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SPEECH BY MR KOH YONG GUAN, MANAGING DIRECTOR OF THE MONETARY AUTHORITY OF SINGAPORE AT THE MILLENNIUM LAW CONFERENCE:

FINANCIAL SUPERVISION IN THE NEW MILLENNIUM
10 APRIL 2000

1. INTRODUCTION

1.1 I am honoured to be invited to speak at the Millennium Law Conference.

1.2 The organisers had asked that I speak on issues related to the Internet challenge. This is not surprising. Financial services is among those sectors that stand to be radically transformed by the world-wide web phenomenon.

1.3 The Internet is more than just another delivery mechanism or cost-effective platform for financial providers to launch a global strategy. The Internet will alter the competitive dynamics of the financial sector in a fundamental way. By expanding the richness in consumer choice, the Internet is playing a powerful role in driving consumer education and shaping their expectations. This in turn accelerates the pace by which financial products and services are engineered and rolled out.

1.4 All these forces mean that the financial market place today is constantly and continually changing. Some have noted that technology deregulates markets faster than regulators are ready to do. As regulators, we can ill-afford to do our job in the same way if we are not to hinder the growth and development of the financial sector in the new economy.

1.5 The revolution in IT has been the key driver behind these rapid changes. It has sped up disintermediation and automation in many ways. The sale of products through Internet portals and extension of day trading to retail investors are among the more obvious developments to date. There is intense competition, not just from traditional rivals, but also from non-financial players.

1.6 The new competitive financial landscape ignores geographical and sectoral boundaries. Banks are acquiring insurance companies and vice versa. Stock exchanges around the world are demutualising and forging alliances. Many now offer competitive products on a single platform. Traditional mortgages are being securitised and the credit risks are spread to the capital markets. Catastrophic risks from the insurers are being offered to investors in the form of futures and options. You can even buy derivatives to hedge against specific weather conditions.

1.7 These are challenging times. No one can predict how financial markets will develop over the next five to ten years. The fact is that the typical regulatory structure no longer mirrors the market structures. We are seeing the emergence of international financial conglomerates. These powerhouses not only exercise massive international reach, they have global expertise in banking, securities and insurance all within one entity.

1.8 To make sense of this financial revolution, we need to understand the motivations beneath these changes. We have to look ahead and see where the problems and opportunities lie. It is not just going to be a race among businesses. One might even envisage increased competition among regulators as well. To succeed, we need an effective and flexible regulatory approach that is conducive to the development of new business models. Institutions today can relocate rapidly in the face of legal or regulatory obstacles. Financial centres that do not respond to the new environment will simply lag behind.

1.9 MAS has articulated its five-year vision to propel Singapore into a world-class financial centre by 2003. We aim to be a global financial hub offering the full range of financial services. We were mindful of the financial revolution when we started our liberalisation process two and a half years ago. But change is happening even faster than what we initially anticipated. The challenge for MAS is to ensure that our supervisory framework keeps pace with the changes so that a conducive environment is in place for a thriving hub.

1.10 Against this backdrop, I would like to share my thoughts on a key issue in financial supervision that is consuming the attentions of regulators worldwide – the convergence of financial services. There are four main areas that I will touch on this afternoon. I will first elaborate on the underlying trends and change factors. Second, I will speak on the implications and challenges for regulators, and in particular, the fundamental questions that regulators must ask and objectives that regulation and supervision must continue to address in the midst of rapid technological change. Third, I will discuss the integration of regulation and supervision across the financial markets. Lastly, I will share some thoughts on how MAS intends to respond to these challenges.

2. UNDERLYING TRENDS

2.1 By convergence of financial services, I refer to convergence at both the institutional and product levels.

<u>Consolidation of Institutions</u>

2.2 For many years, banks, insurers and securities brokers have pursued and developed their expertise in their respective fields. In many markets, regulatory barriers protected incumbents from competition. Financial institutions enjoyed good profit margins and had little incentive to venture beyond their traditional domains.

2.3 But things are changing. Customers are no longer satisfied with going to a bank to open a checking account, then seeing an insurance agent for retirement planning and then turning to a broker to buy shares. He prefers a one-stop financial service provider. He wants convenience and an integrated approach to money management. Many will want to ride on the new technology to do all these things from home or office.

2.4 Markets are also shifting. With financial liberalisation and globalisation, intense competition has led to falling margins. Banks, insurance companies and stock broking firms compete for the same savings dollar. They have to look for ways to improve cost efficiency, explore synergies and meet customer demand. Regulatory barriers are also breaking down, marked by the repeal of the 66 year-old Glass-Steagall Act in the US. The introduction of Gramm-Leach-Bliley Act allows bank holding companies in the US to undertake the full range of financial activities including insurance and securities. Similar developments are expected in Japan.

