Lim Hng Kiang: Dynamism, confidence, collaboration - regional exchanges in the new financial landscape

Keynote address by Mr Lim Hng Kiang, Minister, Prime Minister's Office, Second Minster for Finance and Deputy Chairman of the Monetary Authority of Singapore, at 23rd East Asian and Oceanian Stock Exchanges Federation (EAOSEF) General Assembly, Singapore, 15 April 2004.

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Mr JY Pillay, Chairman, EAOSEF and Chairman, SGX
Mr Toshitsugu Shimizu, Secretary General, EAOSEF
Dr Yu-Kyung Kim, Chairman, EAOSEF Working Committee
Distinguished guests, ladies and gentlemen

Introduction

A warm welcome to everyone, especially to many of you who have travelled to join us here in Singapore. I understand that the EAOSEF General Assembly was previously hosted by Singapore in 1988. Today, we meet here again, but amidst a global setting that has changed significantly. The world is quite different today. Economies and markets alike, are increasingly intertwined. Globalisation of markets and rapid advances in technology have altered the global marketplace. This is especially so in the world of exchanges and clearing houses, where the competitive landscape is changing rapidly worldwide.

Challenges facing exchanges

The late 1990s saw a flurry of mergers, alliances and demutualisation among leading exchanges. They were gearing up for a battle with the alternative trading systems. But the threat from alternative trading systems did not materialise. No established exchange has been supplanted. Even in the U.S., which has the highest number of alternative trading systems, none have made significant inroads into the dominance of established exchanges.

The wave of consolidation has, however, created mega-exchanges in the U.S. and Europe, and competition among them has proceeded at a furious pace. The Chicago Board of Trade (CBOT) faces a serious challenge on its home turf from Eurex, the all-electronic exchange owned by Deutsche Börse and the Swiss Stock Exchange. Eurex is now offering electronic trading in U.S. dollar denominated fixed income futures which have been the mainstay of the CBOT. The pan-European exchange, Euronext.Liffe, is offering electronic trading in Eurodollar futures contracts in direct competition with the Chicago Mercantile Exchange (CME). CME has responded quickly, announcing initiatives to accelerate the migration of its flagship Eurodollar contract to GLOBEX, its electronic trading platform. And just this month, it was reported that the New York Stock Exchange may enter the derivatives market too. Hardly a week passes without press reports of strategic moves by the exchanges.

Securities exchanges have not been spared from the competition. London Stock Exchange (LSE) will launch its Dutch Trading Service, euroSETS, in May this year. This will allow the most liquid stocks listed on Euronext-Amsterdam to be traded through LSE. This bold move is being watched closely by the industry, and may challenge conventional wisdom on the contestability of stock exchange liquidity. The outcome of these contests could significantly alter the competitive landscape for exchanges in the next few years.

Key drivers of consolidation and competition

One key driver behind the consolidation and competition is technology. Exchanges and clearing houses are very much technology businesses today. Trading pits have given way to electronic trading engines in many jurisdictions. Central counterparties can no longer operate without sophisticated IT-based risk management systems. Technology has allowed exchanges to offer different types of instruments - equities, bonds, futures and options - on a single platform. It has enabled improvements in risk management processes, and open access by participants and alliance partners.

The cost of investments in technology, however, is high and can only be justified if it is supported by a large volume of trades. Shareholders will also demand that these exchanges earn competitive returns on their investments in technology. Small exchanges will thus, find it difficult to make the necessary investments to compete. This has been a key driver behind the formation of mega-exchanges, and will continue to fuel their drive for expansion.

Another key driver is the need for economies of scale. Exchanges and clearing houses thrive on liquidity and scale. The likelihood of a cost efficient execution of a trader's order is higher the larger the pool of traders on the same platform. Similarly, in the case of clearing houses, the benefits of netting and the efficiency of collateral management are greater the larger the number of counterparties using the facility. The pressure to seek economies of scale and competitive returns is accentuated for demutualised exchanges.

