Ravi Menon: Global regulatory reforms – what's done, what to watch for

Opening remarks by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the 4th Pan-Asian Regulatory Summit, Singapore, 25 September 2013.

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Distinguished guests, ladies and gentlemen, good morning.

Exactly five years ago, this month, Lehman Brothers collapsed and unleashed a financial crisis of unmatched scale and impact. The crisis exposed deep fault lines in the global financial system and spurred far-reaching financial regulatory reforms, aimed at building a more resilient financial industry that better serves the needs of the real economy.

This morning, I will take stock of the impact of these regulatory reforms:

- the progress we have made in making the global financial system safer; and
- the possible unintended consequences that we must watch for.

As a member of the Financial Stability Board, the Basel Committee on Banking Supervision, and various other international regulatory forums, the MAS has been a strong proponent and early implementer of many of these reforms. But we have not flinched from going above international standards where necessary or refraining from some measures in other jurisdictions which we regard as not relevant in our context.

Progress in regulatory reforms

Let me start with the progress in regulatory reforms.

Increasing the capacity to absorb losses

A centrepiece of the reforms in banking is the new Basel III capital standards. Basel III does three things.

- First, it raises the quantity of capital that banks must hold. By providing a buffer for banks to absorb losses, capital helps to minimise spillovers to the rest of the system.
- Second, Basel III raises the quality of capital that banks must hold. The crisis has shown that common equity is the most effective capital instrument to absorb losses and write-downs.
- Third, Basel III brings back to banks' balance sheets many off-balance sheet exposures and applies appropriate capital charges on them. Many banks that had to be rescued in 2008 had capital adequacy ratios well in excess of the minimum requirements then. They got into trouble because they had many risky off-balance sheet exposures they did not hold capital against.

Singapore has fully implemented the Basel III capital requirements, two years ahead of the timeline prescribed by the Basel Committee. And by 2015, Singapore-incorporated banks will meet capital requirements which are 2% points higher than the Basel III minimums – in effect a surcharge to reflect their systemic importance in our economy and financial system.

There is no global capital standard for the insurance industry. This is a lacuna that needs to be plugged. But the International Association of Insurance Supervisors ("IAIS") has taken the lead to formulate standards for a risk-based solvency regime for insurers. The EU has built on this to develop detailed capital standards known as Solvency II. Many jurisdictions are reviewing their rules with the intent to align with IAIS standards.

Singapore was among the first jurisdictions in Asia to introduce a risk-based capital ("RBC") framework for insurers, in 2005. In 2012, MAS embarked on a review to enhance the framework, known as "RBC 2", to take into account the new IAIS standards and best practices, including relevant aspects of Solvency II. MAS will be conducting a quantitative study to assess the impact on the insurance industry of the proposals under RBC 2.

There are no global capital standards for capital markets services providers. The International Organisation of Securities Commission ("IOSCO") has, however, set out principles for the solvency of securities market intermediaries. Based on these principles, MAS has implemented a risk-based capital framework for capital markets services licensees.

Strengthening liquidity buffers

The second important area of reform is setting – for the first time – international standards for bank liquidity. Banks are in the business of transforming short-term liabilities (mainly deposits) into long-term assets (mainly loans). This fundamental mis-match in maturity opens banks to the risk that they may not be able to finance short-term liabilities as they fall due. Even solvent banks with lots of capital can fail if liquidity risks are not well-managed.

The new Liquidity Coverage Ratio ("LCR") sets the global minimum standard for bank liquidity. Essentially, the LCR framework requires banks to have an adequate stock of high quality liquid assets that can be converted into cash to survive a 30-day period of stress.

In Singapore we have had liquidity rules for a long time. Our risk-based Minimum Liquid Assets framework requires every bank to hold a minimum percentage of its qualifying liabilities in liquid assets. We are now looking to adopt the Basel III LCR rules, with some enhancements to suit domestic conditions.

- Although Basel III applies the LCR framework only to internationally active banks, we propose to extend the LCR requirement to all banks in Singapore in the first instance and grant various reliefs on the basis of risk-mitigating circumstances.
- We will also have a tighter definition of what qualifies as eligible liquid assets and not recognise equities and mortgage-backed securities.

MAS has issued a consultation paper on the implementation of the LCR framework and will carefully consider industry feedback.

Constraining leverage

The third important area of reform is in constraining the build up of excessive leverage. At the height of the crisis in 2008, the banking industry was forced by markets to reduce leverage in a manner that led to downward pressure on asset prices, which in turn led to losses, declines in bank capital, and contraction in credit. Even banks with high risk-based capital adequacy ratios were found to be excessively leveraged.