2.5 Financial institutions are seeing the benefits of merger. The new entity is able to leverage on the expanded customer base and expertise of the combined entities. It can exploit cross-selling opportunities and cut costs by consolidating branch networks. It will enjoy economies of scale in terms of capital expenditure for IT infrastructure and even branding. In short, there are compelling business reasons for financial institutions to restructure and adopt new business models.

2.6 We have seen waves of mergers and acquisitions among global financial institutions. The Citicorp-Traveller's merger was only the precursor. It created a global brand for retail financial services and started what some analysts called the race to become the Coca-Cola of financial services. The merger will help Citicorp realise its ambition of having a billion customers worldwide. Insurance companies have not been idle. In Europe, the French financial giant AXA Group has been very aggressive in acquiring insurance and asset management companies in different parts of the world. Similarly, Japanese financial institutions have not been immune to the pressure to merge.

2.7 If competition is the impetus, then the Internet would be the accelerator. With its seamless and interactive nature, the Internet is an ideal medium for financial product aggregation. Firms find it easier and cheaper to broaden customer reach, and to distribute a whole array of financial products via the web. The focus has shifted from selling individual products to meeting customers' total financial needs. Customers find that having all their financial needs met at a single contact point is no longer a dream. Information can now be disseminated in real time. Price discovery and comparison of product features heighten competition and customer demand. "Consumer empowerment" is something that will increasingly have to be contended with. Financial institutions are poised to provide every service for global clients and offer more personalised services in the industry. Some firms even offer financial planning tools through the Internet for free.

Merging of Financial Products

2.8 The transformation of financial products is no less dramatic. Advances in computing power and applications have supported product innovations and improvisations. Financial engineering, sophisticated risk modelling and simulations allow financial instruments to be broken down into their basic constituents. This leads to insights into the pricing of risks, and allows re-grouping of basic building blocks. Products that straddle banking, capital markets and insurance, are now common.

2.9 For some time now, insurance companies have packaged investment-linked policies, combining the financial protection of life insurance with the investment returns of a mutual fund. Recently, banks issue credit derivatives, which bear the characteristics of insurance. They also sell index-linked notes and market funds, a hybrid of banking and securities products.

3 IMPLICATIONS FOR REGULATION

3.1 How should regulators react to such a flood of changes? We have to stay sensitive to market developments, but not be overwhelmed by them. The instinct is to return to fundamentals. I begin by asking three questions that I think all regulators should ask:

- Who and what are we protecting?
- What are we protecting them from?; and
- Why are we protecting them?

3.2 The answers to these questions are inter-related. To put it succinctly, there are two key issues. Regulators protect the real economy from the ramifications of financial systemic failures. We also have to preserve the integrity and credibility of the financial market so as to safeguard the interests of depositors, investors and policyholders. In the latter, this arises because of the information asymmetry between providers and consumers. These objectives remain relevant, but their complexion is bound to be altered by these trends.

3.3 First, concern with systemic risk is heightened. Huge and complex financial institutions may pose a threat to systemic stability when they fail. With their global nature, risks can spread quickly to otherwise sound markets in different regions. Regulators have to be equipped with new skills to oversee and supervise complex institutions. Greater international co-operation among regulators is also needed.

3.4 Second, national regulators have mainly guarded against systemic risk arising from the banking system. This is too narrow now. Financial markets are now more integrated and globalised. More funds are being channeled into capital markets. Insurance is also claiming a growing share of personal savings. As bank deposits shrink, the management of systemic risk must extend beyond the banking system.

3.5 Third, the notion of depositor protection is also being re-examined. In the wake of the Asian financial crisis, Asian regulators are questioning the wisdom of bailing out individual banks in the name of depositor protection but at a large public cost. An efficient bankruptcy regime and prudential safety nets, such as deposit insurance and policyholders' protection fund, have now gained acceptance.

3.6 Finally, national regulators are finding it more difficult to shoulder the sole responsibility for safeguarding consumer interests. The Internet transcends national boundaries, and exposes consumers to a myriad of suppliers and products. It is increasingly difficult for national regulators to block out all unlicensed service providers. Consumers have to be empowered to exert market discipline on service providers.

