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AT THE 26TH ANNUAL DINNER OF

THE ASSOCIATION OF BANKS IN SINGAPORE (ABS)

21 JUNE 1999

INTRODUCTION

Chairman ABS, ladies and gentlemen. I am happy to be here at your 26th Annual Dinner.

We stand at an important threshold in the development of the banking industry in Singapore. Last month, MAS announced a broad ranging programme to allow greater competition in the domestic banking industry and to upgrade local banks. This programme will transform the banking scene over the next few years and spur Singapore's development as an international banking centre.

The banking liberalisation package is one of the last major pieces of MAS' overall set of policy reforms and strategic initiatives aimed at developing Singapore as a world-class financial centre. The basic framework is now in place, although it will take MAS several years to flesh out these initiatives, and implement them fully. It is now up to the private sector to generate value-adding activities, create new products, and develop the markets.

Tonight, I would like to share with you my thoughts on three key challenges that banks in Singapore must respond to as we enter the new millennium. They are (a) technological change; (b) financial disintermediation; and (c) skills development.

YEAR 2000 ISSUE

But first, let me deal with an immediate issue. Our immediate task in the next half of 1999 is, of course, achieving a smooth transition into the Year 2000.

Banks and financial institutions in Singapore have been working very hard over the past few years to make their systems Year 2000-compliant. The ABS has taken the initiative to co-ordinate their efforts and develop best practices for system testing and risk management.

On its part, MAS has so far conducted more than 350 inspections to ensure that individual financial institutions are ready for Year 2000. We expect all financial institutions to complete their internal testing of mission critical systems and external tests, as well as develop and validate business continuity and contingency plans by the end of this month.

Singapore has participated successfully in the Global Payment Systems Test initiated by the New York Clearing House. All our participating banks and financial institutions reported that their test transactions conducted through the MAS Electronic Payments System or MEPS and the other large value payments systems around the world proceeded smoothly. Our efforts to prepare for Year 2000 have not gone unnoticed. Singapore and Hong Kong are the first two countries in the world to receive an ALL GREEN rating from the Global 2000 Co-ordinating Group.

Tonight, I would like to announce a further measure that we will take as part of our Year 2000 efforts. MAS has accepted the proposal by the ABS to declare 31 December 1999 a bank holiday. This will enable banks to begin their year-end processing and back-ups early so that these activities are completed in time for the New Year.

As I mentioned in my speech at the Global 2000 conference in March, the extra holiday will make no difference at all if we are not ready by then. But MAS is satisfied that our banks will be ready. A bank holiday on 31 December 1999 will help banks to ensure that they have complete and correct records of customers' accounts and year-end positions at the start of the new millennium. We are not alone in making this decision. More than 20 other countries have designated 31 December either as a bank or public holiday. However, we have decided against declaring 3 January 2000 a bank holiday, although some other countries have done so. In our assessment, our financial system will be ready to resume operations from the outset of the new millennium.

TECHNOLOGICAL CHANGE

Internet Banking

Looking beyond the immediate task of tackling the millennium bug, I would now like to move on to the broader challenge that banks in Singapore will face from technology. In the 1960s and 1970s, mainframe computer systems enabled banks to consolidate and automate their backroom processing and clearing functions to achieve dramatic cost reductions over previously manual processes. In the 1980s and 1990s, PC and network technologies enabled banks to access customers' account records maintained in different branches and offer them a wide network of automated teller machines, or ATMs. And now, at the brink of the new millennium, advanced communications technology and the Internet are causing a fundamental change in the way banks compete. Internet technology is driving this change by: (a) reducing the cost of service delivery; (b) breaching geographical boundaries; and (c) altering the bank-customer relationship.

First, the Internet has dramatically reduced the cost of providing banking services. The cost per transaction on the Internet has been estimated at one cent, compared to 27 cents for an ATM transaction and more than a dollar for a branch transaction. This low cost has attracted new entrants operating "virtual banks". Free from any existing branch cost structure or legacy systems, these new entrants can focus their investment in technology and launch new and innovative Internet banking products quickly. Notable examples are FirstDirect in the UK and Security First Network Bank in the US. FirstDirect managed to break-even within four years after commencing business.

Second, the Internet has the potential to make banking almost a borderless business. A customer can access a web-site anywhere in the world. For instance, FirstDirect secured more than 600,000 on-line customers within six years. Although the success of these players is still largely confined to domestic customers, in time either they will extend their customer base beyond their home countries, or other banks will take advantage of the technology to do so.

