Lee Hsien Loong: Building one financial world

Address by Mr Lee Hsien Loong, Deputy Prime Minister of Singapore and Chairman of the Monetary Authority of Singapore, at the 42nd ACI World Congress, held in Singapore on 25 May 2001.

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Managing financial integration: Asia's experience

The last 25 years has seen the emergence of an increasingly borderless, integrated financial world. The collapse of the Bretton Woods system set in train the deregulation of domestic financial markets and the removal of barriers to cross-border finance. Overall, the outcome has been positive. Globalised financial markets have helped to integrate national economies into a global trading system, and finance growth through better allocation of world savings. But the benefits have not come without hazards. Shocks are now transmitted quickly from one financial system to another. Large speculative flows threaten to destabilise economies from time to time. The margin for policy error is narrow, and the penalty severe.

One consequence of greater financial integration is that countries can no longer count on sound macroeconomic fundamentals alone to attract foreign capital. When deciding whether to lend or invest and at what price, international players increasingly look to the stability of countries' financial systems, the degree of transparency, the quality of the legal framework and the standards of corporate governance. On these counts, Asia has much catching up to do.

For too long, East Asian countries directed their domestic banks to lend to well-connected family-based firms and conglomerates. Even when the countries deregulated financial systems and freed their capital accounts, they did too little to strengthen financial supervision and regulation, develop liquid markets, and promote sound corporate governance. International creditors were eager to participate in the Asian miracle, and accepted a close nexus between borrowers and lenders as the "way" business was done in Asia. But lending on the basis of familiarity and relationships is prone to abuse and a recipe for financial mishaps. The Asian crisis of 1997/98 vividly brought home the risks of this approach.

The Asian crisis is now past, but we are not back to the status quo ante. The situation today is troubled, but it is different from that in 1997/98. Unlike then, there is no contagious financial panic, no more hot money to flee the region, crashing currencies and economies one after the other. The markets are more subdued, although they are not immune to shocks, especially from political developments. Global investors and traders have been chastened by the experience of the 97/98 crisis, and now differentiate more carefully between economies, the different problems that they face, and the varying degrees of seriousness with which they are tackling their problems.

Part of the current problem is cyclical: Asian countries are major exporters to the US, and have been affected by the current slowdown in the US economy. This will pass when the US economy picks up. But many Asian economies also have serious structural problems, especially in their financial systems. Resolving these problems will be an arduous task. Countries need to establish rigorous supervisory regimes, foster a sound credit culture in banks, and apply international standards of accounting, disclosure, and loan classification and provisioning. Complicated and deeply entrenched ties between the state, banks and industry will have to be untangled.

In Indonesia the priority is a still more fundamental one: to resolve the political and security crisis, re-establish an effective government, and restore confidence. Only then will basic preconditions exist to begin to tackle Indonesia's economic problems, which in themselves are daunting enough, and will take considerable time to overcome.

While Asia struggles with its problems, the rest of the world has moved on, especially the OECD countries. Their financial industries are being rapidly transformed, and progressively although not fully integrated with one another. This has presented a special challenge to Singapore, a major financial centre in the midst of a troubled region. We cannot totally insulate ourselves from the problems of our neighbours. Yet we have to keep up with developments in other financial centres, to preserve and strengthen our position. Our regulatory environment must stay in line with best practices elsewhere, and our domestic financial institutions must gear up to cope with competition from formidable foreign players. Otherwise, we risk being sidelined.

Fortunately, when the Asia crisis struck our financial system was basically sound, so the banks and other financial institutions emerged relatively unscathed from the storm. This gave us the flexibility to press on with reforms and liberalisation. I will highlight three main dimensions along which greater integration is taking place, and discuss Singapore's policies and responses in each of them: the emergence and consolidation of international banks, regulatory cooperation and harmonisation, and the shakeout in the location of financial activities.

Dimensions of greater integration and Singapore's response

Emergence and consolidation of international banks

The first dimension is the emergence and ongoing consolidation of large international banks. International banks are seeking scale and scope through mergers and acquisitions. This is driven by deregulation, technology, and large economies of scale, as well as by the demand for one-stop, integrated financial services from banks' customers who are themselves globalising. The ability to offer clients access into several markets in different classes of financial instruments has become a valuable competitive edge.

