Lim Hng Kiang: Bank capital adequacy and institutional structure – Singapore's approach

Keynote address by Mr Lim Hng Kiang, Minister for Trade and Industry and Deputy Chairman of the Monetary Authority of Singapore, at the 38th Association of Banks in Singapore (ABS) Annual Dinner, Singapore, 28 June 2011.

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Introduction

Chairman, ABS,
Council members of ABS,
Ladies and Gentlemen

It is my pleasure to be here this evening. I was last here to deliver the keynote address in 2007, prior to the global financial crisis.

As economies now recover, especially in Asia, it is easy to forget how close the global financial system was to the precipice. Following the failure of Lehman Brothers, the solvency of many well-known financial institutions in the advanced economies came into question. Weaknesses and failures at the core of their banking system were transmitted to almost all sectors and countries. A global meltdown was averted only through extraordinary actions taken by central banks, governments and financial institutions themselves.

Regulators globally have had the benefit of some distance from the depth of the crisis to reflect on what needs to be done to strengthen the resilience of the financial system. MAS has been doing likewise and tonight, I would like to explain MAS' approach to reforms in the regulation of banking.

Post-crisis reflection

Singapore's financial system withstood the global financial crisis well. This did not happen by chance. Singapore banks were, on the whole, prudent and had less risky balance sheets. MAS has always required banks to meet high prudential standards, exceeding international norms in several areas. This ensured adequate safeguards were in place and, in turn, helped to maintain market confidence during the downturn. In its annual assessment on Singapore last year, the IMF stated that "Singapore's strong supervision and risk management systems had been crucial in safeguarding financial stability in the global downturn."[1]

Although banks in Singapore were relatively unscathed during the crisis, we cannot be complacent. Over the past 40 years, Singapore has evolved into an international financial centre, anchored by strong local and foreign banks. We are a small and open economy, intricately connected to the global financial system. Such openness and connectivity has strengthened the diversity of our financial system, but has also made us vulnerable to contagion risks from the external environment. Locally-incorporated banks and most foreign branches here did not have significant exposures to the complex financial assets that caused severe losses in the U.S. and Europe. Despite this, they were not immune to the ripple effects of the global spike in risk aversion.

Our approach to regulation is to allow the financial sector to grow, innovate, and support the needs of the economy, without compromising the safety and soundness of the financial system as a whole. With this context, let me now turn to the reforms.

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[1] International Monetary Fund, Executive Board Assessment, 23 July 2010.

The emerging global regulatory paradigm

Following wide-ranging discussions and consultation, the global regulatory community has made progress to strengthen the resilience of the financial system. The Basel Committee on Banking Supervision has strengthened global minimum capital standards as part of its Basel III Framework. The Financial Stability Board ("FSB") has released guidelines to reduce the risks posed by systemically-important financial institutions, or "SIFIs".

MAS welcomes the Basel III reforms. They will strengthen the resilience of individual banks during periods of stress, and in doing so, contribute to banking sector stability. Basel III is a major step forward in several areas:

(i) First, it strengthens capital requirements for trading activities, off-balance sheet vehicles, securitisation, and counterparty credit derivatives.

(ii) Second, it improves the quality of capital, with a greater focus on common equity to absorb losses.

(iii) Third, it raises the level of capital that banks will have to hold to absorb losses in both going-concern and unwinding scenarios.

(iv) Fourth, it introduces international liquidity standards for the first time, to make banks more resilient to short-term funding disruptions and longer-term liquidity mismatches.

The FSB is finalising its recommendations for global systemically important financial institutions, or G-SIFIs. This will comprise a package of measures, the most important of which are quite clear:

- First, G-SIFIs will have to meet higher capital requirements, above the Basel III minimums. This is to reflect the greater risk that their failure would pose to the financial system.
- Second, resolution frameworks have to be established, to ensure that all banks, however complex or large, can be resolved in an efficient and safe manner. Such frameworks may involve the simplification of firm structures and the design of "bail-in" mechanisms, where creditors are forced to absorb losses when a bank is close to failure[2].
- Third, G-SIFIs will face more intensive supervisory oversight, guided by an enhanced set of core principles for effective banking supervision.

