Lee Hsien Loong: Capital markets in the new economy

Speech by Mr Lee Hsien Loong, Chairman of the Board of Directors of The Monetary Authority of Singapore and Deputy Prime Minister, at the 25th Anniversary Celebration Dinner of the Singapore Investment Banking Association, held in Singapore, on 6 September 2000.

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Chairman, SIBA, Mr Koh Kah Yeok, distinguished guests, ladies and gentlemen,

Introduction

I am happy to celebrate with the Singapore Investment Banking Association (SIBA) your 25th anniversary.

For many years, SIBA has actively provided industry feedback on government policies, especially on capital market regulations and developments. These inputs have helped MAS to create a conducive environment for all financial players.

Last November, your association broadened its charter, reconstituted itself to include a wider spectrum of activities and financial institutions, and changed its name to SIBA. This was a timely move.

I am pleased to note that you have formed the SIBA Debt Capital Market Committee. As an *MAS survey*[1] shows, corporate debt issuance more than doubled last year to S$ 19.5 billion. In the first half of this year, corporate debt issuance is already S$ 21.2 billion, exceeding the volume for the whole of last year. More diverse issuers are tapping the debt market, and interest from local investors has grown. An industry body to champion the development of the debt market, and institutionalise a feedback channel to MAS, will therefore play a useful role.

Global trends in capital markets

In the financial industry, globalisation is proceeding apace. There has been a worldwide wave of consolidation among financial institutions, stock and derivative exchanges, and even regulatory bodies. In 1999, there were 900 merger-and-acquisition (M&A) transactions among banks, worth US$ 300 billion worldwide.[2] The securities industry has been no less active, with exchanges and clearinghouses in a flurry of mergers and alliances.

While globalisation and integration are established features of capital markets, two more recent trends are noteworthy: firstly, stronger linkages between capital market and treasury activities, and secondly, the impact of technology and the internet on capital markets, particularly in the securities industry.

MAS' guidelines on treatment of credit derivatives and securitisation

The links between capital market and treasury activities reflect an increase in cross-border transactions. In the US and Europe, the spate of mergers and acquisitions has boosted the volume of foreign exchange flows. The mergers have also led to greater use of securitisation and credit derivatives, and caused European credit derivative markets to expand significantly.[3]

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[1] 1999 Survey of the Singapore corporate debt market.

[2] "European banking turns decisive corner on road to consolidation", International Wealth Management, July 2000.

[3] "Use of credit derivatives in bank mergers soars", International Financing Review, March 2000.

In Singapore, the burgeoning capital market has similarly benefited our treasury industry. Increased debt issuance has led to more swaps and other money market activities. Participants are using more sophisticated treasury and capital market products. We must keep our regulatory framework up-to-date, so that it provides clarity, and allows growth and innovation.

Credit derivatives form one potential growth area. Credit risk is an important issue for banks, particularly in Asia. Before credit derivatives were invented, banks generally had to stop extending new loans or services to customers to whom they had excessive exposure. This worked against the banks' efforts to maintain valued client relationships. Credit derivatives provide banks an alternative. Banks can now repackage and divest excess credit risk exposures, and continue to service their clients.

MAS has studied how credit derivatives should be captured under the existing capital adequacy framework for banks. It has circulated draft guidelines to industry players and associations for comments. MAS has now finalised the guidelines,[4] which address capital treatment for three main credit derivative products: the credit default swap, the total rate of return swap and the credit-linked note.

The guidelines reaffirm the principle of maintaining capital for risk exposure. If banks assume credit exposure via the use of derivatives, they will be subject to capital charges. But if banks use credit derivatives to hedge their underlying risk exposures, they will be granted relief, depending on the degree of risk transfer. For example, where the hedge is imperfect, because of mismatches in maturity, asset or currency, regulatory relief will still be available, albeit to a smaller extent.

A second promising area is that of securitisation. Like credit derivatives, securitisation allows banks to manage their credit risk and capital more effectively. In its basic form, securitisation involves pooling assets in a special purpose vehicle, which is then funded by issuing securities.

MAS has circulated draft prudential guidelines for securitisation to industry participants for comments. The guidelines for banks have been finalised.[5] These take into account feedback from the industry and existing securitisation transactions. They set out the capital treatment of securitised assets, as well as disclosure, separation and other requirements for the various roles that banks take on in a securitisation transaction.

