Lee Hsien Loong: Consolidation and liberalisation: building world-class banks

Speech by Mr Lee Hsien Loong, Deputy Prime Minister of Singapore and Chairman of the Monetary Authority of Singapore, at the Association of Banks Annual Dinner, Singapore, 29 June 2001.

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Introduction

Two years ago, MAS embarked on the first phase of a programme to liberalise the banking industry. The aim was to strengthen our local banks through competition, provide Singaporeans with quality banking services, and enhance Singapore's position as an international financial centre. We phased in the liberalisation measures progressively, to give local banks time to upgrade themselves to meet the competition, and maintain the stability of the financial system.

The first package of measures in 1999 comprised a few main elements. MAS permitted 4 Qualifying Full Banks (QFBs) to establish up to 10 locations each, relocate their existing branches and share ATMs among themselves. We granted 8 new Restricted Bank licences to banks that wanted to expand their wholesale S$ business. We also gave Offshore Banks more flexibility to lend in Singapore dollars and engage in S$ swaps, and even wider leeway to 8 Qualifying Offshore Banks.

These measures marked the start of a major and irreversible process of change. We could not foresee exactly how the industry would respond and develop. So MAS committed to reviewing progress at the half-way mark before deciding on further liberalisation measures. We have now completed this review.

Local banks' upgrading and consolidation

Since the first liberalisation package was announced, the local banks have made progress in building up their capabilities. They have generally strengthened their management teams, and invested heavily in infrastructure to provide banking services more efficiently, especially via electronic channels. They have improved their customer relationship management systems, which will allow more effective data mining of their customer databases and cross-selling of multi-sector products. Local banks have also been seeking opportunities and expanding their presence in the region.

An important and more visible sign that local banks are gearing up for competition is of course the process of consolidation that is underway. The opening gambit was made on 12 June when OCBC announced that it was making a voluntary general offer for Keppel Capital Holdings which owns Keppel TatLee Bank. Ten days later, DBS made an unsolicited bid for OUB. And just three hours ago, UOB made a competing bid after reaching agreement with the controlling shareholders of OUB. All the local banks are now busy reassessing their positions. It is likely that a new configuration will quickly crystallise.

MAS views this as a very positive development for the banking industry, and more importantly for Singapore. If the consolidation is well executed, a stronger group of local banks will emerge, able to hold their own domestically, provide Singaporeans with better services, and compete in the region. Let me elaborate.

The importance of consolidation

Economies of scale have become critical in banking today. Banks in the developed countries have been merging and consolidating, globally, in search of greater scale and efficiency. Their customers are demanding faster access to more customised and integrated financial services. Banks can now deliver one-stop service through faster distribution channels, and develop sophisticated customer relationship systems to customise products. Technology has made this possible. But the cost of investments in technology is high, and can only be justified and recovered if it is spread over millions of customers. Banks like Citicorp have spent tens of billions of dollars, developing IT systems to support their consumer banking services.

Being a big bank is no guarantee of success, as shown by the persistent difficulties of the Japanese banks over the last decade, which in the 1980s were among the biggest banks in the world. But being a small bank is definitely a significant handicap. The logic of Singapore’s position is inescapable: if we want strong banks, then they have to be big banks, and if they are to be big banks, then we must have fewer banks. This is the reality in many small countries. Switzerland, with a GDP and population about twice our size, now has only two big banks – UBS and Credit Suisse – both of which are world-class players. The Netherlands, four times as big as Singapore, has three – ABN-AMRO, Rabobank and ING, plus Fortis which is partially Belgian. These have become major international players.

Australia, which is slightly bigger than the Netherlands, also has 4 big banks, but they are mainly domestic, smaller than the Dutch although bigger than the Singapore banks. The Australian government maintains a "Four Pillars" policy, under which it will not allow any of the 4 banks to merge or take over any of the others, in order to maintain sufficient competition in the domestic market. But there is debate in Australia over whether this "Four Pillars" policy is sustainable, or whether it will cause Australian banks to lose out in the long run, by preventing them from becoming large enough to be truly viable.

Singapore's economy is ¼ the size of Australia's. Singapore cannot afford a "Four Pillars" policy. If we tried that, our banks would be like bonsai plants, root-bound by the small pots in which they grow. Our biggest bank – DBS, even after the merger with POSBank, is ranked only 115th in the world by asset size. In banking size is not everything, but size is important.

If the local banks fail to achieve enough scale, they will not be able to invest in cutting-edge technology and management systems, or to attract the talent necessary to compete with the best players. Their service standards and product range will not be able to keep up with their foreign competitors. They will find it difficult to diversify their earnings by competing in fee-based businesses, like asset management and cash management. Customers, especially the more sophisticated ones, will take their business to the foreign banks already in Singapore.

