Tharman Shanmugaratnam: Key issues in Asian financial markets

Keynote address by Mr Tharman Shanmugaratnam, Chairman of the Monetary Authority of Singapore, at the ACI (The Financial Markets Association) 52nd World Congress, Singapore, 15 March 2013.

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Mr. Manfred Wiebogen, ACI Global President
Distinguished guests, ladies and gentlemen

1. I am delighted to be here today with all of you.

2. The last time Singapore hosted the ACI Congress was back in 2001. In fact, it was just before 9/11. The world was in a very different place. Asia too was so different from today. The wounds of the Asian crisis of the late 90s were still fresh. Investor confidence in the various countries in the region was uneven. And Asian capital markets were by and large in their infancy.

The new financial landscape

3. We are now in a new phase in global finance. Global finance is deleveraging, after the great credit bubble that began more than a decade ago and came to an end in 2007. But deleveraging still has some way to go, and some years to go, before the overall level of leverage relative to economic activity gets back to a sustainable level.

4. The pace of deleveraging has been moderated so far by central banks, who have taken onto their balance sheets unprecedented levels of both public and private sector debt. Their actions have reduced the risks of catastrophe. But it also means we have a long way yet to go in reducing debts and returning to sustainable growth.

5. We are also seeing important shifts in the structure of global finance, besides the gradual contraction in global liquidity. It is too early to say where we will be five years from now, but some of the broad brush-strokes in this new landscape of global finance are already with us and likely to stay:

- The return on equity in global banking has fallen, and will not return to pre-crisis levels, given stricter capital and liquidity rules.
- Deposits have become more important as a source of bank funding.
- Banks in certain major jurisdictions have retreated from global markets, and worryingly, and may stay in retreat for some time.
- The securitised debt markets should recover, but with less leverage underpinning them, and hopefully greater risk transparency.
- In the derivative markets, there will be greater standardisation of products, and much greater reliance on common market infrastructure – for trading, clearing and reporting of trades. High volume, low-margin platforms will likely gain in competitiveness.
- Wealth management will remain a growth industry, especially in Asia, where the pool of wealth is growing most rapidly and the need for diversification remains great.
- And outside of intermediated finance, companies will seek new ways of raising funds, including through private placements.

6. Will this mean a safer financial world? Maybe. That will depend on whether we persist in seeing through the regulatory reforms that began a few years ago. It will depend on

whether we keep to a sensible balance in regulation – and that includes not over-doing bank regulation and under-doing the oversight of shadow banking. It will also depend on whether we all stay intensely alert to the risks of the future, including especially the risks that we do not yet see or know, rather than focus only on the last battle or on preventing the last crisis from recurring.

7. What of global capital flows? There too we see shifts, as global finance responds to a two-track world of economic growth. The prospect of sub-par growth in the advanced economies for a number of years, together with central bank actions to keep interest rates very low, have led to what is becoming a furious search for yield. Pension funds and insurance funds need better yields badly, and they are putting more monies in the emerging markets and other risk assets.

8. This is likely to be more than a cyclical trend. We are seeing a secular shift in assets towards the emerging markets. Advanced country funds in fact remain significantly underweighted in emerging market assets, and are gradually correcting for this. At the same time, sovereign debt ratings have been raised in several emerging economies, in Asia especially[1], at the same time that a number of advanced economies[2] have seen their ratings lowered. Asia is certainly not free from risks, and there is much work ahead to preserve and improve sovereign ratings. But no one can assume that the recent rebalancing of risk assessments vis-à-vis the advanced economies is temporary.

9 What this continuing shift in global funds also means, however, is that there is critical need to add depth and breadth to Asian financial markets. It will not be possible to absorb a greater share of global savings without developing this depth and breadth in markets, and a robust market infrastructure. Otherwise, both global and Asian capital flows within the region will lead to recurrent bubbles, whether in equities, property markets or currencies, rather than find their way to the most productive investments in Asia's economies.

10. Asia's financial markets have grown significantly over the past decade. But the capital markets, and especially for bonds and securitised debts, remain small in relation to Asia's GDP. Further, the region's financial markets are still relatively small and fragmented.

11. There is by the same virtue, great potential to develop Asian financial markets and enable them to play a stronger role in promoting balanced and sustainable growth.

12. We will have to push ahead with reforms at two levels to develop these financial markets. Gradual and progressive financial liberalisation can bring about more liquid and broader domestic financial markets. It will also help spur domestic demand by households, and provide smaller enterprises with better access to capital in several Asian economies. Secondly, at the regional level, we have to inject greater momentum into improving cross-border market access and harmonising rules and standards.