The guidelines seek to define clearly the roles, responsibilities and risks that banks retain or undertake, when they participate in a securitisation transaction. They also ensure that banks hold appropriate capital against the risks they accept. Thus, a bank that has securitised its assets will be granted capital relief only where the transfer of risks and rewards of the securitised assets has been effective and complete.

The internet and its impact on the securities industry

The second major issue is the impact of technology and the internet on capital markets.

In the securities industry, the internet has caused fundamental change, slicing the value chain more and more finely, and recombining it in novel configurations. Functions previously offered as a package by brokers, such as analysis and advice, recommendation and order routing, are being separated and broken up. New entities, such as aggregators or navigators, have emerged, offering hitherto-unseen types of services.

These changes will bring major benefits to the industry and investors.

Firstly, the internet has fostered a free flow of investment information. With a surfeit of news, financial institutions are rethinking their business models. Research and analysis previously available

[4] To be published as Notice 627.

[5] To be published as Notice 628. Similar guidelines will be issued to finance companies and merchant banks.

only at substantial fees to institutions and high net worth individuals are gradually becoming available to online retail investors as well.[6]

Secondly, the internet offers increased business opportunities and potentially limitless reach.

Thirdly, the internet offers increased scope for cross selling financial products. Successful online firms like Charles Schwab and E*Trade are leveraging on their huge customer base to diversify into banking, bill payment and other areas of services.[7]

Lastly, do-it-yourself finance facilitated by the internet allows institutions to cut whole layers of customer administration costs. The internet is reducing the cost of capital, at the expense of the spreads that intermediaries traditionally enjoyed from a proprietary informational edge. This reduction of what has been called "knowledge float" will benefit both lenders and borrowers.

But at the same time, the internet means new challenges. The same borderless nature can mean footloose customers and businesses. Cyberspace so blurs physical distinctions and facilitates convenient access that financial institutions can uproot themselves, go elsewhere, and yet seamlessly offer the same services online. Jurisdictional boundaries become harder to enforce, while new business models potentially raise new operational, strategic and systemic risks.

Evolving the infrastructure for electronic finance in capital markets

MAS has been closely monitoring these developments and scrutinising their implications for our financial centre.

As financial activities consolidate globally into fewer centres, and services spill over traditional borders, we need to constantly move up the value chain, in order to capture and root intellectual content creation in Singapore. A flexible and responsive supervisory framework is critical to accommodate rapidly changing business profiles of e-finance.

In prescribing rules to regulate new activities, we are unable to run ahead of innovation, because we cannot tell for sure which way technology, or the industry, will develop. Instead, we will monitor technology and market developments closely, and craft and update our rules in step with the market place.

Securities licensing in the electronic realm

Two months ago,[8] MAS announced its intention to regulate securities and futures trading activities under a single licence, and the provision of personal investment and financial planning advice, also under a single licence. We shifted toward a unified licensing regime and a more holistic approach to personal investment advisory services, because the distinction between securities and derivative markets is blurring. Financial products are converging, and one-stop distribution channels are emerging.

Those changes were part of a broader framework of review we have undertaken for the securities and futures industries. MAS has now completed a study of another facet of the securities industry. We

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[6] For instance, Merrill Lynch provides its online clients access to some of its research and videos of analysts' daily briefings. From The Economist, 20-26 May 2000.

[7] Charles Schwab offers bill payment facilities, while E*Trade has set up an online bank, E*Trade Bank. In May 2000, E*Trade acquired an ATM network to cross-sell E*Trade bank, brokerage, mutual fund, and asset management products.

[8] These announcements were respectively made on 6 July by Minister Lim Hng Kiang at the third annual conference of the Investment Management Association of Singapore and on 7 July 2000 by DPM Lee Hsien Loong at the first anniversary dinner of the Securities Investors Association (Singapore).

have reviewed securities licensing requirements in the electronic realm for market intermediaries: investment advisers and dealers.

Objectives in supervising intermediaries

Our key objectives in supervising intermediaries are:

1. to reduce systemic risk in the securities market;
2. to keep markets fair, efficient and transparent; and
3. to safeguard investors' interests by requiring high professional standards among financial service providers and investor disclosure.

