Lee Hsien Loong: Remaking Singapore's financial sector

Speech by Mr Lee Hsien Loong, Deputy Prime Minister of Singapore and Chairman of the Monetary Authority of Singapore, at a MAS Staff Seminar, Singapore, 29 October 2002.

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I. Introduction

We are gathering in an uncertain environment. On the economic front, Asia’s key export markets – the US, EU and Japan – remain weak, blighting South East Asia’s prospects for recovery. In Northeast Asia, China’s vitality and transformation continues to dominate investor interest. After September 11, security has become the top concern worldwide. The bomb blasts in Bali and the recent hostage taking in Moscow are sobering reminders that the war on international terrorism has just begun. All these developments have implications for Singapore’s growth prospects and our aspirations to become a world-class financial centre.

Certainly, these are challenging times. But if we could suspend the present for a moment, let us cast our minds back to 1997, when we embarked on this journey to remake our financial sector.

II. Reflecting on the last 5 years

Five years ago, the global financial landscape was undergoing dramatic changes. Financial markets were becoming more integrated, with freer and faster flows of information and capital. Globalisation was boosting liquidity and facilitating growth. But it was also transmitting market disturbances with greater speed and virulence, and complicating the conduct of monetary and exchange rate policies.

Globalisation, coupled with deregulation, technological change, and borderless competition, was revolutionising the way financial institutions competed and did business. There was a wave of mergers and acquisitions, as institutions sought to diversify risks, reduce costs, and exploit synergies.

Financial centres faced similar pressures. As technology eroded time-zone advantages, institutions consolidated their activities within fewer financial centres. We believed that consolidation was imminent in our time zone. If there were to be only a few financial centres left in Asia, we wanted to make sure that Singapore was one of them. So we launched a fundamental rethink of our approach to supervising and developing the financial sector.

Creating a more conducive regulatory environment

Our new approach could be broadly summarised in four main thrusts. First, we sought to create a more conducive regulatory environment to foster dynamism and innovation, while maintaining the safety and soundness of our financial sector. MAS shifted its emphasis from regulation to risk-focused supervision, so that we could deal with stronger and weaker institutions differently. We wanted to rely more on disclosure and market discipline, with investors judging and taking risks for themselves. We also pushed for higher standards of corporate governance in the financial sector, to cultivate a stronger risk management culture, better internal controls, and greater transparency.

Liberalising the financial sector

Our second thrust was to liberalise the financial sector to promote competition and enterprise. We deregulated the stockbroking industry, and lowered protective barriers in banking and insurance. This would provide international institutions greater incentive to root more activities in Singapore, while spurring local institutions to upgrade their capabilities and sharpen their competitive edge. Consumers would benefit from a wider offering of products and services at competitive prices.

Taking a more strategic and proactive approach to development

Third, we adopted a more strategic and pro-active approach to developing the financial sector. We actively went out to attract new business here. For institutions already in Singapore, we tried to anchor them more firmly, and encouraged them to expand and introduce new activities here.

Enhancing monetary policy effectiveness

Finally, we had to enhance the effectiveness of our monetary policy. Free capital flows and complex derivative products had made it impossible to completely insulate the Singapore dollar against attack. Our approach had been to operate an inscrutable monetary policy and impose comprehensive restrictions on non-resident borrowing of Singapore dollars. This was not only becoming untenable, but was also hampering the growth of our financial markets. We needed a more explicit and transparent monetary policy stance, and more precisely targeted safeguards against the risks of internationalising the Singapore dollar.

III. The changes in the financial and economic landscape

We launched these major changes just as the Asian Crisis was breaking. But we did not foresee how difficult the next five years would be. Southeast Asian countries became mired in political difficulties triggered by the crisis. Malaysia dismissed its Minister of Finance and imposed exchange controls. Indonesia saw the fall of the Suharto government, only to be succeeded by a totally different dispensation. More recently, the region has woken up to the reality of extremist groups linked to Al Qaeda, using terror to undermine countries and bring about an Islamic state in Southeast Asia.

