developed and developing countries across the world into a deep and synchronous recession.

5. My second observation is that we should not underestimate how fast risks can build up. In the years leading up to the crisis, many new financial products developed and grew very swiftly. Credit default swaps for example, grew from just US$919 billion in 2001 to more

than $62 trillion within 8 years. In 2004, outstanding mortgages held in non-agency MBS in the US were just US$670 billion. It tripled to over US$2 trillion within 2 years. It is a similar story with the origination of subprime mortgages. In the same period, global CDO issuance more than tripled from US$157 billion to about US$550 billion. These assets were held in banks and non-banks globally. When the financial crisis struck, the world was shocked not only by its severity, but also by the speed in the transmission of shocks throughout financial markets. There is no better illustration of how new sources of systemic risk can build up rapidly.

6. In a similar vein, the sharp deterioration of the fiscal positions of many governments has also led to a re-assessment of sovereign risks. About 10 years ago, investors were concerned that the strong budget surplus of the US Federal Government might lead to a severe reduction in the supply of US Treasuries. Today, bond vigilantes are focusing attention on not just the short term fiscal health of governments, but on the impact of demographic changes, large entitlement benefits and unfunded pension liabilities on the longer-term fiscal health of these governments.

7. My third observation is the speed of structural changes in emerging economies and transformation in the patterns of global trade and investment. As these are superimposed on cyclical changes, it is often difficult to disentangle the two. Emerging markets, especially Asia, have weathered the crisis relatively well, and recovered quickly. This year, the IMF expects emerging Asia to grow by nearly 7%, almost double the rate forecast for the global economy as a whole. Many analysts expect the differential in growth rate to persist in the coming decade. The global economy went through stagflation in the 1970s, disinflation in the 1980s, and a roaring decade in the 1990s. In 2000s, we had the dotcom bubble, and a severe financial crisis. How the coming decade will turn out, especially for emerging economies, will change many of the risks and return assumptions on a wide range of asset classes.

Dealing with the implications

8. The growing complexity and interconnectedness in financial and economic systems, the increasing speed of change, as well as the ongoing structural changes in emerging markets will have profound impacts on all sectors of the global financial industry. These driving forces will shape the evolution of the financial system and the economy, as well as the risk-return profiles of a range of financial products. Financial institutions, investors, regulators, policymakers and researchers will have to make significant changes to their mental models, policies and practices. Let me touch briefly on some of these implications.

Implementing policy reforms

9. Given Asia's changing dynamics, Asian policymakers face some difficult balancing acts in navigating the challenges. They need to grow the financial system to support economic growth and promote the efficient intermediation of savings, but in ways which are safe and stable. They need to deepen capital markets, and permit the growth of hedging instruments and derivatives while keeping out instruments that are complex or opaque. They need to reduce the opportunity for regulatory arbitrage across different sectors, and treat similar risks in similar ways, without adopting a one-size-fits-all approach that reduces the diversity of players in the industry which might in turn reduce the overall resilience of the financial system. There is merit, for instance, in having diverse players such as pension funds and insurance companies that have different investment horizons and requirements in their asset-liability matching. Policymakers must support the global reform agenda, to help build a more resilient global financial system, while taking into account local and regional circumstances. In particular, as Asian economies undergo rapid transition, policymakers will have to evolve their financial systems to meet the rapidly changing needs of their economies.

As the systems become more complex and more plugged into the global system, the risk to financial stability will increase.

10. Indeed, post-crisis, central banks and regulators are focused on financial stability and the need to be proactive with regards to the risk of asset bubbles. Many parts of Asia in particular are vulnerable to property bubbles, not only because of current liquidity conditions, but also because many investors believe that in a growing economy, the property market can only move up. Many have forgotten how the property markets in the region slumped during the 1997/98 Asian Financial Crisis.

