# Tharman Shanmugaratnam: Ensuring strong anchors in our banking system

Speech by DPM Tharman Shanmugaratnam, Chairman of the Monetary Authority of Singapore, at the 39th Association of Banks in Singapore (ABS) Annual Dinner, Singapore, 28 June 2012.

* * *

Mr. Piyush Gupta, Chairman of the ABS,

Council Members,

Ladies and Gentlemen,

I am happy to be here this evening to join you at the 39th ABS Annual Dinner.

**The continuing lessons from the crisis**

Four years after Lehman Brothers collapsed, the global financial crisis is still with us. Its new epicenter, as we all know, is in Europe. The combination of weak banking systems and overstretched government balance sheets in several European economies has proved toxic. It has led to a loss of confidence and unsustainably high borrowing costs, not just for Greece but for a few other larger Eurozone economies. It has also resulted in the virtual disappearance of the unsecured interbank market, which is the lifeblood of any financial system.

Each major crisis yields lessons for all countries, and there will be many lessons arising from the crisis in Europe. In several European economies, as in the US, entitlement spending by government has outrun future revenues, and it is no longer possible to borrow away the problem.

But there are major lessons too in banking, and the main ones are in fact the old lessons. Spain, the current focus of attention in the markets, is a case in point. Its government finances were in fact in better shape than in many other advanced countries. But troubles had been accumulating in its banking system, caused especially by small and medium sized banks having made excessive loans to a property sector that has now crashed – a familiar problem repeated almost in cycles, across a range of countries. The result is a cutback in credit, a deeper recession, greater strain on government finances both as revenues decline and the government is forced to bail out banks, and worsening bank balance sheets as banking assets lose further value and borrowing costs increase. We are therefore seeing a vicious cycle of economic decline and a loss of confidence.

The situation is not unique to Spain. The specifics of the balance sheet problems vary from country to country, but a self-reinforcing cycle of feedbacks between falling economic activity and weak bank and sovereign balance sheets is now taking place in several countries in Europe. It is complicated by an increasing fragmentation in politics, which makes the journey to a credible and lasting solution in the Eurozone all the more complex and challenging in the years to come.

The problems in the Eurozone and the US underline the absolute necessity for consistently sound banking practices and governance by banks. The crisis also provides lessons for regulators and the supervision of banks. The IMF has found that regulatory intervention in Spain lacked timeliness and effectiveness, even though the problems in banking had been identified early on. Regulators must be prepared to take early and decisive corrective actions to forestall a build-up of risks in individual banks and the banking system as a whole.

Further, contagion amongst banks is a fact of life. Financial systems can be severely stressed by their weakest points, even if it involves a single bank or a group of small banks. The Northern Rock episode in the UK was an example in the earlier phase of this crisis. The Spanish cajas or regional savings banks are now another. The largest Spanish banks are widely acknowledged to be well capitalised, to have lower exposure to the property sector and to have well diversified earnings internationally. But until the troubles in the cajas are resolved, even sound Spanish banks are being penalised by higher funding costs, and citizens and tax payers too are exposed. Confidence is therefore about banking systems, not just about individual banks. This is all the more why regulators have to be vigilant in spotting weaknesses and requiring corrective actions, both across a system and in individual banks. The weakest point matters.

## International regulatory reforms

The global financial crisis has prompted a major review of international regulatory standards. We have achieved much, with the new rules developed through the Basel Committee on Banking Supervision and the Financial Stability Board – new rules on the quantity and quality of capital and liquidity and the ongoing work to strengthen cross-border supervision and resolution frameworks for global banks.

The Basel Committee has proposed several reforms to minimise the risk of failure of global systemically important banks ("G-SIBs"), and to minimise the impact if any of them should fail. It is also recognised that some banks are systemically important within their own domestic markets even if they are not internationally active to the same extent as the G-SIBs. The failure of these domestic systemically important banks ("D-SIBs") can have a major impact on an economy, and indeed unpredictable consequences for a broader region. Bankia for example, is not a G-SIB. The Basel Committee has recommended higher loss absorbency requirements for G-SIBs, and is studying an appropriate regulatory framework for D-SIBs. MAS is very much part of that discussion.