Meanwhile China surged ahead, largely unaffected by the crisis. South Korea launched vigorous reforms, cleaning up its banks and restructuring its chaebols. For a few years, the US economy, with its insatiable appetite for imports, was the world's solo engine of growth. This helped the region to begin recovering from the blow it had suffered. But then the dot-com bubble burst, and far from the V-shaped recovery confidently predicted by many experts, the US economy has shown persistent weakness, weighed down by high levels of household and corporate debt.

These upheavals have taken their toll on the global financial industry. After the dot-com bubble and the crash in global equity prices, finance is no longer a hot industry on the go. Profits have fallen, and bad assets have had to be written off. Deals have dried up, and investment banks are slashing payrolls. The excesses of the boom years are now manifesting as corporate scandals, putting the industry on the defensive, both with the public and with regulators.

Singapore's financial sector has been affected by all these developments. Despite all our efforts to liberalise and grow the financial sector, it only grew by an anaemic 1.1% per annum from 1998 to 2001. Many jobs have been lost.

However, these disappointing numbers do not tell the whole story. If we look deeper, we will see the significant progress that we have made in spite of the difficult conditions. Indeed had we not embarked on these policy changes, the Singapore financial sector would probably be facing serious problems today. More importantly, we have laid firm foundations to capitalise on opportunities when the financial industry picks up again, as eventually it will.

IV. Work done and assessment

Conducive regulatory environment

Let us now assess the progress we have made in our strategic thrusts. First, creating a conducive regulatory environment. Here our efforts have centred on developing risk-focused supervision, improving corporate governance, and promoting disclosure and market discipline.

Risk-focused supervision

We have institutionalised the risk-focused supervisory approach, to varying degrees. We have created risk-based supervisory frameworks and are building risk profiles of individual financial institutions. This will help us to tailor our supervisory plans for them. We are conducting shorter but more frequent examinations that are focussed on the more critical risk areas of institutions. We are also allocating greater supervisory resources and attention to the systemically more important institutions.

We have made progress towards a regulatory framework that is more flexible, integrated, and sensitive to the regulatory burden imposed on supervisee institutions. Our two new pieces of legislation – the Securities and Futures Act (SFA) and the Financial Advisors Act (FAA) – embody this new approach, with their streamlined, modular licensing regime and alignment of regulatory requirements and business conduct standards across similar classes of activities.

Nonetheless, much work remains.

First, MAS must build up its expertise in integrated supervision. Boundaries between financial activities are blurring. Supervision of institutions and activities on a silo basis increasingly needs to be complemented by integrated supervision. We must further harmonise rules across similar financial activities, align supervisory approaches across financial industries, and supervise financial groups on an integrated basis. This will help reduce the opportunity for regulatory arbitrage, and also shrink the gaps in the coverage of our supervisory radar.

Second, we need to facilitate the implementation of risk-based capital frameworks for our financial institutions. The New Basel 2 Capital Accord will be a major priority for MAS and the local banks. The New Accord will allow banks to better align their capital with underlying risks, but it will require banks to put in place elaborate systems, databases, and processes to assess the riskiness of their assets. MAS will continue to work closely with the local banks to effect a successful transition into Basel 2.

Corporate governance

In corporate governance, we have raised the bar for the financial sector significantly, and especially for the local banks. The local banks have set up Nominating Committees chaired by independent directors, to ensure that competent individuals are appointed to the Board and key management positions. The local banks will rotate their auditors every 5 years. The local banking groups are also preparing to separate their financial and non-financial activities and unwind cross-shareholdings. This will help local bank managements to concentrate on their core business of banking and finance, and limit the risk of contagion from non-financial businesses to the banks' business.

Market discipline and caveat emptor

Our efforts to promote market discipline and a caveat emptor regime have focussed on enhancing the amount, quality and timeliness of information disclosed by institutions. We have shifted from a merit-based supervisory approach to a disclosure-based approach that emphasises market discipline to incentivise financial institutions to conduct their business in a sound, efficient, and professional manner. The local banks in particular have significantly improved their disclosure practices.