Key themes in the development of Asia's financial markets

13. Let me now touch on three themes that will influence the development of Asia's financial markets in the decade ahead:

i. ***Firstly***, the changes in the OTC derivatives markets as a result of global reforms;

ii. ***Secondly***, the harnessing of technology to transform Asia's financial infrastructure; and

iii. ***Thirdly***, the increasing international role of the RMB.

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1 For example, South Korea, Indonesia, Thailand and the Philippines.

2 Namely the US, Japan, France, peripheral Europe.

I. Structural shifts in the OTC derivatives markets as a result of global reforms

14. First, the structural shift in the global OTC derivatives markets. Most of you will be familiar with the changes that are coming into place, in steps, as a result of global reforms – more standardised products, and more robust market infrastructure: central counterparties for clearing, trade repositories for reporting, swap execution facilities for trading where appropriate. The global reform process is now shifting from rulemaking to implementation.

15. We are already seeing the shift in Asia's OTC derivative markets. The new market infrastructures are expected to provide greater transparency and allow risks to be managed more effectively among market participants. Market practices will be redefined, with the need to report and clear selected OTC derivative trades within more than one jurisdictions.

16. However, we are also seeing a proliferation of Central Counterparties (CCPs) and trade repositories being set up in Asia. While this will provide choice to Asian market participants, it may also increase risk and lead to higher costs.

17. Regulators will need a comprehensive view of risks in the cross-border, interconnected market. Having multiple CCPs and trade repositories in the region may risk fragmentation, and may hamper monitoring of systemic risks as regulators may see only their own segments of the market. Market participants will also face additional costs if CCPs and trade repositories lack economies of scale.

18. Asian regulators will therefore need to work closely together to enable infrastructural entities to offer their services across different jurisdictions. For example, the infrastructure of a DTCC global trade repository and AsiaClear CCP in Singapore offers the prospect of effective surveillance by regional regulators and economies of scale. We will continue to ensure that our market infrastructure operates in a transparent and accessible way so that the needs of regional regulators and the industry can be met under clear and robust guidelines.

19. At the global level too, there are real benefits for regulators to ensure inter-operability in market infrastructure to allow for more effective risk monitoring. However, inter-operability will require time and effort, as risk management practices such as margin eligibility standards have to be harmonised across CCPs in different jurisdictions.

20. As Asia's infrastructure is still at an early stage of development, we have an opportunity to harmonise practices while making the changes needed to respond to emerging global regulatory reforms. It is heartening to note that Asian regulators are working closely on OTC derivatives regulations. A good example was the joint letter from Singapore, Hong Kong and Australia to the US CFTC, expressing our concerns on the extra-territorial application of the US rules.

II. Harnessing technology to transform Asia's financial infrastructure in a game-changing fashion

21. Regulators everywhere are confronted with highly connected global markets. Collecting and managing information is now a core competence in itself, for effective surveillance of the financial markets. Similarly, market participants are making greater use of technology in risk management – performing complex portfolio valuation and mitigating risks such as through intra-day margining at CCPs, and often across global books and in multiple time zones and jurisdictions. Moving collateral across markets swiftly and efficiently is also now a core competence.

22. Besides risk management, technology can be useful in developing liquidity in Asian markets. It can bring greater pricing efficiency and transparency, as we are seeing in the US and EU financial markets as trading moves to electronic platforms.

23. In Asia, there is room for our financial markets to embrace greater "electronification" of trading, notwithstanding our smaller markets. To illustrate, an estimated 80% of trades are

executed in electronic platforms in developed country FX markets, whereas 85% of FX trades in Asia are still executed by voice. A reduction in transaction costs can promote greater liquidity for Asian asset classes, and broaden participation from investors including retail traders.

III. Growing regional and international role of the RMB

24. Let me go on to the third theme I wanted to talk about, which is that of RMB internationalisation, and how this will shape Asia's financial markets development.

25. The status quo will not last. Currently, only 0.6% of global payments are settled in RMB, vastly below China's share of global trade (10%) or investment flows. There is clearly room for growth.

26. In the long run, if we envisage China with deep and liquid capital markets, and a largely liberalised capital account, the RMB market will potentially play a transformational role in Asian finance. For now, even with limited convertibility, there is considerable potential for greater use of the RMB. The economic fundamentals are driving this. Besides China's growing share of global trade, there is a rapidly growing trade between China and the rest of the Asian region, and especially ASEAN. Further, China's foreign direct investments are expanding strongly, especially into Asian markets. Outbound Foreign Direct Investment (FDI) from China has increased almost seven-fold in the last seven years (to US$77 billion in 2012[3]), and is expected to expand further in the coming decade. A growing part of this FDI is expected to be RMB-denominated, and this too will contribute to greater offshore use of the RMB.