Implications for regional exchanges

Exchanges in this region are unlikely to be insulated from competitive pressures for long. Analysts are of the view that the cost of competition will drive greater consolidation in the U.S. and Europe. Once this wave of growth opportunities mature, the mega-exchanges will look to Asia as the next frontier of growth.

Regional exchanges need to gear up for the competition and find ways of staying relevant to the international network of traders and investors. Shutting out competition and maintaining the status quo is not a viable option. More companies will seek alternative pools of liquidity and investors if domestic exchanges cannot satisfy their need for greater liquidity and connectivity to a larger network of traders and investors. Investors will also bypass local exchanges to invest overseas.

Engaging in deeper regional collaboration

What can governments and exchanges do? There are several initiatives that we should consider.

Capacity building

Firstly, capacity building in the region. Regional capital markets, particularly Asian bond markets, have made significant progress in recent years. There is however, scope for us to continue to explore ways to further grow and develop our capital markets. Capacity building plays a critical role in this respect. Concerted efforts to enhance the skills and sophistication of market players and regulators will not only strengthen markets but also provide an essential pre-condition for closer collaboration amongst the regional capital markets. To this end, ASEAN finance officials have agreed to collaborate on a training initiative to enhance regional expertise in capital market development. The initiative will, as a start, place focus on four broad areas, namely: (a) legal, regulatory and supervisory framework, (b) risk management, (c) liquidity enhancement, and (d) market infrastructure for trading, clearing and settlement. The Asian Bond Market Initiative also encourages technical cooperation amongst ASEAN and the plus 3 countries of China, Japan and Korea.

Profiling Asia

Secondly, profiling Asia. More than 6 years have passed since the Asian financial crisis. Most Asian economies have fully recovered. Confidence has returned and growth momentum restored. Asian countries can continue to engage international investors at an individual country level. There are, however, merits to working together to profile Asia in a more concerted manner. A collective effort will have greater pulling power and generate far greater interest from investors. The region has taken large strides in stepping up the pace of reforms since the Asian crisis. It is perhaps timely for regional governments to join hands and raise the profile of the region. As a start, the ASEAN countries have agreed at the recent ASEAN Finance Ministers' Meeting to organise efforts to profile ASEAN better. International investors can then have the opportunity to appreciate more fully the progress and reforms ASEAN economies have made since the Asian crisis.

Exchange alliances

Thirdly, extending regional collaboration to the exchanges. The region can derive greater benefits by working together. The successful launch of Asian Bond Fund I and the impending launch of Asian Bond Fund II clearly demonstrate this.

Exchanges in the region have already taken steps to adapt to the evolving competitive landscape. Many have restructured, demutualised, and expanded their product offerings. One area where more can be done is to explore deeper strategic collaboration amongst exchanges in the region. Liquidity is vital to the development of a stock market. Markets with higher levels of liquidity tend to have higher stock valuations. Asian stock markets are, however, generally smaller in size and less liquid than the stock markets of the more developed countries. Asian exchanges' share of trading typically account for less than 20% of global trading volumes. Asian savings are thus still largely intermediated through the more developed markets. It is sensible to work towards greater integration of Asian stock markets to attract both international investors' interest as well as the growing pool of Asian savings. The regional exchanges should consider closer collaboration in order to create a larger network.

Strategic alliances amongst exchanges, whether in the areas of trading, or clearing and settlement initiatives, may therefore be a way for Asian exchanges to create value in the increasingly competitive marketplace. An exchange alliance, which can take various forms, is not only a means to provide a more efficient mode to service cross-border trading but is also a step towards building a pan-Asian market place. Market linkages will help broaden product offerings for investors and generate greater international interest in Asian securities. A more centralised counterparty arrangement will allow better management of collateral and counterparty risks. This will ultimately enhance the liquidity of our markets. Recognising the potential benefits of establishing linkages, the ASEAN Finance Ministers have recently agreed to explore ways to forge alliances within the ASEAN securities markets.