We must continue to update our disclosure standards in line with industry developments and international best practice. Furthermore, the mindset change is not yet complete. The public still expects to be protected from downside risks, for example when playing the stock market, but more so when depositing their money in banks. Hence one major motivation for introducing deposit insurance is to change this mindset, and get people to understand that only a limited first tranche of their deposits with a bank is protected should the bank run into trouble.

But disclosure by itself is not enough. It must be accompanied by investor education. Investors have to understand and use the information provided to them. They must learn to make sense of this information and use it to look after their own interests. We also need a pool of knowledgeable analysts and journalists who will shine the spotlight on any obscure fine print that the lay investor fails to notice. A more informed and sophisticated investor base will reinforce market discipline and form the basis for a more vibrant and mature financial sector. In all these respects, we have a long way to go.

Market discipline also requires an effective enforcement regime. To preserve investor confidence, penalties for transgressions must be swift and appropriate. MAS now has the power to investigate and bring a court action for market misconduct under the new civil penalty regime. This will complement the existing criminal penalty regime administered by CAD.

Liberalising the financial sector

We began to open the financial sector to greater competition while the region was reeling from the Asian Crisis. This went against conventional wisdom. Opening up during such a time seemed like throwing away the life-jackets as the flood waters rose.

We thought otherwise. We could see the flood approaching – not just the storm we were then in, but the greater climatic challenge posed in the longer-term by the worldwide changes in the financial industry. We decided that we had better learn to swim before the deluge overwhelmed us. Furthermore, our actions to liberalise in the midst of the crisis would send a clear signal that Singapore's financial centre would always be open for business.

Banking

The two major areas of liberalisation have been in banking and the capital markets. Liberalisation has brought about major changes in the local banking scene. From six local bank groups (not counting POSBank)[1] in 1997, we are now down to three through mergers and acquisitions. More importantly, the local banks have rationalised their operations, upgraded their risk management systems, and introduced new products and services. The recent housing loan price war is an example of consumers benefiting from more banking competition. But fiercer competition has also inevitably meant that small accounts enjoy fewer cross-subsidies, and have to bear higher charges and tighter usage limits. The Basic Banking Account scheme will help reassure consumers that necessary reforms will not leave them without banking services.

Overall, our banks face tougher challenges than before – fiercer domestic competition, greater uncertainties in the region, more complex operations, and stronger pressure to improve returns. Perhaps the local banks sometimes look back on the good old days with nostalgia. But we had no choice. The old dispensation was not sustainable. Even the present situation may not last.

Certainly, the local banks have built up their size and regional footprints. They are now the three largest banks in Southeast Asia. But will this be enough for them to hold their own against bigger players? Our largest bank, DBS, is only ranked 86th in the world in terms of assets[2]. Australia has a "4-pillars" policy that discourages consolidation amongst its major banks. But Singapore has not established its own "3-pillars" policy, and most probably cannot afford one. Of course, whether further consolidation actually takes place, and if so when, is for the players and the market to decide.

But further opening up of the banking sector is inevitable. We have been negotiating FTAs with Australia and the US, and are very close to reaching agreement with both. Our FTA partners expect to be given greater access to our financial sector. The local banks must brace themselves for further liberalisation, by upgrading themselves and keeping pace with international best practices.

Capital markets

In the capital markets, the Stock Exchange of Singapore and SIMEX have demutualised and merged to form the Singapore Exchange (SGX). SGX is now listed and has expanded its product offerings to include single stock and bond futures, and exchange-traded funds. In the stockbroking industry, with the liberalisation of fees and opening up of access, commissions have shrunk. The brokerages have been consolidating, upgrading their capabilities and widening their service and product offerings. Now, your broker will not only buy and sell shares for you, but may also help you to invest in unit trusts or cash management accounts, or give you financial advice. But the restructuring is taking place in a very difficult bear market, and the process is not yet complete.

From the point of view of growing the industry, the results of the liberalisation have been disappointing. There has been no post-liberalisation "Big Bang" in the local capital markets. This is partly the result of poor market conditions globally, and partly the way equities markets have developed. Unlike the trading of bonds and derivatives, the trading of stocks is mostly confined to their home markets. But since there are only a limited number of large Singapore companies who have not yet been listed, Singapore will have to try harder to bring in foreign listings, particularly from India and China. One approach may be for SGX to leverage off Singapore agencies with presence in these countries, like EDB and IE Singapore.