However, in order to keep to the spirit and intent of the new measures, sensible judgement will be the key to implementing the new rules. Sensible implementation requires national regulators to take into account the impact of their actions on economic growth and international finance even as they exercise national discretion to address prudential issues in their banking system. There are two risks of a broader nature that we have to keep clearly in focus in international discussions, so that what we do now to strengthen our respective national systems does not lead to new problems and vulnerabilities internationally, further down the road.

First, we have to ensure that the cumulation of enhanced capital and other requirements on global banks do not impede them from playing their critical roles in global finance. The global banks play a major role as providers of liquidity in home, host and international markets. Even in emerging markets, debt and equity market liquidity often relies on active participation by global banks. Enhanced regulatory requirements should therefore be targeted, risk appropriate, and applied in a non-discriminatory way on banks posing the same level of risk, be they domestic or global banks.

The safety buffers for global banks, which clearly needs to be enhanced, cannot therefore rest too heavily on premiums in up-front capital, liquidity and other regulatory requirements. We should strengthen supervision and crisis resolution capabilities to complement and avoid an over-reliance on regulation. Strengthen continuous supervision rather than rely excessively on upfront regulatory requirements. Effective international coordination among supervisors requires more open and transparent sharing of information between home and host supervisors – home supervisors will want to be well informed about the requirements imposed on significant overseas subsidiaries, and host supervisors need to be kept apprised of developments at the parent bank. Cross-border supervisory colleges and crisis management groups are therefore critical, and they have to be strengthened to ensure that national policy measures are globally consistent and mutually supportive. So that is the first risk, of going too far with respect to global banks such that the global financial system is impaired.

The second risk is that of the fragmenting or balkanising finance. We are already seeing signs of this, and most especially in the wake of the European crisis. Deleveraging by some international banks is leading to a pull-back into home markets. But some regulatory responses, not just market responses, may reinforce this pull-back, by restricting the flow of capital and liquidity outside home markets. Not only will this ring-fencing of national systems weaken international banking and trade, it may introduce new risks to financial stability when global banks are not able to deploy liquidity from one part of the banking group to other parts in need. Better international co-ordination in the implementation of rules is therefore needed to ensure that they serve their intended national objectives without weakening the global system as a whole and introducing new vulnerabilities.

## A sound financial system anchored by a core of strong local banks

Just as we derive lessons from troubled banking systems, it is worth looking too at those that have not run into problems. It is notable that among the jurisdictions with systemically important financial centres, Canada, Australia, Hong Kong, and Singapore have held up well during the global financial crisis. A little remarkably, the top ten banks in Bloomberg's latest annual ranking of the world's strongest banks included four Canadian banks, the three Singapore local banks and two Hong Kong banks. There is no room for complacency – the financial crisis has shown how volatile financial markets can be and the speed with which contagion can spread. Banks have to be constantly vigilant against the build up of risks and maintain strong buffers against contingencies.

But let's look at these four banking systems for a moment, – Canada, Australia, Hong Kong and Singapore. They share two characteristics in common.

(i) They are anchored by a handful of banks with a significant share of the domestic market.

(ii) These "anchor" banks are closely supervised and regulated.

Several economies, including some in emerging countries, which had completely opened up their banking systems and left themselves without local anchors, have now found themselves to be vulnerable. Banking systems need strong anchor players, who are well regulated and diligently supervised, and are able to take the long-view, enabling their interests to be closely aligned with that of the economy. In a crisis too, strong anchor banks may be needed to acquire distressed financial institutions whose failure could otherwise have a systemic impact.

But having anchors with a substantial share of the domestic market is not sufficient to ensure resilience. Without adequate competition, they will earn what the economists call oligopolistic rent, rather than serve the needs of an economy by innovating and introducing efficient services. Anchor banks have to be competitive.

This is why we have progressively opened up Singapore's domestic banking sector since 1999. We have allowed greater competition, particularly in wholesale banking where local players are not protected, and increasingly in retail banking too. It has involved some risks. We took a risk. But the result is now widely acknowledged to be stronger and more dynamic local banks, with much improved systems of management, risk controls, technology and expertise. Banking liberalisation provided the spur for our local banks to raise their game and compete with some of the world's largest banks while maintaining high prudential standards and they have done well.

We had previously announced the Government's policy of maintaining the local banks' market share at no less than 50% of total resident deposits. This remains our position. We are committed to having strong local banks at the core of the banking system. In a very real way, our three strong local banks also give Singapore the confidence to continue opening up the banking sector to foreign competition.