These objectives are in line with the principles of the International Organization of Securities Commissions, and principles adopted in other developed markets.

Current interpretation of investment advice and dealing in securities

Our current securities legislation relies on broadly worded definitions like "investment adviser" and "dealing in securities" to bring certain activities under our regulatory ambit.

Under present laws, "dealing in securities" covers any activity relating to transactions in securities, which contain an element of inducement. A broad spectrum of activities could possibly constitute "dealing in securities": broking in securities, referring customers to open accounts with licensed dealers for the purpose of trading in securities, or providing prospectuses and application forms to prospective customers.

As for "investment advice", our current interpretation accepts that the provision of factual information does not constitute investment advice.

What constituted dealing or investment advice used to be fairly clear-cut and well-established. But the breakdown of the securities value chain has blurred the distinctions between fact and investment advice, and between dealing in securities and merely providing information. We therefore need to refine our interpretation of these terms, institute basic safeguards and spell out how to treat new entities.

Licensing approach

In licensing investment advisers and dealers, our approach is to require persons conducting securities activities in Singapore to possess suitable qualifications, relevant professional experience and good character. This would give comfort to investors that they can expect competent advice and reliable execution from investment advisers and dealers.

Our licensing requirements for the new electronic market intermediaries should not be unduly onerous. They will not impose heavy prudential capital requirements. The main focus will be on website disclosure of credentials, physical addresses and other relevant information. In lieu of a corporate track record, licensees need only demonstrate individual qualifications and experience.

Bona fide intermediaries who subscribe to the objective of providing financial services of high standard should be pleased to come under our licensing ambit. With qualified intermediaries operating within an environment based on transparency and disclosure, investors would have a suitable basis for making well-informed decisions. This is another step towards realising the "caveat emptor" philosophy.

New licensing principles

MAS will therefore adopt the following licensing principles for securities activities conducted through the internet:

Interpretation of the activities of an investment adviser and a dealer

Context and circumstance

Our first principle is that MAS will examine the context and circumstance in which activities are conducted, to determine whether licensing is required. This applies to both investment advice and dealing in securities.

Suppose, for example, a web page of a business school provides a tool for calculating the value of shares. Should we require the business school to be licensed? In deciding this, MAS would take into consideration the fact that the business school's primary mission is education, not investment advice. In this context, we are unlikely to require the business school to be licensed to provide such a tool on its web page.

Interpretation of the activities of an investment adviser

Fact versus opinion

Our second principle relates to investment advice. In determining what constitutes investment advice, MAS will use the "fact versus opinion" test as a general guide, supplemented, where appropriate, by the context and circumstance principle. The presence of interpretation, selectivity or subjectivity will require licensing.

Let me explain. A wealth of information on securities is available on the internet. It ranges on a continuum from pure factual statements, to calculated parameters, to outright buy/sell/hold recommendations.

While investors often use factual information concerning securities to guide their decisions, MAS takes the view that factual information itself is not investment advice. Data based on historical time series are facts, whereas forecasts would be considered subjective. Further, filtering data through the choice of parameters, for example, to display only shares with favourable financial ratios, would be considered selective, and would require licensing.

The "fact versus opinion" principle sets out quite clearly what would require licensing as investment advice. Nonetheless, in this information continuum, there remain some grey areas involving implicit advice. For instance, where the interpretation and presentation of facts leads to a specific conclusion, MAS would need to review the context and circumstances, such as other information on the website, to decide whether licensing is required.

Analytical tools: a common device which challenges our interpretation of "advice" is an analytic tool, for instance, computer software aimed at facilitating investment decisions. Such a tool may require licensing. In making this judgment, we would consider the output of this tool, subjecting it to the "fact versus opinion" test. If the output goes beyond factual information, and includes subjective or interpretative content, this tool would require licensing.[9]

Other securities regulators have adopted the same stance in regard to the provision of implicit investment advice.

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[9] To avoid attracting licensing requirements, analytical tools should operate within the following guidelines: they (a) should not go beyond factual information; (b) should disclose analytical processes transparently and (c) provide sufficient disclaimers to the effect that the tools are for informational purposes, and should not be relied upon as investment advice concerning securities.