Basel III's leverage ratio seeks to set a 3% floor for the amount of Tier 1 capital that a bank needs to hold relative to its total exposure. The ratio is designed as a non-risk based measure to complement the risk-sensitive capital adequacy ratios. It acts like a stop-gap to constrain the overall size of the balance sheet, especially given the uncertainty involved in the risk models that banks use to calculate their capital needs. But the leverage ratio – precisely because it is a non-risk based measure – cannot be a substitute for risk-based capital requirements and should not be set at too high a level as to become the binding constraint on banks. If it were so, banks may have the perverse incentive to increase their exposure to risky assets so as to earn a higher return on capital.

The final calibration and definition of the leverage ratio is expected to be finalised in 2017, with the minimum leverage ratio requirement coming into effect in 2018. Singapore-incorporated banks can comfortably meet the current testing minimum of a 3% leverage ratio.

Making OTC derivatives trading safer

The fourth fundamental area of reform is in the OTC derivatives market. The crisis highlighted how the opaque inter-connections across financial institutions engaged in trading complex derivative contracts over-the-counter led to rapid contagion and systemic crisis when liquidity suddenly dried up.

Reforms have focused on four areas: standardisation of derivative contracts; central clearing; higher margin requirements for non-centrally cleared trades; and mandatory reporting of all trades. In particular, reporting to trade repositories will provide much-needed transparency on exposures across market participants.

MAS has taken steps to implement the trade reporting regime in Singapore. Financial institutions which book prescribed OTC derivatives in Singapore are required to report such trades to a trade repository licensed by MAS. The reporting framework will be up and running next month, starting with interest rate and credit derivatives. The degree of standardisation of contracts in these asset classes is higher, so starting with these contracts will provide for a smoother phase-in.

We have received feedback from the industry on operational difficulties in obtaining customer consent in order to report counterparty information to trade repositories. We are looking to amending legislation to address this issue.

Ending too-big-to-fail

The high-profile, public rescue of many large, systemically important financial institutions in the last crisis has galvanised a powerful resolve to end the “too-big-to-fail” problem. But this has proven to be one of the most challenging tasks facing global regulators.

To be sure, the FSB and Basel Committee have made good progress on several fronts.

- First, they have identified a list of global systemically important banks (G-SIBs).
- Second, they have set out additional loss absorbency requirements for G-SIBs to reduce the probability of these institutions failing.
- Third, there is ongoing work on a resolution framework to minimise the cross-border negative externalities that can be created by their failure.

At the same time, major jurisdictions are embarking on plans to reform banking structures in a bid to end “too-big-to-fail”.

- In the US, the Volcker rule prohibits US-operating banks from engaging in proprietary trading or from acquiring or retaining an ownership interest in a hedge fund or private equity fund.
- In the UK, the Vickers Commission recommends ring-fencing retail banking activities, and subjecting the ring-fenced entity to higher capital requirements.
- In the EU, the Liikanen report proposes a mandatory fencing off of banks’ proprietary trading and market making activities from the rest of the banking group, if the activities exceed a certain threshold, with higher capital charges imposed on the investment banking ring-fence.

To the extent that structural measures help to simplify business models and facilitate the resolvability of very large and complex global banking groups, they can help to reduce the risk and impact of failures. But it is not clear if the benefits of such measures outweigh the costs in all instances.

First, it is worth considering whether size or complexity are the critical factors. The Global Financial Crisis started not with large universal banks or large global banks, but with narrow or specialised players: Northern Rock in the UK, and investment banks like Bear Stearns and

Lehman Brothers. Interestingly, the Liikanen report observed that there was no business model that performed particularly well or poorly during the crisis.

Second, it remains unclear if structural reform measures can make a bank or banking group safer if a culture of excessive risk-taking is not curtailed and if risk governance frameworks are not strengthened.

MAS subscribes to the universal banking model on the premise that it is not the separation between risky and non-risky activities that matters as much as ensuring that risk is well managed wherever it is.

- For domestic banks, MAS does not impose any structural measures. The focus is instead on ensuring that their risk management capabilities are commensurate with the complexity of their activities and that capital and liquidity buffers are healthy.
- For foreign banks that have a significant presence in the retail market, MAS will require local incorporation of their retail operations. The banks can choose to subsidiarise their entire operations within the same legal entity or continue to operate its wholesale banking business under a branch structure. There is no retail ring-fence required.

Unintended consequences

It is imperative that we press on with the regulatory reform agenda and not succumb to reform fatigue. But even as we do so, we need to be mindful of unintended consequences.