The local banks cannot rely on government protection forever. Even if we had not liberalised the banking industry, the foreign banks here would still have been able to use technology and new delivery channels to compete for retail business. In fact, the most innovative foreign banks have been growing their market share despite the restrictions that we have placed on them. Over time, local banks that cannot compete would become marginalised.

This would not be a good outcome. In the event of a crisis, we want to be able to count on strong institutions with a major stake in the country, whose interests will be aligned with those of the long term interests of the Singapore economy. Banks which are tied more closely to Singapore will be more likely to act in support of financial and economic stability. That is why MAS remains committed to building strong local banks with a significant share of the domestic market.

This is the reality that Singaporeans must understand and accept, as we debate the pros and cons of bank mergers. If small banks were economically viable, we would not be meeting tonight with every Singaporean bank either a bidder or a takeover target. The fact that they are bidding and being bid for proves not just that the smaller local banks are vulnerable, but also that the bigger ones themselves feel insecure, and rightly so. If the local banks stay small and weaken over time, we will be worse off for it. In the longer term, stronger and larger local banks offer far better assurance of Singapore's interests.

MAS' approach to consolidation

While MAS welcomes the process of consolidation, it will remain strictly neutral, and will not seek to influence the outcome. We have made it known to all the participants that we will allow the local banks to bid for one another. The new configuration should be determined by the free play of the market. MAS will leave the banks and their shareholders to decide whom they should merge with or acquire, subject to five conditions being met:

a. First, the banks should have the capability to achieve effective integration following the merger. The management of the acquiring bank must understand the financial, operational, and cultural issues involved in integrating two entities and have a credible plan in place.

b. Second, the merger must not impair the bank's financial soundness. In particular, the bank must meet MAS' capital adequacy requirements at all times. Consolidation should not compromise the safety and soundness of the bank.

c. Third, we will consider the impact of the merger on competition. Consolidation should not lead to the emergence of one or a small group of overly dominant banks, which are in a position to engage in monopolistic or other anti-competitive behaviour.

d. Fourth, the consolidation should not lead to loss of service for small depositors, for whom affordable banking services are a necessity.

e. Fifth, any cross-border partnerships should not result in the foreign partner taking control of a Singapore bank.

I will elaborate on these five considerations in turn.

Managing the integration

Consolidation, whilst necessary for the local banks to be competitive, is not in itself sufficient to produce strong banks. Having merged, the banks will have to integrate and rationalise different management teams, information and risk management systems, and internal control procedures. The reality is that some mergers work while others do not. Good execution of a merger will produce a stronger bank, by yielding the expected synergies and cost savings. Poor execution will only lead to a more unwieldy and riskier bank.

A larger scale and wider range of activities will demand stronger and more institutionalised management. Singapore banks have benefited from having their principal shareholders, including family shareholders, play an important role in overseeing the banks, although most no longer run the management. The controlling families have had the entrepreneurship and business acumen to build up the banks, and their long-term interests were substantially aligned with those of the banks. This situation currently serves us well, but is not likely to endure over the longer term. The ongoing consolidation, the lifting of foreign shareholding restrictions, the separation of banking and non-banking activities and the process of generational change will result in a reduction in the relative shareholding of the major shareholders. Succession planning is critical.

The transition from the present framework to the new landscape will need to be carefully managed. The banks have already started taking steps to enhance corporate governance and professional management. MAS has also implemented measures to ensure that the Boards and key committees of the banks have sufficient representation of independent directors, and to encourage the Boards to appoint qualified professionals to run the banks. MAS will continue, by moral suasion and prescription, to encourage the banks to strengthen and institutionalise their managements, especially those merged banks which emerge from the consolidation.

Safety and soundness

While bigger banks are likely to be stronger and more diversified, they pose a larger risk to systemic stability if they run into difficulties. MAS will intensify its supervision of the merged banks, placing stronger emphasis on evaluating the banks' internal risk management processes and control structures. In the US, the Federal Reserve Board installs examiners almost continuously in the large and complex institutions under their purview, in order to monitor and supervise the banks more closely. MAS does not expect to have to do the same, but more frequent inspections and closer supervision of the banks will be necessary.

While MAS will intensify its supervision, the first responsibility for soundness and prudence lies with the Board and management of the bank itself. Bank management must ensure that they have in place robust, group-wide risk management systems adequate to the new scale and risk profile of the combined entity. This again underlines the importance of top quality institutionalised, professional management for the banks.