Interpretation of the activities of a dealer

Referrals for opening of trading accounts

A third principle associated with dealing activity relates to referrals for the opening of trading accounts. MAS will not require the licensing of portals which refer investors to open trading accounts with stockbrokers, provided the stockbrokers themselves are licensed by MAS. This is so, even if the websites offer incentives for account opening. The reason is that trade orders will be handled by licensed dealers supervised by MAS.

Passive distribution conduits for advice and dealing

Our fourth principle relates to websites acting as what we consider to be passive distribution conduits. Passive conduits, whether for investment advice or for dealing in securities, will not require licensing. Some examples include the following:

1. Hypertext links and reproduction of investment research reports: portals often provide hypertext links to websites of licensed or exempt financial institutions, for example, in advertisements. Or they may reproduce investment research reports from such institutions directly on their own websites.[10] Such portals would be considered passive conduits, akin to a newspaper or TV advertisement.

2. Investment advice by persons not carrying on a business: a growing number of online discussion fora, chat-rooms and bulletin boards allow persons to post their opinions concerning securities. An entity providing a platform for public discussion of securities would not attract licensing.[11] Neither would a participant, as long as he is not deemed to be "carrying on a business" of providing advice.

In the context of dealing, we will treat two common practices as passive conduits. First, websites providing hypertext links to, or advertisements for, licensed dealers. But websites should not advertise for, or link users, to unlicensed dealers, including overseas dealers not licensed by MAS. Second, licensing is not necessary for providing prospectuses and application forms passively on websites, or via email upon the request of investors. These merely improve on the efficiency of paper distribution.[12]

Websites must not go beyond being passive conduits. MAS will consider portals or websites providing facilities for accepting or relaying orders to dealers as licensable. This is because such a facility carries the risk of failure to transmit trade orders in a timely and accurate fashion, potentially to the detriment of investors.

Overseas websites specifically targeting Singapore residents

Our final principle deals with overseas websites. MAS will apply the same licensing principles to overseas websites which specifically target Singapore residents, as it does to local websites. This is to ensure that foreign and local internet players are treated on the same regulatory basis.

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[10] Portals which reproduce investment research reports should (a) attribute the report sources accurately, (b) should not exercise editorial control over, or modify contents of reproduced reports, and (c) should not endorse or otherwise comment on the reports.

[11] The webpages of such entities should contain disclaimers to the effect that the views expressed are not those of the entities.

[12] Websites providing prospectuses and application forms in a passive manner should display disclaimers to the effect that they do not have the intention of inducing investors to subscribe for securities.

Going forward

Several of the new licensing principles can be implemented based on the existing Securities Industry Act and licensing framework. Others will require amendments to the legislation. The new provisions will be included in the forthcoming Financial Advisers Act and the Omnibus Securities and Futures Act, and announced in 2001.

MAS has already received a number of new applications which fall under the proposed securities licensing framework. These are currently being evaluated. As I have just discussed the licensing principles broadly, interested parties should approach MAS to discuss the details of the revised licensing framework in relation to their business models. MAS will also be seeking further comments from relevant industry players on these changes.

Conclusion

The vitality and dynamism of global capital markets have ushered in challenging times for the financial services industry. With technology breaking down geographic and sectoral boundaries, links between markets, institutions and instruments will flourish.

Experience in developed economies show that financial services, notably stock trading, can take rapidly to the internet. This should be no surprise. As an Economist online finance survey recently described, financial institutions deal in a product - money - that has long been accepted as “virtual”. Unlike a piece of clothing, account-holders are happy to accept their money represented as figures on an ATM screen, or by a credit or smart card.[13]

The new financial landscape calls for a tripartite, complementary response from regulators, industry and investors. The MAS as regulator will foster healthy market practices, while maintaining a sound overall investment environment. At the same time, in a democratised environment, investors need to recognise that there is little substitute for self-education, and thereby exercise greater caution in making individual investment decisions. Finally, industry participants need to set high professional standards and observe an exemplary code of conduct, in order to retain their customers and build their reputations which, in the long term, are their most precious assets.

[13] “Online finance: a virtual threat”, The Economist, 20-26 May 2000.