Third, the traditional relationship between banks and their customers is being transformed. Major international banks are leveraging aggressively on technology to build extensive databases on their customers. Through data warehousing and mining, more and more banks are becoming able to profile customers’ needs and offer relevant products and services at various stages of a customer life cycle. Instead of viewing retail customers as just cheap sources of funding, the more progressive banks are seeing them as purchasers of products and services that yield fee income. Those banks unable to do so will be at a marked competitive disadvantage.

Internet banking is of particular relevance to banks in Singapore given the high level of IT literacy and Internet usage among our population. A Sunday Times report indicates that we already have about 425,000 Internet users. While online banking is an idea that still needs some getting used to among Singaporeans, it would not take very long before Internet banking catches on in a big way here once the inertia is overcome. All of us would have personal experiences about how the use of email has increased almost exponentially in our offices in the last few years. We now exchange email with one another constantly, at odd hours, from far corners of the world. We never know whether the person we are emailing is in the next room, or ten thousand miles away. My own expectation is that Internet banking, when it comes, will sweep on us as suddenly and as pervasively as email had in our offices and homes.

I am pleased to note that our local banks are already offering Internet banking. They offer a diverse range of services, including account information, funds transfer, credit card and bill payment, electronic payment for shares and even bidding for COEs. But there is much scope for further improvement.

First, local banks must strengthen their ability to cross-sell products on the Internet. Experience in the US has shown that customers look towards web-sites that offer more diversified product offerings, including non-traditional banking products. Local banks have to keep abreast of these developments and consider the viability of distributing non-banking products such as insurance and unit trusts over the Internet, alongside their branch network.

Second, our banks must further increase their branding and service quality to enhance customer loyalty. Customers can move between Internet bank accounts quickly as these services are easily substitutable, and switching costs are minimal. Our banks must invest more in technology, especially in customer data-mining and outbound marketing calls, to ensure that their Internet service offering remains attractive in the more competitive banking environment that is evolving.

Third, given that investment in technology is costly and the payback period can be long, local banks should consider pooling their resources in research and development of new technology, and sharing consolidated backroom processing facilities to defray their investment cost. This is an additional reason why MAS believes that consolidation among local banks is necessary. Only thus can local banks compete effectively with international players who have a much larger customer base world-wide to spread out their investment cost.

FINANCIAL DISINTERMEDIATION

The Challenge from Capital Markets

The second major challenge that our banks will have to contend with in the next millennium is financial disintermediation. The process first began in the US more than a decade ago with the rapid development of the public capital markets and the wide acceptance of mutual funds by retail customers. Since then capital markets around the world have grown and become increasingly integrated. Mutual funds and other substitutes for savings have also sprung up in financial markets outside the US.

These developments have far-reaching implications for traditional commercial banking. On the asset side, easier access to capital markets and new capital funding instruments have enabled corporate borrowers to raise funds at lower cost as compared to direct bank borrowings. And many companies who were previously corporate borrowers now have better credit ratings than the banks that used to lend to them. According to *The Economist* magazine, banks and thrifts in the US now have only about 28 per cent of the financial services market, half their market share 20 years ago. Although the same magazine recently noted that bank loan syndication is staging a comeback in the US, it remains to be seen whether this can reverse the disintermediation process.

On the other side of the balance sheet, banks are under pressure to innovate and expand their product range to maintain their funding base. Savers are becoming more sophisticated and have more avenues and instruments to invest their cash. Mutual funds, money-market funds, insurance products, pension savings plans and other substitutes for deposits have become very popular in the US and elsewhere. In the US, it is estimated that the share of retail deposits as a percentage of per capita GDP has fallen from about 55 per cent in 1985 to just over 30 per cent in 1998.

In Asia, disintermediation is not yet a major threat to banks, because capital markets are not as well developed and depositors are less discriminating. But this situation will not continue for long. In Singapore, a new generation of younger, computer-literate and financially savvy professionals will look for better services and higher returns than they can get from traditional bank deposits in local institutions. This is a segment of the market which local banks cannot afford to lose.

Secondly, like other developed Asian financial centres, we in Singapore are making strong efforts to develop the capital markets. This is to deepen and broaden the financial sector, as well as provide a more stable source of long-term funding for corporate investment. This process began even before the Asian crisis and has gathered pace since.

In Singapore, we have already put in place most of the policies for developing the capital markets. We adjusted guidelines to prevent the internationalisation of the Singapore Dollar, to allow foreign corporates of good standing to issue debt in Singapore Dollars, and our banks to transact repos in SGS with non-residents. On the equity and derivatives front, plans to demutualise and merge SES and SIMEX are on track, and we should see the new combined exchange launched later this year. The exchanges' efforts are now aimed at introducing a broader range of products.