Competition

We should not allow an enlarged bank, or a few banks in a consolidated banking industry, to use their market power to engage in monopolistic or other anti-competitive practices that raise prices, diminish consumer choice, or erect barriers to entry by other players. MAS does not think this will happen. It is unlikely that the largest bank in the system will have an over-dominant share. For example, if OUB merges with one of the larger banks, their combined market share of non-bank deposits will be at most about 30%. This will still be significantly less than the share of the largest banks in other small countries, like the Netherlands and Hong Kong.

Secondly, the competition will not just be among the remaining local players. The banking liberalisation programme will continue to introduce greater competition from foreign banks, in the range and pricing of products they offer and quality of service.

Thirdly, the Government will be vigilant against any abuse of market power. The Competition Act that MTI is now considering will help us to do that.

Small depositors

Given the prospect of mergers and rationalisations, it is natural that many bank customers are apprehensive and worried about how they will be affected. A merger will result in rationalisation of branch and ATM networks, which will inconvenience some customers. But overall, customers should have access to more branches and ATMs after the merger, even though not every existing branch and ATM can necessarily be retained. And because a larger merged bank can operate more efficiently and realise revenue synergies, it should be able to provide better service and greater choice to customers. Of course the bank will have to handle the implementation carefully and sensitively, giving customers adequate notice of changes and helping them to adjust. It is in the bank's own interest to do this, and I am sure they will make every effort to do it well.

Unfortunately this does not mean that as a result of a merger, every bank service will become cheaper or free. This is not possible, not because of mergers, but because of competition. Competition will force banks to watch their bottom lines more closely, and to make each service and product break even. It will become harder for banks to continue cross-subsidising services that they used to provide for free or below cost. That was a luxury that they could only afford in a protected and languid market where profits came easily, a state of affairs which was unsustainable in the long run. DBS is already facing this pressure – the public is upset that some branches have been closed, but analysts and investors are criticising DBS for not rationalising the branch network and extracting cost synergies fast enough.

Furthermore, as banks focus more on returns, they will tend to concentrate on the middle and upper segments of the market, where they can sell a wider range of services and earn better margins. However, if all banks neglect small depositors, this would cause a problem to lower income Singaporeans, in a society that is increasingly cashless.

Other jurisdictions like the US and Australia also face the same problem, and either have implemented or are studying requirements for basic banking accounts. In the State of New York, banks are required by legislation to provide such accounts, while in some other US states the banks have voluntarily offered such services so as to avoid the heavy hand of legislation.

Banks have to be allowed to recover their costs, just like utilities and public transport companies. But they should not simply opt out of the responsibility to service the mass market. The Government will therefore ensure that in this competitive environment, low-income Singaporeans continue to have access to basic banking services at affordable prices.

This is not an immediate problem, even after consolidation among the local banks. DBS already has an obligation to play a social role, and service the mass market, because that was a condition of the sale of POSBank to DBS. Most of the local banks also service small depositors. This will continue. However, over the longer term, the conflicting pressures on banks on the one hand to provide a public service, and on the other to earn competitive returns for shareholders, will persist and intensify.

ABS has encouraged banks that engage in consumer banking to provide affordable basic banking services to lower income Singaporeans. MAS welcomes this, and hopes that these banks will find ways to meet this need. MAS will monitor the situation closely, together with ABS and the banks. When it becomes necessary, MAS will require all banks with significant retail operations in Singapore to provide basic banking accounts with defined minimum features to low income Singaporeans.

Cross-border partnerships

As the financial industry continues to change rapidly and the global banks grow even larger, consolidation among the local banks alone may not be sufficient. Apart from seeking growth and acquisitions abroad, the local banks may also seek out foreign partners. Strategic partners can bring expertise and market discipline to Singapore banks. MAS has encouraged the local banks to explore such strategic alliances and is prepared to approve significant stakes by foreign banks, provided three conditions are met:

a. One, the foreign player must be more than a financial investor. It must become a strategic partner bringing specialised skills, new technologies, or business strategies to the bank. The outcome must be in the long term interests of the bank;

b. Two, the strategic partner must be a sound and well-managed entity. The alliance should not result in a higher risk profile for the Singapore bank through, for example, increased contagion and reputation risks; and

c. Three, the Singapore character of the bank must be retained. Foreign parties cannot become controlling shareholders, even if the controlling stake is less than 50%. To allow this would circumvent a key objective of our liberalisation programme, that is to build strong local banks which can underpin the stability of the banking system.