27. The overseas expansion of Chinese corporates will be reinforced by the growing presence of mainland Chinese banks as they grow their regional and international presence. In Singapore, we extended Qualifying Full Bank (QFB) privileges to Bank of China and ICBC as part of the China-Singapore FTA. Both banks are growing their Singapore operations as Southeast Asian hubs. We are also seeing interest from other Chinese financial institutions.

28. The re-denomination of China's trading flows in RMB will allow Asian corporate and financial institutions to more effectively manage their exposures to China. While USD would remain an integral global settlement currency, RMB is likely to be increasingly used for trade denomination and contract pricing.

29. As we see greater acceptance and use of the RMB as a trade settlement currency, there will also be important implications for the interactions between China and Asia's financial markets, and indeed for global financial markets.

30. For one, it will be critical to facilitate the development of a single fungible offshore RMB market, as the market grows in multiple jurisdictions. (Currently, the industry has designated different currency codes, such as the CNH and CNT, to reflect these existing market frictions.) Regulators and market participants will have to work together to avoid fragmenting liquidity across markets, and to promote efficiency in the offshore RMB market.

31. In addition, China plans to launch its international payment system, known as CIPS, in 2014. The development of a single centralised cross-border RMB payments infrastructure also augurs well for market efficiency and standardised practices for RMB payments across the region.

3 CNBC, 17 Jan 2013. "China's outbound investment leaps to record high in December".

Singapore's role as an offshore RMB market

32. As an international trading and financial centre, Singapore will seek to support the growth of a resilient offshore RMB market in the Asian region by:

i. Building RMB liquidity;

ii. Enhancing access to RMB for funding and investment purposes; and

iii. Integrating the offshore RMB with existing Asian local currency markets.

33. ***Firstly***, Singapore can leverage on its strengths as a key wholesale funding centre to ***increase liquidity and circulation of the RMB in Asia***. We are already seeing good growth in RMB deposits, both non-bank and interbank. We are also one of the largest centres for RMB payments outside Hong Kong. As a major regional funding centre, Singapore has traditionally supported the liquidity of the Asian markets and can partner China in promoting sustainable offshore use of the RMB.

34. In February this year, ICBC Singapore was appointed by the People's Bank of China (PBC) as the RMB clearing bank in Singapore. The RMB clearing bank will be an important channel for RMB liquidity to circulate between China to Singapore.

35. In addition, PBC and MAS together announced an expanded Currency Swap Facility last Friday. This will see a doubling in the size of the swap facility from RMB150 to RMB300 billion. The scope of the Currency Swap Facility will also be expanded to allow MAS to provide RMB liquidity to banks in Singapore, where needed. This backstop facility will further strengthen confidence in Singapore's offshore RMB market, and encourage more financial institutions, corporates, and investors to step forward and participate in the RMB market via Singapore.

36. ***Secondly***, with a strong RMB pool, Singapore can provide ***enhanced access to RMB funding for corporates and investors***. Singapore is a major source of FDI to China and serves as the Asia-Pacific headquarters for many multinational companies (MNCs) and Asian corporates with operations in China. We also serve as the regional treasury centre for a large base of Chinese corporates.

37. With the new RMB clearing arrangements, we can expect financial institutions based in Singapore to reach out to local and regional corporate and investors and encourage greater participation in the offshore RMB market.

38 ***Thirdly***, Singapore can support the ***integration of offshore RMB with Asian local currency markets*** and act as a test-bed for ***new RMB products***. The development of a wider range of RMB products will be healthy. It will create additional ways in which corporates can redeploy their RMB funds in the offshore markets, and provide additional products for investment.

39. The financial industry in Singapore has good expertise in developing FX and derivatives instruments, with several emerging Asian FX teams based here. It is well equipped to develop customised offshore RMB capital market instruments, especially for Asian market participants. For instance, banks in Singapore can explore how to encourage offshore RMB bond issuance in Singapore with longer maturity tenors and different issuer profiles.

Conclusion

40. Let me wrap up briefly. Global deleveraging is being accompanied by the continued inflow of funds into Asia's emerging market economies. This shift poses risks if not well-managed, but it is also an opportunity. The next phase of development in Asia's financial markets is therefore critical. We have to develop greater breadth and breadth in Asian markets, so that savings flows translate into sustainable economic growth rather than recurrent bubbles in asset markets.

41. Thank you and I wish you a successful conference.