Inconsistent implementation of rules

The first unintended consequence is the inconsistent application of rules across jurisdictions and across sectors.

Inconsistent application of rules across jurisdictions leads to the risk of regulatory arbitrage. Take for example, the new capital rules. It is laudable that within such a short period of its promulgation, 25 of the 27 member jurisdictions of the Basel Committee have issued the final set of Basel III regulations.

But the implementation has been uneven. The Basel Committee conducted studies on the consistency of risk-weighted assets measured in the banking book under the internal model approach. It found considerable variation across banks in average risk-weighted assets for credit risk. A material part of this variation was due to different bank and supervisory practices. Such differences in measurement could result in capital ratios varying, in extreme cases, by as much as two percentage points in either direction.

To enhance consistency in implementation, the Basel Committee is considering three steps:

- first, improve public disclosure and regulatory data collection to help the market and regulators to better understand how risk-weighted assets are derived;
- second, narrow the range of acceptable modelling choices for banks; and
- third, provide additional supervisory guidance for model approvals.

Inconsistent application of rules across entities carrying out similar activities leads to the issue of shadow banking. The higher capital and liquidity requirements required under Basel III may create the incentive for activities to be conducted outside the regulated banking sector. The FSB estimates that shadow banking constitutes about 25% of the total financial system, and with regulation of banks still tightening, analysts expect the shadow banking sector will continue to grow.

But this is not to suggest that intermediating credit through non-bank channels is to be discouraged. The shadow banking system can provide market participants and corporations with a useful alternative source of funding and liquidity. Some non-bank entities may have specialised expertise that enables them to provide certain credit intermediation services more efficiently and at lower risk. Shadow banking need not be a bad word in finance.

What we do need to watch out for is the accumulation of risks in the shadow banking sector and the potential spill-over of these risks to the regulated banking sector. The FSB is setting out approaches to monitor the shadow banking system and to identify possible regulatory measures to mitigate shadow banking risks.

In Singapore, MAS has taken steps to limit the opportunities for regulatory arbitrage between the bank- and non-bank sectors by adopting broadly consistent rules for similar activities, even if they are being conducted by different types of entities. For instance, capital requirements for banks, insurance companies, and capital market intermediaries are broadly aligned for similar types of risks, to deter regulatory arbitrage.

Cross-border implications of national rules

The second unintended consequence is the cross-border implications of national rules.

- Take for example, the US CFTC's OTC swap rules. These rules apply to financial institutions operating outside the US including foreign-domiciled financial institutions and foreign branches of US financial institutions.
- Another recent example: the European Market Infrastructure Regulation requires financial market infrastructures to be subject to European rules or rules that are deemed equivalent to Europe's before they can provide services to EU players.

These rules are well-intended and seek to address genuine regulatory concerns in these jurisdictions. But extending national rules across borders often gives rise to overlapping regulations, which can create additional compliance costs for internationally active financial institutions. If there are conflicts between different national requirements, or if the burden of complying with multiple sets of rules is significant, this may prevent the execution of trades on a cross-border basis. The risk is that the global derivatives and foreign exchange businesses, for example, might become trapped within regional borders, creating fragmented markets.

Cross-border application of national rules may also risk complicating home-host collaboration, the principle of consolidated supervision, and cross-border resolution.

- A BIS working paper published in April 2013 cautioned that it may be difficult to design resolution plans for global banks which are required by different national regulations to operate different business models.
- An IMF staff discussion paper published in May 2013 highlighted that differences between national structural reforms could lead to cross-border regulatory arbitrage by global banks, posing a challenge to consolidated supervision.

In the event that the imposition of national regulations across borders is unavoidable, we need robust mutual recognition frameworks in place. Such frameworks should be based on an outcome-based approach, and not a line-by-line correspondence of rules.

- We are encouraged that regulators in the US and Europe have adopted a substituted compliance or equivalence assessment approach so that entities can comply with just the set of rules applied by the jurisdictions in which they operate.
- MAS supports substituted compliance and equivalence assessments as an important measure to avoid potentially duplicative or inconsistent rules, particularly for entities with international operations.

In the area of OTC derivatives trading, MAS is putting in place the rules and infrastructure to support cross-border operations and to help reduce uncertainty to the industry. To allay concerns from the industry over the regulatory burden of having to comply with both home and host regulations, we are participating in equivalence assessments under the US and European regimes.

Thus far, ESMA, the European securities regulator, has recommended to the European Commission that the Singapore framework is broadly equivalent to Europe's, paving the way for central counterparties in Singapore to offer their services to European participants.