Some of the local banks have already had initial discussions with prospective foreign partners, although so far nothing has materialised. These proposals have not failed because of regulatory objections. MAS' stand is clear: as long as the foreign partner is not seeking to take control of the local bank, we are open to discuss all possibilities.

Banking liberalisation – the second phase

The consolidation being played out among the local banks is a clear indication that they understand the urgency of strengthening their competitiveness. Overall, the local banks have responded well to the liberalisation programme, upgraded their capabilities and maintained their market shares. This has given us confidence to proceed now with the second phase of liberalisation. The second package of measures has three main components: freeing up entry to domestic wholesale banking, enhancing competition in retail banking, and instituting prudential safeguards necessary for a more liberal banking environment.

Freeing up entry to wholesale banking

First, we will significantly broaden participation by foreign banks in the domestic wholesale market. We have to do more to encourage quality international banks to use Singapore as their Asian base. Granting them more access to corporations and high net worth individuals will strengthen their business case to develop their operations in Singapore.

Opening up the wholesale market to international banks will also benefit industries in Singapore. It will give our industries better access to world-class financial products and services that will help them develop their businesses.

MAS will make a fundamental shift, towards a licensing regime that distinguishes between retail and wholesale banks, away from the 3-tier licensing regime of Full, Restricted and Offshore Banks. We will rename the existing Restricted Bank licence as the "Wholesale Banking" licence to better reflect the wide range of activities that can be already conducted under the licence. We will phase out the Qualifying Offshore Bank and Offshore Bank licence, and upgrade all existing QOBs and OBs to Wholesale Bank status over time. The upgrading will allow these banks to accept S$ fixed deposits above $250,000 and operate S$ current accounts. It will also remove limits on the amount of S$ lending that they otherwise face as offshore banks.

We plan to grant some 20 Wholesale Banking licences over the next two years. Banks will be admitted to Wholesale Banking status in priority of their financial strength and ability to contribute to Singapore's financial industry. The 8 Qualifying Offshore Banks will be given priority in the upgrading. Existing Offshore Banks as well as banks that do not yet hold a banking licence in Singapore are encouraged to apply. After these 20 licences are granted, we will review the pace of upgrading the remaining Offshore Banks.

Enhancing competition in retail banking

In retail banking, we will maintain the momentum of liberalisation by improving on the first package of measures. We will take applications for the two outstanding QFB licenses. We will also expand what a QFB is allowed to do:

a. With immediate effect, they will be permitted to establish up to 15 locations (previously 10), of which up to 10 (previously 5) can be branches, and the rest off-site ATMs.

b. From 1 July 2002 QFBs will be allowed to provide debit services on an EFTPOS network. QFBs can negotiate with an existing EFTPOS network such as NETS, Visa or Mastercard, for access on fair commercial terms. QFBs will then be able to provide debit services such as debit cards, and cashback at retail outlets. Using the Visa network alone to provide debit services will open up more than 23,000 terminals to the QFBs. With cashback services, each EFTPOS terminal, whether run by NETS or a credit card company, becomes a potential cash withdrawal point.

c. Also from 1 July 2002, QFBs may offer Supplementary Retirement Scheme accounts, accept CPF fixed deposits, and offer agent bank accounts under the CPF Investment and Minimum Sum Schemes. Liberalising the CPF Investment Scheme alone will open up a large pool of funds that could be placed with the QFBs. About $62 bn of funds in CPF Ordinary and Special Accounts are still available for investment under the CPF Investment Scheme.

These measures will significantly enhance competition in retail banking in Singapore. With 6 QFBs permitted to share ATMs among themselves, the increase in locations could result in a QFB ATM network of 90 or more locations across Singapore. Together with access to a nationwide EFTPOS network, this provides QFBs with significant scope for expanding their presence in the domestic market. For consumers, these changes will mean more choice and greater accessibility.

The only part of the retail payments system not yet liberalised will be access by the foreign banks to the local banks' ATM networks. Foreign banks have not been allowed to provide their customers with ATM services on the local banks' networks. We will maintain this restriction for now.

Safeguards

These changes to the wholesale and retail banking markets represent a substantial opening up of the industry. We expect foreign participation in Singapore's banking industry to increase as we liberalise. More people will invest and deposit their money with foreign banks. MAS is therefore looking into two measures to safeguard depositor interests – subsidiarisation of systemically-important foreign banks and deposit insurance.