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[1] DBS, OCBC, OUB, UOB, Keppel Bank and Tat Lee Bank. We excluded POSBank as it was technically not a bank.

[2] The Banker, Jul 2002.

Strategic and proactive approach to development

In developing the financial sector, we sought to target key activities that would help to make us a world-class financial centre. Our pro-active approach has yielded results, both in expanding specific activities, and more generally in sensitising MAS to the needs of the industry.

Debt market

While the equity market has found it hard to grow, we have made some progress with our debt market, albeit starting from a very low base. The relaxation of the S$ non-internationalisation restrictions helped. We have issued more SGS to increase market liquidity and create a benchmark yield curve[3]. The corporate bond market has also seen significant growth[4]. Issuers include supra-nationals such as the International Finance Corporation and the African Development Bank, well-regarded corporates such as GE Capital, and this year Freddie Mac. Singapore has been included in the JP Morgan and Lehman Brothers global bond indices.

Our challenge now is to sustain the growth in the local debt market. We need to work with market participants to broaden the debt markets' investor base and improve swap market liquidity. But our most difficult problem is that our starting premise has yet to materialise. We had envisaged that as the region recovered, corporates and governments would again need funding, and this time their debt funding would be in the form of tradable paper rather than bank loans. This has not happened … yet.

Wealth management

Wealth management has been our most successful growth area. Since 1998, Singapore's total assets under management have doubled, no mean feat in this climate. Singapore has overtaken Hong Kong in terms of discretionary assets under management. More players, ranging from large institutional fund managers to boutiques, have set up shop in Singapore. The local fund management community is now more diverse and covers a wider universe of investment styles, geographic foci and asset classes.

Singapore as a financial centre

In aggregate, we have made promising headway in a few fields, but Singapore still has not set itself apart decisively from other Asian financial centres like Hong Kong and Sydney. Southeast Asia's predicament has a lot to do with this. In the long term, we have to rely on the region recovering its stability and vitality. But meanwhile we must do our best to differentiate ourselves. We offer political and economic stability, the rule of law, efficient infrastructure and a highly-skilled professional workforce. These are exceptional attributes, which lend themselves well to activities like wealth management. We need to find new ways to market them and bring in business.

Enhancing monetary policy effectiveness

Our decision to progressively relax restrictions on the use of the Singapore dollar was a calculated risk. At a time of heightened volatility in currency markets, it stood in stark contrast to our regional neighbours. However, the liberalisation has yielded dividends. Our capital markets have grown and deepened without adversely affecting our ability to manage the exchange rate.

In practical terms, we have now gone as far as we can to relax the restrictions while still maintaining the principle of not-internationalising the Singapore dollar. All but two restrictions have been lifted – thou shalt not borrow Singapore dollars to speculate in the currency, and if thou shouldst borrow for offshore purposes, then thou shalt either swap or convert the Singapore dollars before taking them out. These remaining commandments are an important signal that we have not changed our fundamental stand against outright speculation on the Singapore dollar, even though we have permitted nearly all activities of legitimate investors.

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3 Today outstanding SGS is about S$53 billion, compared to just over S$20 billion in 1997.

4 From 1998 to 2001, corporate debt issuance in Singapore has increased eightfold to S$72 billion.

The change in our conduct of monetary policy has also been cautious and incremental. We have progressively become more explicit in stating our assessments and intentions. We now publish MAS' assessments of the state of health of the economy in the Macroeconomic Review, and the factors considered in each policy review through the Monetary Policy Statement. We even publish a chart showing the movements in the trade-weighted index, although not our policy band or the trade-weights themselves. Enterprising analysts have tried to divine the trade-weights of MAS' basket of currencies from the graph, not totally unsuccessfully.

This enhanced disclosure has made our monetary policy more effective. Despite the more volatile external environment and the liberalisation of the use of the Singapore dollar, there has been less need for MAS to intervene in the markets to manage the exchange rate within our policy band. Greater market understanding of MAS' thinking, underpinned by sound and credible policies that are in line with economic fundamentals, have contributed to continued confidence in the Singapore dollar.