We have also submitted to CFTC an application for substituted compliance in respect of requirements on US banks operating here. We are in active discussions with CFTC, and will work with them on the substituted compliance determination, where appropriate, as our OTC regulatory regime comes into force.

Impact on trade finance and long-term finance

The final unintended consequence is the impact on trade finance and long-term finance. There are concerns that the various regulatory reforms taken together may lead to a pull-back in trade finance and long-term investment financing. The global regulatory community and national governments have become increasingly sensitised to these concerns.

In the area of trade finance, the Basel Committee consulted the World Bank, the World Trade Organisation, and other relevant bodies. A number of adjustments were made to the capital and liquidity rules to facilitate trade finance.

- In the area of capital rules, the Basel Committee waived the one year maturity floor for certain trade finance instruments under the advanced internal ratings-based approach for credit risk. It also waived the sovereign risk-weight floor for certain trade finance-related claims using the standardised approach for credit risk.
- In the area of liquidity, the Basel Committee issued guidance for national supervisors to apply relatively low run-off rates for trade finance commitments.

Preliminary data suggests that the availability and cost of trade finance has not been greatly impacted to-date by the implementation of Basel III. Spreads have normalised post-crisis and pricing appears to be influenced more by broader macro factors and competition. Further, there are many well-capitalised banks, especially in Asia, that are well-placed to operate in the new regulatory regime; and many of them have stepped up.

We should continue to monitor closely the impact of regulatory changes on trade finance. Trade is the lifeblood of Asian economies.

But we have a bigger challenge in long-term financing, especially for infrastructure. It may be the case that the post-crisis financial system may not be adequately structured to provide certain types of long-term financing.

- First, longer-term corporate and project finance loans already attract a higher capital charge compared to short term loans. Coupled with the increased overall capital requirements under Basel III, this may create a disincentive for long-term loans.
- Second, to meet liquidity requirements, banks may substitute long-term lending activities with short-term lending. In calculating the Net Stable Funding Ratio, lower weights are assigned to loans with maturities of less than a year.
- Third, Solvency II, which will impose higher risk charges on longer-dated assets, may result in insurers de-risking by taking on shorter-dated assets.
- Fourth, the interaction between central clearing, margining and capital requirements may impact the variety and liquidity of some derivatives such as long-dated interest rate swaps used to hedge risks associated with long-term financing.

There may be scope for some intelligent, risk-sensitive fine-tuning of regulation:

- The design of risk weights for insurers should not penalise them for holding good quality long term assets, if they are matched by long term liabilities.
- The preferential treatment of sovereign debt in bank regulation should be re-examined, so that banks are not disincentivised from holding good quality, long term corporate debt.
- Better calibration of the risk weights for securitisation for banks and insurers may be necessary.

But the fundamental solution does not lie in diluting regulatory requirements. Policymakers should also focus on ways to develop sustainable alternative sources of long-term finance.

At the same time, we must recognise that the immediate constraint on infrastructure development in Asia is not financing per se but the supply of bankable projects with an acceptable risk-return profile to attract banks or investors. We need integrated solutions that involve risk-sharing arrangements and bring together bank and non-bank capital.

In Singapore, we are working in partnership with a diverse group of stakeholders, to help build such an ecosystem to support long-term financing and unlock the supply of bankable projects.

- Multilateral agencies and well-rated public sector entities could provide guarantees or credit wraps that would allow banks to reduce their risk exposures to such long-term projects, thereby encouraging them to originate such loans.
- Bank loans could be structured in ways that facilitate their seamless migration from banks to capital markets.
- Institutional investors such as pension funds, insurance companies, and sovereign wealth funds could invest in project bonds, infrastructure debt funds, and securitised project loans, taking the risks off banks' balance sheets.

Conclusion

Let me conclude.

We have made reasonable progress in making global finance safer. The regulatory reforms since the crisis have helped to strengthen the resilience of the financial system. But the work is far from complete.

We must not forget that regulation must be complemented by rigorous supervision and sound risk management. We cannot rely too much on regulation alone to make finance safer. As Jacques de Larosiere reminds us:

"Strong, intrusive supervision as well as careful risk assessment and management by bankers are of the essence. They will never be replaced by rules."

Put differently, a culture of prudence and risk governance is a better guarantee of safety and soundness than all the rules on capital and liquidity that we can draw up.

Finally, we want finance that is not only safe but also purposeful. Regulation must not seek to eliminate all risk and must be impact-sensitive. Let us not lose sight of the bigger picture: a sound financial system that is able to play its vital role of intermediation, to support sustained economic growth and help create opportunities for individuals and enterprises.

Thank you.