Singapore's regulatory approach

Many jurisdictions are now considering their responses to the FSB and Basel Committee recommendations. MAS' regulatory approach is guided by three principles:

(i) First, we must maintain the high standards of financial regulation which have become associated with Singapore. Maintaining high regulatory standards is completely compatible with fostering a vibrant financial sector. Being a well-regulated, trusted and stable financial centre is a source of advantage for Singapore. It provides confidence for banks to operate in Singapore and for customers to transact with banks here.

[2] "Bail-in" is the process where bank debt in failing firms is forcibly converted into equity. This is intended to make it possible to rapidly recapitalise a bank such that it can continue in business without an equity injection from taxpayers.

(ii) Second, our rules must be risk-appropriate. International standards must sometimes be enhanced to be appropriate for Singapore's context. They must be targeted to address well-defined risks or concerns that could have systemic implications.

(iii) Third, our approach must be sensitive to the impact on industry. No new regulation is costless. MAS must weigh the cost of new regulations on institutions which have to comply with them, against the broader benefits that those regulations have for the economy and society.

With these principles in mind, I will now outline MAS' approach to the issues I mentioned earlier. I will first touch on what Basel III will mean for Singapore's capital adequacy requirements. After which, I will share MAS' views on the current debate on universal banking.

Capital requirements for locally-incorporated banks

MAS has reviewed its bank capital adequacy rules. We will require Singapore-incorporated banks to meet Basel III earlier and at a higher standard.

Singapore-incorporated banks will be required to meet the Basel III minimum standards by 1 January 2013, ahead of the Basel Committee's January 2015 timeline. Singapore banks are well-capitalised and are in a good position to adopt Basel III sooner than 2015. Moreover, the long phase-in period provided by the Basel Committee was to ensure that the new requirements did not stall the economic recovery in countries that were at the centre of the crisis. Singapore's situation is different: the recovery has been robust and the economy is well above pre-crisis levels.

MAS will increase the minimum levels of common equity that locally-incorporated banks will be required to hold. The experience of other countries in the recent crisis shows that common equity is the most effective capital instrument to absorb losses and write-downs. Research done by the Basel Committee shows that banks that failed or required government capital injections during the crisis had significantly lower levels of common equity than those banks that did not.

MAS will enhance the quality of regulatory capital in our banks in the following ways:

(i) There will be an explicit Common Equity Tier 1 capital adequacy requirement, to be set at 6.5%. This will be fully phased in by 1 Jan 2015.

(ii) The Tier 1 capital adequacy requirement will be increased from 6% to 8%, to be phased in over the same period. The Total capital adequacy requirement will remain unchanged at 10%.

(iii) In addition to these minimum requirements, there will be a capital conservation buffer[3], set at 2.5%, to be met with Common Equity Tier 1. This will be phased in between 1 Jan 2016 and 1 Jan 2019.

(iv) The new eligibility criteria for regulatory capital will also be phased in between 1 Jan 2014 and 1 Jan 2018.

With these changes, locally-incorporated banks will be required to meet capital requirements that are higher than the minimum levels in Basel III. The requirements will apply at both the bank-group and bank-solo levels. Taking into account the capital conservation buffer, locally-

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[3] The capital conservation buffer is a Basel III requirement for banks to maintain a capital buffer that can be used to absorb losses during periods of stress. Constraints on earnings distributions through dividends, share buybacks and discretionary bonus payments to staff will be imposed on a bank when the conservation buffer is breached. The closer a bank's regulatory capital ratio approaches the minimum requirement, the greater the constraints on earnings distributions.

incorporated banks will have to maintain at least 9% Common Equity Tier 1, compared to the Basel III minimum of 7%. Let me explain the reasons for this.

(i) First, the Basel III minimums do not adequately take into account the systemic importance of banks. Each locally-incorporated bank is systemically-important in Singapore and has a substantial retail presence. Together, they account for more than half of the total non-bank resident deposits and loans in Singapore. Hence, higher capital levels are required to strengthen their ability to absorb unexpected losses effectively in a crisis. This is necessary to protect depositors, reduce risks to the real economy, and safeguard our financial stability. The experience of countries at the centre of the crisis in Europe and the U.S. showed that the total cost of a financial crisis to the economy and the public can be substantial.