Subsidiarisation of systemically-important foreign banks

Local banks are required to maintain a minimum of $1.5b in paid-up capital and meet MAS' capital adequacy ratio requirements to ensure that they have adequate resources to support and expand their operations. MAS' requirement of a minimum of 8 percent Tier I capital and 12 percent Tier I plus Tier II capital exceeds the international standards set by the Basel Capital Accord. However, QFBs and foreign banks can operate as branches, and accept retail deposits without any paid-up capital in Singapore.

This has led local banks to complain that the playing field was tilted against them. It was tenable in the past when individual foreign banks had a small share of the domestic market and we placed greater reliance on the home supervisor. But as we open up further, we need to make sure that the prudential safeguards that apply to foreign banks are commensurate with their increased role in the retail deposit market.

MAS is considering requiring systemically-important foreign banks with a large retail presence to subsidiarise their operations in Singapore. This means that the foreign bank will have to incorporate in Singapore and meet MAS' minimum paid-up capital of $1.5b, as well as MAS' CAR requirements. Subsidiarisation will provide greater clarity and certainty in supervision. A subsidiary is a separate legal entity from the parent. It will have its own assets and will have to maintain its own capital. This will allow us greater flexibility to ringfence the subsidiary, and minimise contagion arising from problems that may emanate from the bank's home market or global operations, especially where the home jurisdictions have laws which favour depositors in the parent bank over depositors in overseas branches.

Subsidiarisation will not turn the subsidiary into a local bank. The foreign parent bank will in most cases own 100% of the subsidiary and want full control over its activities. MAS will continue to treat the subsidiary as a foreign bank, and will exempt it from a requirement placed on local banks to maintain a majority of Singapore citizens or permanent residents on their board of directors.

MAS is studying this issue and will make a decision later this year. We would not be the only jurisdiction with a subsidiarisation requirement. Several reputable jurisdictions, such as Australia, the US, and Canada, go even further and require that in order to accept any retail deposits at all, foreign banks must incorporate locally and meet the minimum capital requirements imposed on locally incorporated banks.

Deposit insurance

We will study the need for a deposit insurance scheme in Singapore. Unlike most countries, Singapore does not have a deposit insurance scheme. In the past, sound management and conservative practice by the local banks, coupled with strict regulation and supervision by MAS, helped to avoid problems in our banking system. On the few occasions when a foreign bank has run into difficulties, MAS has managed to ring-fence the banks' Singapore operations in time – as we did during the Asian crisis – so that Singapore depositors did not suffer losses.

However, as we liberalise, foreign banks will gain market share. Local banks will also venture abroad. The safety and soundness of both local and foreign banks will increasingly be affected by factors beyond our control. We have seen how in other countries even well-run international banks supervised by highly-regarded authorities can nevertheless run into financial trouble. Even as we strengthen MAS supervision, we cannot expect our supervisors to always be in time to pre-empt any difficulties that the bank has not prepared itself for.

No government can promise to bail out depositors whenever a bank runs into trouble. If a government did so, depositors would lose the incentive to seek out sound banks, and banks would lose the incentive to lend prudently, knowing that even if they run into trouble their downside risks will be absorbed by the government. This is what bankers call moral hazard. However, in the absence of a deposit insurance scheme, there will be an implicit expectation, both by depositors and banks, that if something goes wrong, particularly with a large bank, the government will be there to pick up the pieces. And should a mishap happen, the government may come under strong political pressure to do so. This can be destabilising.

Deposit insurance makes clear where depositors stand: depositors know exactly how much of their money will be protected if a bank fails. Government statements that it will not bail out depositors beyond the insured amounts become more credible. However, deposit insurance is not without its downside. If its coverage is too broad, or it insures too large a proportion of deposits, it can cause the same problems as a government guarantee. A poorly designed deposit insurance scheme may make the banking system less rather than more stable. These problems can be mitigated if the deposit insurance scheme only insures small deposits, or sets premiums in line with the relative riskiness of banks, or discriminates between banks and subsidiaries that are incorporated here from those that are not. These are complex issues that need careful study, which MAS has begun.

Conclusion

This liberalisation package will provide further impetus for upgrading and progress in the local banks and Singapore's financial sector development. We will review the progress made in another 2-3 years, before deciding on further moves.

Consolidation and continued liberalisation are important in building strong banks. But they are not in themselves sufficient. Banks must press on to upgrade their capabilities. They must keep abreast of international best practices, new products, technological developments and new ways of doing things, while retaining the support and confidence of consumers. ABS can play a part to help the banks do this. The government will do its best to maintain a sound regulatory framework, conducive to competition and innovation. But finally, success will depend on the quality and passion of the people in the financial industry. Together we have to build the skills, develop the businesses, and enhance the regulatory framework to make Singapore the premier financial centre in Asia.