Koh Yong Guan: Risk management development in Singapore

Opening address by Mr Koh Yong Guan, Managing Director of the Monetary Authority of Singapore, at the first MAS Risk Conference, Singapore, 31 January 2002.

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Ladies and Gentlemen

Introduction

It is my pleasure to address the first MAS Risk Conference. I will cover two areas :

- First, the changing financial landscape and the challenges they pose for risk management; and
- Second, the introduction of three risk management initiatives.

Changing Financial Landscape and Challenges

Over the last few years, there has been a fundamental change in the volatility of financial markets. The frequency and the contagion effects of crises affecting financial markets have also risen.

The volatility of financial markets has increased. The lowering of regulatory barriers to capital flows has integrated global financial markets. This has increased the correlation and the transmission of volatility from one financial market to the next. As a result, the diversification benefits derived from investing in several markets have dissipated, leaving market participants exposed to greater financial risks than before.

The emergence of complex derivative instruments has increased market liquidity, but also financial risk for those who are not well acquainted with the use of these instruments. While these new instruments have allowed market participants to transfer their credit risks and enhanced the efficient pricing of such risks, the use of derivatives for speculative purposes can result in large losses.

The Basle Capital Accord of 1988 was a landmark document for the banking industry. It helped increase the capital held by internationally active banks, and created a more level playing field for banks under different jurisdictions. However, there were some weaknesses in the Accord. The most important of these was the practice of assigning the same risk weight to all counterparties in each class, irrespective of the differences in their credit-worthiness. These issues led regulators to propose a more risk sensitive framework. The proposed new Capital Accord will have a great influence on the risk management practices of banks. The new Accord, however, poses challenges to Asian banks and regulators alike. Banks will have to develop more sophisticated risk management capability while regulators will need to build up technical knowledge as well as supervisory resources to validate banks' risk management systems.

As financial markets progress towards greater transparency, the market disciplinary mechanism will reward banks that manage their risks effectively, and penalise those that do not. Good risk management practice is thus even more essential for banks to maintain their competitiveness over the long run.

The frequency of shocks has increased. In the past 10 years there has been an average of one shock every year starting from the Gulf War in 1991 to the Latin American crisis of the early nineties and so on down to the Asian Economic Crisis in 1997, the Russian Bond Default Crisis in '98 and most recently last month, Argentina's default. The causes of these stress events are wide-ranging.

In addition, these shocks have shown a greater tendency to spread rapidly to other financial markets. The rapidity with which the Asian crisis spread across East Asia in '97-'98 is a good example.

Many of us here today may wish that we have the ability to predict with certainty when the next crisis will strike. It is, however, far more fruitful to adequately prepare ourselves for the inevitable. And that, in short, means enhancing our risk management capability.

Risk Management Initiatives in Singapore

MAS will introduce three risk management initiatives to help financial institutions in Singapore better manage the challenges ahead.

The first initiative is a MAS guideline that aims to help banks prepare themselves to meet the ill effects of financial crises and shocks. One of the ”defining” features of a financial crisis is that it strikes suddenly and once it has struck, it gives very little time for financial market participants to react. How then can we better prepare ourselves for a crisis?

Stress testing offers financial institutions a systematic methodology to prepare for financial crises. Stress testing is based on the old military saying, “the more you sweat in peace the less you bleed in war”. That is, financial institutions that have a comprehensive programme to stress test their portfolios will be better prepared when a stress event occurs.

Stress testing consists of assessing the attributes of a portfolio, assessing the scenarios that are likely to occur and calculating the stress loss should a crisis come to pass. With a rigorous stress-testing programme, a bank can alter the composition of its portfolio, if preset stress loss limits are exceeded during stress tests, thereby limiting its losses should a stressful event actually occur. Stress tests are fairly common for market portfolios but are still not widely used to assess stress loss of credit portfolios, particularly, loan portfolios.

We are releasing on our website today a consultative paper on credit portfolio stress testing. The paper will be further developed with your inputs before we release it as a formal MAS guideline. We invite you to send in your comments by May 2002.

In the coming months, financial institutions in Singapore can also expect to receive the MAS risk management guidelines for market risk, credit risk and liquidity risk management. These guidelines will spell out the key principles for sound risk management which banks are encouraged to follow. Improvements made to risk management in order to comply with these risk management guidelines will help banks develop prudent and understandable policies, and improve their methods for measuring and managing firm-wide risks.

These guidelines will incorporate comments from industry practitioners and other experts in the field of risk management.

Next, there will be a significant addition to Singapore’s risk management infrastructure. To help financial institutions mitigate credit risk through information pooling, the Singapore Consumer Credit Bureau will be launched in September this year. MAS welcomes this joint-venture initiative between the Association of Banks in Singapore (ABS) and a consortium comprising Dun & Bradstreet International and Baycorp Advantage, among others.

With the rising popularity of consumer credit across Asia and the likely increase in credit risks due to the difficult economic conditions, financial institutions are increasingly faced with the challenge of improving the quality of their consumer credit portfolios while increasing their market share in the face of global competition. Take for example the credit and charge card. In 2001, total card billings in Singapore were S$11 billion and bad debt written off by financial institutions was S$79.5 million. Over the past year, the personal bankruptcy rate has risen by 19%. Credit and charge cards approval rate has risen by 14.4% over the same period.

The availability of timely and reliable customer credit information is therefore vital in banks’ decisions to grant or sustain credit facilities. The establishment of a credit bureau in Singapore is timely and will enhance the reliability of banks’ internal credit rating systems. Participating banks will disclose and in turn receive credit information from the credit bureau for the purpose of assessing the credit worthiness of their retail customers. Credit information will include both positive and negative data[1] and access to the bureau’s database will initially be restricted to the participating banks, banks’ customers and the bureau itself.

The establishment of the credit bureau is likely to increase credit business, lead to more competitive pricing of credit facilities and lower credit loan defaults and delinquency rates. To address the concerns over the treatment of credit data, MAS would follow two broad principles.

1 Refers to the submission of customer’s payment histories on their credit facilities. Positive data refers to timely payment (i.e. a good customer) and negative data refers to overdue payments.

First, it is important that individuals have access to their own credit files and to have any inaccurate information corrected. Any dispute resolution process should be timely and effective, and should also be covered in the Consumer Banking Code that ABS is currently working on. Second, it is also important that individual privacy is respected and customer data are not misused for purposes other than what they were originally intended for. A good starting point is the principle of reciprocity on data usage, which all participating members to the bureau will need to adhere to. High standards of confidentiality is also expected of both the bureau operators and participating members. The ABS will continue to work with MAS to ensure that these principles are observed.

The launch of the consumer credit bureau will mark the beginning of a new risk management process in Singapore. It will further bolster the integrity and transparency of Singapore's financial sector.

Apart from ensuring that our regulatory framework is progressive and our infrastructure is world class, MAS is also taking an active approach to promoting industry best practices in risk management. The guidelines that we have introduced are steps in this direction. This Risk Conference is another such initiative. The objective of organising such a conference is to highlight emerging fields in risk management by bringing together risk practitioners and academics, to share their experiences and exchange ideas. Such a forum will help the industry and regulators keep abreast of the latest developments in financial risk management

I hope you will find this first Risk Conference that MAS has organised useful and fruitful.

Thank you.