The best defence against speculative attacks remains Singapore's sound economic fundamentals and a credible exchange rate policy. MAS works with the other economic agencies to manage and preserve these economic fundamentals. Our role is to provide in-depth assessments of economic developments and short and medium-term economic outlooks. MAS has developed sectoral leading indicators and a new macroeconomic model of Singapore, which help us to better anticipate events that could impact our economy, and give us time to work out appropriate policy responses.

Of course, we must not forget the important deterrent role played by our strong reserves. We have to manage the reserves under our charge wisely, to deliver good long-term risk-adjusted rates of return while providing for unexpected demands on our liquidity. Hence, we have also strengthened our investment and risk management capabilities to diversify into different instruments and markets.

V. Priorities moving forward

Going forward, I would sum up our key priorities under five thrusts.

Managing within a riskier environment

First, we must manage within a riskier environment.

The financial sector we now supervise is more unforgiving. Volatile markets and poor economic conditions have heightened the risks financial institutions face. Competition has put pressure on margins, inducing financial institutions to take on more risk to maintain their earnings to satisfy increasingly demanding investors. With liberalisation, our financial sector is no longer sheltered from these risks.

Our response is not to avoid these risks but to learn to manage them. We have to continue enhancing our risk-based supervisory capabilities. The foundations are in place. We need to collect better information and use it more effectively to produce accurate risk profiles of the institutions we supervise. These risk profiles, constantly updated, will help MAS to detect problems early and take prompt corrective action. Likewise, instead of preventing institutions from taking risks, we must encourage them to better identify, monitor, and control the risks they take. Constant vigilance will help institutions to monitor their own status, and pre-empt any deterioration before damage is done, either to the institution or worse to the financial system as a whole.

At the same time, MAS must continue to balance its natural inclination to regulate or supervise away what is new and strange and therefore risky, with the need to encourage the financial sector to be more dynamic and innovative. Nowadays when presented with new and ingenious schemes dreamt up by investment bankers, my first reaction is often to ask whether it may be too clever to be sound. Such scepticism on the part of financial supervisors is natural and healthy, but it should not deter innovation or become our dominant mindset.

More broadly, because of the emergence of global financial conglomerates and the trend towards increasing risk transfers across financial industries, regulators need a holistic understanding of what and where potential vulnerabilities are, and how exogenous shocks might impact and permeate through the financial system. MAS must therefore enhance its capabilities in integrated supervision and financial surveillance. This is more critical as Singapore becomes more closely integrated into the global economy.

We are also conducting our monetary policy in an environment of increased market uncertainty. Our exchange rate policy band should certainly be supported by sound fiscal and macroeconomic fundamentals. But at the same time our policy should be both proactive and pre-emptive, to sustain non-inflationary growth despite volatile market conditions. We therefore need good financial market intelligence to keep abreast of market dynamics, shifts in market sentiment as well as large-scale capital flows that are potentially destabilising. We have had a fairly easy ride managing our exchange rate so far. However, this does not mean that the markets will never try to attack the Singapore dollar, or that if they do it will not gravely harm our economy.

Strengthen partnership with industry

Second, we must strengthen our partnership with industry.

The industry plays an important part in all of MAS' initiatives. MAS needs a good understanding of how the market works, whether in supervising the financial sector or in managing the exchange rate. We must always be able to see our policies from the private sector's point of view. What does it mean to them? Does it reflect how the market really works? How burdensome will our requirements be? Can players get around our policy intent? And how do we prevent that? But however hard we try, we will still be at one remove from the market practitioners themselves. The private sector will have the best knowledge of industry developments and emerging trends. MAS would continue to tap into this wealth of knowledge through systematic and constructive consultation with industry.

For a start, MAS has introduced guidelines to formalise public consultation as a standard procedure whenever significant changes in our regulatory framework are planned. This is a valuable approach which should be extended to all facets of MAS' dealings with industry. Industry feedback will help us refine our policy and avoid mistakes and unintended consequences.