In this regard, SIMEX has recently decided to launch a Singapore Dollar interest rate futures contract. This will give investors and financial intermediaries another instrument to manage their interest rate risks. It will also help promote greater liquidity in the Singapore Dollar bond and derivatives markets. There are some risks to this as the contract will offer would be currency speculators an additional and more convenient mechanism to hedge their interest rate risks. But these are incremental risks that MAS will need to manage. Singapore's sound macroeconomic fundamentals and MAS' proven track record for managing the Singapore Dollar exchange rate will help to minimise these risks. SIMEX is working out the specifications of its new contract and will be making an announcement in due course.

Singapore's efforts to develop the capital markets and fund management industry will bear fruit in the coming years as the region recovers and investors return. But this will bring financial disintermediation to the doorsteps of banks in Singapore. Our local banks will have to catch up quickly with their competitors from other countries who have had years of experience in managing the disintermediation process and meeting the challenges posed by the emergence of the capital markets.

What can we learn from the experience of the leading international banks? First, many of them are combining with non-bank financial services companies in an attempt to tap a larger pool of customers and compete with non-bank entrants in financial services. Citicorp's merger with Travelers is one example of such an alliance.

Second, the leading banks are re-engineering their processes and focusing on non-traditional banking activities to cushion the erosion of their traditional earnings. They are leveraging aggressively on technology to cut their processing costs to the bone, extend their customer reach and cross-sell an increasing range of non-traditional banking products and services. Non-traditional sources of revenue from asset gathering and capital markets activities have also gained prominence.

A third response to the disintermediation process has been the development of credit derivatives. Credit derivatives allow banks to separate the roles of originating and holding credit risk. By repackaging and selling their credit risk to non-bank financial institutions and other investors, banks can reduce their concentration levels while maintaining their relationship with their customers.

The growth of the credit derivatives market over the last few years, mainly in the US and Europe, has been phenomenal. According to JP Morgan, the size of the global credit derivatives market is estimated at more than US$215 billion in 1998, exceeding five times its size in 1997. The credit derivatives market in Asia is nascent and there is potential for banks in Singapore to leverage on the well-established legal framework here to develop the market. On its part, MAS will issue guidelines on credit derivatives by the end of the year.

SKILLS DEVELOPMENT

The third key challenge facing banks in Singapore is improving the quality of their management and professional staff. Traditionally, our well-educated and English-speaking workforce has given us a lead over the rest of the region. But this is not an unassailable lead. We must expand our skills pool further, as increasingly sophisticated activities emerge in our market and other financial centres build up their capabilities. The ability to leverage on cutting-edge technology, develop new products, and offer all round quality service will be key in differentiating our banks in the region. Banks in Singapore – both local and foreign - must enhance their skills set further so that they expand in higher value-added areas like loan syndication, project financing, credit derivatives and risk management.

Banks will also need to attract and retain top management talent internationally to weave these capabilities into successful strategies for growth in the region. Our local banks must continue to upgrade their capabilities further, as despite our strength compared to regional players, we have far to go compared to the best international practices.

MAS will work actively with the industry and the institutions of higher learning to identify and bridge gaps in the financial sector's manpower requirements. We also stand ready to support the industry's skills upgrading efforts through the Financial Sector Development Fund.

BUILDING ON OUR STRENGTHS

Our banks are well-placed to meet the challenges before them. They are strong and well capitalised. These attributes are increasingly important and will command a higher premium, especially in view of the recent stresses caused to financial systems around the world by weak and poorly managed financial institutions. The Basle Committee on Banking Supervision recently issued a proposal for a new Capital Adequacy Framework. The new Framework provides a more comprehensive and sensitive approach to addressing risks in banks. The proposed abolition of the OECD-club rules is timely and welcome. Non-OECD banks with superior external credit ratings, like Singapore banks, will benefit from this change by being able to obtain cheaper funding.

CONCLUSION

To further develop Singapore as a premier financial centre, we must continue to enhance the consultation between MAS and the private sector. The private sector participation was essential for us to make the reforms over the last 18 months. We have now institutionalised this close involvement with the formation of the Financial Centre Advisory Group. Both MAS and the private sector must give their full commitment to this exchange. This is not a mechanism either for delivering edicts, or to lobby for industry special interests. Only then can we stay alert to emerging trends, refine and realign our strategies, and respond effectively to changing market demands. As banks in Singapore move forward to meet the challenges of the next millennium, they will have the assurance of MAS standing behind them to create a more conducive environment for the sustained growth and development of the industry.

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