## Encouraging foreign banks to deepen their Singapore roots

A diverse international presence and global connectivity must remain key strengths of Singapore's financial centre. We host many international banks, who conduct an increasing share of their activities out of their Singapore offices. Some banks have moved their global heads of business to Singapore, or hubbed specific business lines or IT operations in Singapore. Consumers and corporate customers have benefited from the wider range of products and services, offered at competitive rates.

The majority of foreign banks in Singapore operate as branches, taking advantage of the cost efficiencies arising from branching within an international bank. We continue to support the use of branches for the vast majority of banks in Singapore, which are in the wholesale and investment banking businesses.

Additional measures may be appropriate for retail banks that are important to the domestic market. At the individual depositor level, additional safeguards such as a deposit insurance scheme (which we already have in place in Singapore) and local incorporation will provide better protection for depositors from problems emanating from other parts of the banking group.

Local incorporation can also bring benefits to a bank, especially where it has a significant retail presence. Liquidity rules under Basel III will require long-term stable sources of funding to comprise a larger share of a bank's total funding. Competition for deposits is expected to intensify, and banks that can attract stable funding will gain an advantage. Local incorporation can therefore demonstrate a bank's long-term commitment to depositors and other stakeholders in a world of possibly permanent heightened volatility and uncertainty. Beyond local incorporation, encouraging strong international banks to sink deeper roots in a domestic economy will allow them to play a greater role in contributing to financial resilience. Let me elaborate on this important objective of encouraging strong international banks to sink deeper roots in a national economy.

One of the key features of our banking liberalisation has been the Qualifying Full Bank ("QFB") privileges that have been granted to foreign banks. The number of QFBs has increased from the initial four in 1999 to six in 2001 and eight today. QFBs have also been allowed more places of business from 10 in 1999 to 25 today.

MAS will continue to liberalise the domestic banking sector in a progressive and calibrated manner. We will allow greater foreign bank participation in Singapore's domestic financial system in a way that strengthens financial stability and that encourages foreign banks to deepen their roots in Singapore. MAS will make several refinements to the QFB programme:

(i) We will require existing QFBs that are important to the domestic market to locally incorporate their retail operations. The key objective for requiring local incorporation is to strengthen depositor protection. One indicator of importance to the domestic market will be the share of domestic deposits. MAS is also evaluating other factors that may be relevant to individual QFBs and will consult them on the criteria for requiring local incorporation. Not every QFB needs to be locally incorporated.

(ii) A very small number of QFBs may become significantly rooted in Singapore over time. For these significantly rooted QFBs, MAS will consider granting an additional 25 places of business, of which up to 10 may be branches, as part of an overall package negotiated with the home countries of these QFBs which are free trade agreement ("FTA") partners with Singapore. This will bring the total to 50 places of business for such QFBs. Being significantly rooted entails both additional privileges as well as responsibilities to contribute to the stability of the Singapore financial system.

A significantly rooted bank will be determined by both qualitative and quantitative attributes. For example, whether –

(a) the bank is locally incorporated with majority Singaporean/PR Board representation, and what types of businesses are conducted by the locally incorporated entity;

(b) Singapore is one of the major markets for the bank group, constituting a substantial part of group profits and assets;

(c) major business lines and key decision makers are headquartered in Singapore; and

(d) the bank serves a comprehensive spectrum of the local community in Singapore.

A bank that demonstrates these and other characteristics can be considered significantly rooted.

(iii) MAS will consider awarding new QFBs only under FTAs where there are substantial benefits to Singapore. New QFBs that are granted under future FTA offers will have to first locally incorporate before they may establish up to 25 places of business.

This evolution of our QFB scheme, and it is an evolution, should ensure that our local banks continue to have majority share of domestic deposits, while banks awarded QFB privileges can build a deeper presence. Given the size and maturity of Singapore's domestic retail banking market, we have to calibrate our moves to ensure that greater foreign bank participation does not result in a fragmented and inefficient market, but instead leads to a more robust and competitive system. Banks with a meaningful market share will be in a better position to reap the benefits of scale from a more extensive network, to respond to customers' changing needs and at reasonable cost, and to be better rooted in Singapore to contribute to our financial stability and growth.

Taken together, this latest phase in our banking liberalisation and the refinements we are making in regulation and supervision together with our international counterparts, will ensure that Singapore remains both a vibrant global financial centre and one of the rocks of stability in global finance.

Thank you.