(ii) Second, Common Equity Tier 1 capital requirements that are significantly above Basel III will not result in a large reduction in economic output but would be beneficial in reducing the likelihood and cost of a crisis. Several empirical studies confirm this. Notably, the Basel Committee's assessment of the long-term economic impact of Basel III was that the economic costs of going above Basel minimums were still lower than the costs arising from banking crises.

In deciding on the levels appropriate for Singapore, MAS carefully weighed the costs of additional capital against the benefits. Banks that are well-capitalised, prudently regulated, and located in stable financial centres such as Singapore, present an attractive value proposition to depositors and investors. Holding systemically-important banks to a higher solvency standard reduces both the likelihood of failure and impact to the real economy if one of them runs into difficulties.

(iii) Third, the impact on banks' capital structures will be manageable. This is, in part, due to the already high internal capital buffers held by the banks and also due to the transition arrangements that will apply.

In short, the locally-incorporated banks are in a good position to meet the higher capital adequacy requirements and will emerge stronger in a post-Basel III world.

Institutional structure of banking

One strand of the regulatory debate that is still ongoing relates to whether reforms to how banks structure themselves can help promote financial stability. There are several dimensions to this. I will focus on the dimension that is most relevant to Singapore as a financial centre. This relates to the merits of the universal branching model compared to a subsidiary model for retail banking.

Most foreign banks in Singapore operate under a universal branching model. Branches here undertake a combination of retail, commercial, and investment banking activities, without the need to legally separate these activities. Some other regulators prefer that banks operating in their jurisdictions operate as subsidiaries, or separate the retail and wholesale activities into different legal entities.

MAS has a long history of permitting the universal branching model and we continue to support it. The universal branching model provides significant efficiency benefits for banks. It permits a bank to take advantage of economies of scale by sharing management resources and capital across its business lines, in addition to pooling its risks across the banking group. A branch can rely on the capital of the parent bank to borrow from the interbank market for funding purposes. This may not be possible for a local subsidiary with a smaller capital base. A branch structure can also give the banking group a greater ability to withstand idiosyncratic shocks to part of the group, because excess liquidity and capital from one part of the group can be redeployed to the parts in need. This, of course, is provided that the shock is not so large as to overwhelm the group as whole.

During periods of severe stress, however, the close linkages between business functions in a single, integrated entity make it difficult to isolate and contain problems. The provision of essential services by a branch such as domestic lending and deposit-taking, as well as payment transactions, could be disrupted. Local depositors would be exposed to possible contagion or a crisis of confidence arising from problems in the bank's home market, or from problems related to its wholesale banking activities.

MAS imposes a number of regulatory requirements on the locally-incorporated banks to protect depositors, including the higher capital adequacy requirements that I mentioned earlier and a minimum paid-up capital of $1.5 billion. However, there are Qualified Full Banks (QFBs) and foreign full banks which operate as branches and accept retail deposits without any capital in Singapore. MAS' approach has been to closely supervise these branches. They are also required to be members of the deposit insurance scheme, which provides a safety net for all non-bank depositors by insuring their deposits up to $50,000 per depositor per bank.

There are clear benefits, however, for foreign banks with a large retail presence to operate their retail business from a locally-incorporated subsidiary. Where the banks have corporate or investment banking businesses, these activities can continue to operate as part of their existing branches. This will allow banks to continue to benefit from cost efficiencies associated with a branch structure and minimise changes to their business models. Moreover, by conducting retail activities from a separate locally-incorporated entity, the bank will be seen by local retail customers as being strongly committed to the local market for the long-term. International discussions on this topic are ongoing and MAS is monitoring the debate closely.

Conclusion

To conclude, Singapore has built a reputation for credibility and prudence in the last 40 years. Our financial sector has weathered several crises well. But we cannot take this for granted. There will continue to be risks and challenges in the financial and economic environment. The changes to the capital adequacy requirements that I have outlined tonight will help keep our banking system strong, and preserve Singapore's reputation as a safe, open and dynamic financial centre.