11. As I mentioned earlier, risks can build up rapidly. Hence, not surprisingly, there has been much debate on the types of policy tools to address potential asset bubbles. In my view, there is no single tool that works best in all situations. We need a combination of tools that addresses the different facets of the issue. These tools should be simple and easy to understand. More importantly, for these tools to be effective, the intention of the authorities has to be clearly communicated. Policymakers must leave no doubt of their resolve to tackle the potential build-up of risks. This may mean, for instance, the willingness to take progressively tougher measures where the situation warrants. This in essence is what the MAS and other agencies in Singapore have done recently on the property cooling measures. Let me add that these measures are not a substitute for banks' own risk assessment processes. Banks should continue to maintain prudent lending practices. This includes taking into account potentially higher interest rates in their credit assessments, and not assuming that current low interest rates will last indefinitely. MAS will continue to monitor banks' activities and practices closely.

Understanding Asia

12. Asia's growth prospects have attracted global interest and a surge of capital inflows. Asia is now the second highest contributor to global trade, and is expected to overtake Europe in a few years. China, India and Indonesia are growing rapidly, registering GDP growths more than four times that of US and Europe. The prospect of greater Asian currency appreciation has drawn greater fund flows into the region. In 2010, inflows into Asian local bond markets reached record levels.

13. However, investing in Asia is not without risks. The huge capital inflows, if left unchecked, have the potential to increase inflationary pressures and fuel asset-price bubbles. In an informal survey by MAS of 30 major fund managers, almost half cited the possibility of a hard landing of major emerging economies in Asia as a key risk. While inflows have been swift, we must be prepared for a rapid outflow as well. Several years ago, most major investors were investing in Asia but based thousands of miles away. Today, many investors are realising that a ground presence in this time zone is necessary. The rapid structural changes of economies in Asia, the differences in the stages of economic development, in political systems, regulatory regimes and corporate governance standards mean that investors must not only understand the differences within Asia, but they have to be able to respond to swift changes in outlook, and to take into account ongoing structural changes in their assessments. In short, the ability to distinguish noise from trend is essential.

Having the right risk mindset

14. Apart from responding to policy reforms and initiatives, investors and financial institutions will do well to continuously rethink and challenge the fundamental tenets of their investment and risk management tools and methodologies. To do so, it is imperative for investors to have the right risk mindset.

15. We should put once-neglected risks, such as counterparty credit risk, model risk, liquidity risk and technology risks, at the forefront of risk considerations. We have to be

mindful that falling back on historical experience may not necessarily provide the guidance especially when developments are unprecedented. In this regard, boards of financial institutions play a vital role in driving the level of risk consciousness in their institutions and exercising effective risk management oversight. MAS will mandate all local banks and significant insurers, following their Annual General Meetings this year, to have a dedicated Risk Management Committee, and for members of this Committee to have the appropriate balance of skills and expertise to discharge their responsibilities. Starting this year, we will also be requiring mandatory training for all members of the Boards of local banks. At the management level, MAS expects risk management units have to be sufficiently empowered and adequately plugged in to the risk-taking activities of the firm.

Enhancing collaborative partnerships

16. Underlying these specific measures is a basic emphasis on having the requisite knowledge, skills and expertise throughout the organisation's hierarchy in managing risks. In this regard, research and executive education programmes help to increase the body of knowledge and critical understanding of risks in the Asian financial industry.

17. One function of research is to explore unchartered territory and break new frontiers. Many in academia do this important blue sky research. Another significant role of research is in bridging the gap between theory and application. This form of research accelerates market practices in a more immediate and direct way. Many research institutes here in Singapore, including EDHEC-Risk, is focused on direct application. MAS welcomes this. Research institutes can use their presence in Asia to work with the financial industry in the region and help the region navigate the challenges ahead.

Conclusion

18. EDHEC-Risk is setting up its base in Singapore at a time of great transformation of the economic and financial landscape in Asia. A deep understanding of risks provides the foundation for stability and growth. The research and educational activities of EDHEC-Risk Institute will help enhance our understanding of risks, and the development of talent. We welcome EDHEC-Risk Institute to our research and financial community in Asia. Your presence adds to another important strand in the deepening relationship between France and Singapore. I congratulate EDHEC-Risk Institute on the opening of its Asian centre, and wish Professor Amenc, Professor Ducoulombier and your colleagues every success.

19. Thank you.