The wave of mergers has included Citibank and Travellers, Chase and J. P. Morgan, Deutsche Bank and Bankers' Trust, BNP and Bank Paribas. In Japan, the city trust and long term credit banks have merged into 4 major groups, in search of efficiency and rationalisation. In some smaller economies that have opened up their financial industry, most if not all of the domestic banks have been absorbed by foreign players. This has occurred in New Zealand, Mexico, and Argentina. Whether this is a happy development is yet to be seen.

But worldwide, this process of consolidation has not been carried to the limit, nor is it likely to. Most mergers and acquisitions have taken place in the OECD countries, and often within the same country. Cross-border tie-ups like the Deutsche Bank-Bankers' Trust merger have been relatively few. Even in Europe, with economic integration far advanced, hurdles to cross-border consolidation are high.

In Asia, the process of consolidation has barely begun even within the same country, much less internationally. The public, regulators and governments are generally wary of encroachment by foreign banks on their domestic turf. Some of their reservations may be protectionist and nationalist. But countries do have genuine concerns, ranging from financial stability to issues of macroeconomic management and customer protection. These will have to be addressed if the banks are to be allowed to pursue mergers and consolidation in accordance with economic logic.

In Singapore, we have responded to the international consolidation not by trying to shut out foreign players, nor by a totally laissez faire approach, but by a phased liberalisation of our banking sector. We have opened it to greater foreign competition, while simultaneously pushing the local banks to strengthen and upgrade themselves.

The stronger local banks have concluded that they need to develop into significant regional players, in order to diversify their earnings and exploit new growth opportunities. A few have taken the first steps in this direction. Not all their ventures have been successful. But mistakes are the price of experience, and the banks must learn from them, rather than abandon the effort to grow abroad.

We have also encouraged the local banks to consolidate among themselves. The domestic market is too small to sustain five local banks of adequate size to compete regionally. Only one merger has taken place so far, between DBS and POSBank. But I know that all the banks are alive to the competitive trends, and are continually reassessing their position. It is a dynamic situation, and the present configuration is unlikely to be permanent.

Regulatory cooperation and harmonisation

The second dimension of financial integration is the trend towards greater regulatory cooperation and harmonisation. Starting in the 1980's, a series of international fora were created for regulators and policymakers to share experiences, cooperate with one another, and harmonise regulations and policies. Among the multilateral initiatives, the efforts of the Basle Committee and IOSCO are probably the best known.

The Basle Capital Accord of 1988 helped to increase the capital held by internationally active banks, and to create a more level playing field for banks under different regulators. The new Basle standards now being finalised will remedy the weaknesses of the 1988 Accord, and enable banks to set aside capital in accordance with the riskiness of their assets.

IOSCO has provided securities regulators globally with a useful platform to exchange views and enhance cooperation on issues relating to the regulation of the securities markets. It has developed a common set of objectives and principles of securities regulation, which enhance mutual understanding among securities regulators and commissioners. IOSCO has also been actively involved in promulgating standards of public disclosure, and facilitated cross-border capital raising and listings.

The Asian crisis has added impetus to the harmonisation of regulatory standards. It demolished any argument that disparities in credit processes and banking regulations across countries reflected differences in cultural and social norms, and that therefore harmonising regulations was misguided and futile. Everybody now acknowledges that the core principles of sound banking practices and banking regulation are universal. There should be due diligence in credit decisions. A banker should not lend unless he is highly confident that the loan will be repaid. The factors that affect the probability of default will differ across countries. But regardless of the country in which the bank operates, lending based on relationships or names without proper due diligence is simply unsound banking.

More needs to be done to improve regulatory cooperation and harmonisation, to achieve the vision of "One Financial World". There are two elements of improvement. The first is a clearer distribution of responsibilities among regulators for prudential oversight of international financial institutions. The Basle Concordat lays out the allocation of responsibilities between parent and host supervisory authorities for banking institutions. But with the advent of the internet, and more generally globalised banking, it has become harder to pinpoint exactly where financial transactions are being carried out, and which supervisor has responsibility over them. In this environment, supervisors need to cooperate more closely with each other to ensure effective consolidated supervision of the institutions under their charge.