Forging successful exchange linkages is, however, not without its challenges. But these are not insurmountable. Let me briefly outline three of them. Firstly, exchanges' technology and infrastructure will have to be updated and enhanced to cater to an increasingly integrated marketplace and a more sophisticated investor base. There is a need to ensure that the various IT infrastructures are inter-operable and scalable, so as to allow partner exchanges to share common platforms and reap the benefits of economies of scale.

Secondly, greater harmonisation of standards and regulatory requirements is a prerequisite for deeper linkages and alliances amongst the regional exchanges. Some regional exchanges and regulators have made a start by committing to work together under various MOUs. We should take the next step of looking at other initiatives to bring about greater convergence of standards in corporate governance, trading conventions, rules and regulations.

Finally, the success of exchange linkages is highly dependent on investors' interest in cross-border trades via the linkages. To achieve this, the linkages must provide a cost efficient solution for investors' trading needs. There is also a need to cultivate Asian investors' interest in cross-border investments. Asian investors' investment portfolios traditionally reflect a strong home bias. To help profile non-domestic securities and enhance investors' trading interest in these securities, regional exchanges could explore the possibility of cross-trading or cross-listing of securities, particularly in neighbouring exchanges where information barriers are low. More efforts should be taken to facilitate local and foreign investors' participation in our markets. However, investors' interest in cross-border trades is also in part, driven by their level of confidence in how markets are characterised by sensible regulation and high standards of corporate governance.

Enhancing corporate governance and regulation

There has been much focus on the corporate governance and regulation of exchanges in many jurisdictions. As institutions of system-wide or systemic importance, the issues relating to the corporate governance of exchanges are for the most part similar to the issues for banks and insurance companies. Weak corporate governance of such institutions can undermine public confidence in the financial system.

However, unlike other financial institutions, exchanges perform varying degrees of supervisory and regulatory functions over their members and listed companies. Potential conflicts of interests exist between these regulatory functions and the exchanges' commercial functions. These conflicts may be accentuated for demutualised and listed exchanges. While profits are not irrelevant to other exchanges, they are the primary motive for shareholders of listed exchanges. Regulators worldwide have been grappling with these issues as more exchanges demutualise and list.

MAS believes that credibility in governance and regulation is a vital commercial asset for exchanges. Investors are more likely to invest and trade on an exchange if they are confident that they can do so without being defrauded or without other investors having an unfair advantage. Exchanges that operate fair, efficient and transparent markets, where rules are enforced in an impartial way, will have a competitive advantage. MAS and SGX share a strong commitment to maintaining high standards of corporate governance. We take a collaborative approach in working together to continually keep abreast of best practices. No single model has gained universal acceptance, and no model is good for all time. We will continue to work closely together to further enhance the governance and regulatory arrangements relating to SGX where appropriate.

Conclusion

East Asian economies have seen robust growth in 2003. The ADB expects this momentum to continue in 2004.[1] Capital has started to flow back into the region and stock markets have rebounded. Net capital inflows into emerging market portfolio equity investment reached a high of US$30bn in 2003, almost double that seen before the internet bust in early 2000.[2] This positive economic outlook, coupled with growing intra-regional trade and investment, augurs well for the region. Trade and investment links should however, be complemented by greater financial market cooperation and integration.

The governments' resolve to forge deeper collaboration will give an added boost to the region's progress. The exchanges should however, also contemplate possible collaborative initiatives to create new value. Notwithstanding the competitive forces, regional exchanges have much to gain by working together. This is not a zero-sum game. It is in the region's interest that we should cooperate to increase our collective strength. I hope you, as key decision makers of your exchanges, will take this opportunity to consider possible ways of working together. EAOSEF is well placed to facilitate this process. I wish you a fruitful discussion at this forum.

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1 Asia Economic Monitor, Asian Development Bank, December 2003.

2 The Asia/Pacific region accounted for 90% of total flows into emerging markets. Reference: Capital Flows to Emerging Market Economies, The Institute of International Finance, Inc., 15 Jan 2004.