Our contacts with industry need not be confined to Singapore. More often than not, business decisions that affect Singapore are made in the head offices. Where possible, we should extend our presence and reach by linking up with institutions and organisations worldwide.

Deepen talent pool

Third, we need to deepen the talent pool in the financial sector.

The vibrancy of Singapore's financial centre is dependent on this. Without the trained talent, it will be very hard to persuade financial institutions to site new activities in Singapore. MAS must continue its efforts to build up and upgrade this talent pool. While MAS is already co-funding financial skills training, we also need to extend our efforts into improving the quality and quantity of financial training and research conducted in Singapore. One possibility is to set up specialised financial service institutes in Singapore to teach both the art and science of finance, for example in wealth management.

At the same time, the local talent pool must also be supplemented by infusions of fresh blood from abroad. Singapore must continue with its open door policy to attract talented professionals to work here.

Another means of deepening the overall talent pool is through greater circulation of talent between the public and private sectors. MAS has actively hired from industry in order to build up its expertise. This has enhanced our understanding of the commercial environment and invigorated our organisation. Just as MAS has gained from such insider insight, industry too needs its share of talent. Through the mixing of talent between the public and private sectors, industry will also come to understand the intent and thinking behind MAS' policies and actions. Over time, this will lead to a healthier and more constructive relationship where MAS and industry together work toward developing Singapore as a world-class financial centre.

Enhance market discipline

Fourth, we need to continue to enhance market discipline.

The easy part is to establish and enforce the right rules for disclosure and corporate governance. Getting companies to internalise and abide by the spirit of tighter rules will take longer, though our standards of disclosure are already quite good compared to other countries. The most difficult part will be enhancing consumer education and awareness, without which, as I noted earlier, disclosure and caveat emptor cannot work.

We do not need to convert the entire population into Chartered Financial Analysts. But we must help the public to understand basic finance and investment concepts, and to make effective use of the information that is available. They also need to understand that investing is for the long term and should be based on fundamental analysis.

This requires a collective effort on the part of MAS, industry bodies and consumer groups. It is not MAS' role to front all investor education – this is where industry bodies and consumer groups come in. However, MAS will need to act as a catalyst to increase the focus on investor education in the financial sector. MAS can set out clear directions for industry, do more to explain its own market conduct regulation to investors and consumers, work with industry and other partners to co-ordinate current education efforts and, where relevant, co-fund with industry new investor education initiatives.

Focusing and targeting our development efforts

Fifth, we need to focus and target our development efforts.

Despite the adverse environment, there are still opportunities for Singapore. The Financial Services Working Group (FSWG) set up at the beginning of the year has identified three promising areas: wealth management, universal processing centres and an Asia Risk Exchange.

In identifying wealth management, the Working Group has reaffirmed a key thrust of our developmental efforts. It has gone on to single out alternative assets, such as private equity and hedge funds, as areas for development. Universal processing centres and the Asia Risk Exchange will be two new fields for Singapore, where Singapore's efficiency, technology and infrastructure will be important strengths. For universal processing centres we need to consolidate global transactional flows into Singapore. The Asia Risk Exchange will combine Singapore's existing insurance and capital market expertise into a new physical vehicle for the transfer of large and sophisticated risks. It will complement Singapore's risk transfer capabilities and fill a market gap for risk transfer in the Asian time zone.

Singapore needs to move quickly on these initiatives. In wealth management, we must build on our existing base of asset managers as well as broaden our scope of activities to include alternative assets. I am encouraged that the industry has expressed interest in the Universal Processing Centre and the Asia Risk Exchange, and MAS will actively support their efforts.

VI. Conclusion

Although the Asian Crisis was followed by even more difficult conditions than we had expected, MAS has shown that we can embrace change while coping with an adverse environment. So has our financial industry. In the current mood of doom and gloom, we should take a contrarian view and maintain our confidence and resolve. The changes that we are now pursuing will help us to cope with the current difficulties, and prepare us to pick up again as soon as the outlook improves. It may take some time, but we are on the right track to making Singapore as a world-class financial centre.