The second element of improvement is the harmonisation of practices and standards across jurisdictions. This will lower compliance costs for financial institutions, arising from having to satisfy different regulatory and legal regimes in different countries. Unfortunately such harmonisation is extremely difficult, even if we confine ourselves to a small subset of countries. The issues are far too intricate and complex to be resolved in a multilateral setting. Institutional structures, market practices and philosophical approaches differ from country to country. And each country guards its regulatory powers jealously, and wants the freedom to set and enforce its own rules. The multiple national regulators that exist in the European Union are a good example.

Short of complete harmonisation of regulations, one practical approach to pursue is mutual recognition of regulatory regimes. Mutual recognition need not be all or nothing. It can be applied to specific areas, starting from cross-border offerings of financial products such as collective investment schemes and suitable initial public offerings. Institutions can save half or more of their compliance costs, if they only have to comply with one set of regulations recognised by both regulators. This benefits both markets by deepening liquidity and broadening product offerings.

Singapore has participated actively in international efforts to harmonise regulations and policies across jurisdictions. As a small country, our ability to push the envelope on regulatory practices is limited. But we have conscientiously kept abreast of global regulatory initiatives, and adopted the best international standards and practices for regulating and supervising our financial institutions and capital markets, taking into account the specific circumstances of our financial industry.

In some instances, we have found it possible to adopt standards and practices of international bodies and foreign regulators wholesale. For instance, the Committee on Disclosure and Accounting Standards, a private sector led body formed to review disclosure and accounting standards in Singapore, has recommended that Singapore should adopt International Accounting Standards (IAS) as the accounting standards for Singapore.

In terms of mutual recognition, we are currently exploring with Australia an agreement for the mutual recognition of our regulatory regimes in certain activities of the securities market. We are ready to conclude similar arrangements with other like-minded regulators.

Consolidation of financial centres

The third dimension is consolidation of financial activities in fewer locations. Before the collapse of the Bretton Woods system, financial institutions had predominantly domestic clienteles and tended to locate in their respective financial capitals, for easy access to clients. So the largest centres tended to be financial capitals of countries with the largest economic bases. But as the structure of the financial industry evolved post-Bretton Woods, there has been a decoupling between the size of a financial centre and the size of its economic base. Institutions now need to service customers from many countries. It is not feasible for international players to maintain a major presence in every jurisdiction where they operate. So the financial centres that are able to enhance the competitiveness of their constituent firms are the ones that thrive. Proximity to clients has become less critical. What counts now are intangibles such as market information networks, quality of regulation and supervision, credibility, as well as a critical mass of skilled and innovative professionals.

London is a prime example of this phenomenon. Despite not being part of the Eurozone, and having a smaller economic base than financial centres on the continent like Frankfurt and Paris, London has thrived, and by all indications will continue to grow as a financial centre. In Asia too, the trend is towards consolidation of activities in fewer centres, resulting in keener competition between financial centres. This overall consolidation reflects the economics of the industry. But which particular cities emerge as major centres depends also on the competitive advantage which they create for themselves, i.e. the policies they pursue and the activities they promote, to gain a headstart over rivals.

Singapore has therefore taken a pro-active approach to building ourselves up as an international financial centre, and not relied passively on financial institutions choosing to set up here. Our vision is for Singapore to provide a full-range of financial services for East Asia. Obviously, we cannot match London, New York or Tokyo in terms of size or depth of domestic markets. But that should not stop us from becoming a key global node in certain areas. Our approach has been twofold: first, to set fair and transparent rules for the industry, and provide a conducive, open and competitive operating environment. And second, to catalyse the growth of promising sectors of the industry, with incentives and promotional support. We have sought to push in the direction of market forces, rather than against them.

Asset management

One good illustration of how we have sought to promote and develop our financial centre is our efforts to develop Singapore into an asset management hub. We assessed very early on was that there was good potential for growing the asset management industry in Singapore. A rising affluent class across Asia would have assets needing to be managed. Most of the savings in Asian countries are still in the form of bank deposits. There is considerable scope for diverting some of these funds for professional management.

There was also an opportunity for managing the Asian mandates of global portfolio investors, an area where no clear leader had emerged. We believe that global funds and institutions would find Singapore a good location from which to manage their Asian portfolios. Although for now the region is not a hot destination for inbound investments, this will change as the region picks up again.

We therefore carried out a comprehensive strategy to strengthen our fund management industry. We streamlined licensing requirements for fund mangers, and provided more room for indigenous fund managers to grow. We introduced tax incentives, especially for fund managers managing substantial amounts of discretionary funds out of Singapore. We leveraged on our domestic savings, both government and private, to attract fund managers here. Over the last three years, the Government of Singapore Investment Corporation, or GIC, committed to place out S$25 billion, and MAS to place out S$10 billion, to be managed by fund managers based in Singapore. We progressively liberalised rules governing the Central Provident Fund, to allow Singaporeans to invest their retirement savings under professional management, instead of leaving them with the Government.

These policies and initiatives have yielded good results, and attracted new players who have contributed to the depth of our asset management industry. Despite difficult market conditions in the year 2000, Singapore's wealth management industry has remained resilient. The MAS' latest Survey of the Asset Management Industry shows that total assets under management in Singapore did not decline last year, but continued to grow, albeit slowly. As at end-2000, total assets under management in Singapore amounted to S$276 billion. Discretionary assets under management showed a decrease, reflecting the decline in market valuations in the region, but this was more than offset by an increase in advisory assets.

Incumbent managers in Singapore have adopted a long-term perspective. They have increased the scale of their operations, priming for a market upturn. The pool of talent in the industry has grown, with the number of investment professionals located here growing by about 10% in 2000, to a headcount of 1,000. 24 new fund management outfits were established over the last year, bringing the total to 215 companies.

Electronic financial services

Another promising area is electronic financial services. The adoption of info-communication technologies is changing the global financial landscape. New technologies have broadened the scope and utility of financial products. New delivery channels have emerged. Traditional business models are being challenged. The conventional value chain has been disaggregated. Some players are focussing on specific segments of the value chain, such as processing or distribution, seeking to exploit scale economies. Niche and specialised areas have emerged, that open opportunities for a diverse range of innovative players, often start-ups or smaller players nimble enough to exploit opportunities by adopting new technology.

It is difficult to predict who will be the winners and losers in this new landscape. Not all the new ideas or business models will eventually succeed. But technology, automation and the internet will likely be central to the success stories.

MAS is keeping a close watch on these developments. As new business models and entities emerged, we have issued policy notes setting out our views on the electronic provision of services in the areas of banking, capital markets, risk management and third-party aggregators. In March 2001 we released formal supervisory guidelines on the use of the internet in banking (the Internet Banking Technology Risk Management Guidelines), after extensive consultation with the industry in Singapore and abroad, and have been contributing actively to the evolving thinking among regulators on these issues. We are introducing a new consolidated Securities and Futures Act to account for global developments influenced by technology. We seek to clarify in advance what we might or might not regulate, in order to help entities to roll out their services.

Our regulations are reactive; necessarily so because we have to respond to market and industry developments. However, we must respond to market changes promptly, and complement prompt reaction with a forward-looking perspective, seeding innovation and attracting players in electronic financial services (EFS).

The MAS intends to set up a venture capital fund and a grant assistance scheme, to incentivise electronic financial services in Singapore. Our purpose is to position Singapore as a test-bed for innovative electronic financial services, and a centre for incubators of electronic financial services start-ups. The fund is not intended to replace the venture capital industry, but will instead act as a catalyst to develop Singapore into a leading EFS hub. The objectives of these two schemes are twofold:

- To raise efficiency of financial sector players through the employment of EFS technology.
- To attract players to base their regional or global capabilities in Singapore.

We aim to build a strong industry base of major EFS players, develop in the requisite skills and expertise, build supporting e-frastructure, and "electronicise" existing brick-and-mortar financial services.

Conclusion

Barring mishaps, the global industry trend towards greater integration and openness will continue. This will confront both regulators and industry practitioners with complex challenges. The regulator's role is to ensure systemic stability, the integrity of the payments systems, and fair rules of competition, while promoting a conducive environment for the growth of the financial centre. The industry's role is to compete, innovate, and enhance the value of their business. But both seek a more integrated, efficient and sound international financial system. I hope your deliberations at this conference will contribute to this goal.