3.7 Many national regulators are advocating a disclosure-based regime, so as to provide investors with sufficient information to make their own judgement. Such a regime requires a strong regulatory framework and high standards of disclosure. There has to be increased transparency. Accounting and reporting standards need to be harmonised too. This will improve comparability of financial statements. Regulators also need the legislative powers to carry out enforcement and provide appropriate remedy or restitution. It will be even better if we can have a lively educated investor community imposing discipline on financial intermediaries to meet high disclosure standards.

4 INTEGRATED REGULATION AND SUPERVISION

4.1 The regulators' response to market developments has been at two levels. The first is to re-model the way regulators are organised. The second is to re-align the regulatory framework across different sectors. Let me address them in turn.

4.2 Traditionally, regulations have been structured along sectoral lines. Different types of institutions are regulated under different legislation for banking, insurance and securities. In many countries, separate financial regulators administer the various laws. It is therefore not surprising that regulators for the individual industries have pursued the core regulatory objectives with varying emphasis and approaches.

4.3 Bank regulators have focused on depositor protection and systemic stability. They have guarded against bank failures, put in place deposit insurance schemes and given depositors priority ranking. Securities regulators on the other hand, have relied on market discipline to achieve investor protection. They have emphasised disclosure standards, fair market practices and strong enforcement. Systemic issues have been dealt with by ensuring stable exchanges and reliable settlement. Insurance regulators have been primarily concerned with safeguarding the interest of policyholders.

4.4 The blurring of institutional and product boundaries has questioned the effectiveness of the existing regulatory structure. We foresee at least two problems with integrated financial entities.

4.5 First, there will be regulatory overlap when these entities are required to comply with multiple sets of regulations. This increases compliance costs. Second, where there are different regulatory requirements for similar products, an institution will structure itself in such a way to deliver a product via an entity in the group that is subject to the lowest regulatory demands. Regulatory arbitrage will become a concern.

4.6 Shifts in regulatory model have already begun. The UK has restructured its regulatory framework by bringing nine industry regulators (including three self-regulatory bodies) under one consolidated body, the FSA (Financial Services Authority). Australia has two consolidated regulators - APRA (Australian Prudential Regulation Authority) for prudential regulation and ASIC (Australian Securities and Investments Commission) for regulating market conduct. We have been more fortunate in Singapore. MAS has been a single financial services regulator since 1984, overseeing the banking, securities, futures and insurance industries.

4.7 But putting different regulators under the same roof is only a start. Having an integrated supervisor is not the same as having integrated supervision. Even under MAS' umbrella, we have adopted the same silo approach in regulating different industries. Each industry has its own legislation and MAS adopts international best practices in each. The challenge ahead is to integrate financial regulation and supervision. This means aligning the regulatory approach across industries to mirror the convergence of individual markets. A more holistic view in supervising financial institutions and markets will also become essential.

4.8 The trend, regulators are moving towards, is best described as an "objective based" approach to financial regulation. This means that rules and regulations are no longer designed along product lines or types of entities but along fundamental regulatory objectives that we have identified earlier. Unlike entities and products, these objectives are less likely to change with time. An "objective based" regulatory framework will afford more flexibility to cope with the rapid transformation of institutions and products.

4.9 At this point, the global best practice for integrated regulation and supervision is still nascent. The UK has recently begun to consolidate all its financial services legislation into one omnibus Bill. This includes the creation of a single licensing regime and compensation scheme.

4.10 I believe this is a sensible approach for us to consider. MAS is on track. We are already a consolidated financial regulator. Our next milestone will be to integrate financial regulation across industries in a cohesive and meaningful way. I don't expect any easy solution. The issues are complicated and will involve difficult judgement of costs and benefits. It is also going to take some time. And refinements along the way would be necessary. But we have to start work now.

4.11 What would such an approach look like? I doubt anyone at this moment has all the right answers. Let me share some thoughts with you. I hope this will generate awareness and discussion among professionals. It will help in our search for an appropriate formula.

5 Harmonisation of Regulations Across Industries

5.1 I have touched on the need to harmonise regulations across the different industries. This does not mean that we intend to tear down sectoral distinctions completely. We will recognise the inherent differences in the nature of banking, securities and insurance businesses.

<u>Guiding Principles</u>

5.2 There are two key principles that will guide us in developing an integrated regulatory framework. The first principle is consistency. We want regulation of similar financial functions, products or services to be consistent across all types of institutions. Risks of the same nature should be treated similarly. For instance, the rules that apply to unit trusts should be comparable to those of investment-linked policies, since both are essentially investment products - one offered by fund managers and one by life insurers. This consistency will help level the playing field for market participants, and prevent regulatory arbitrage.

5.3 Second, the regulatory framework should be flexible. It is difficult to predict how financial markets will evolve. Bearing in mind the fundamental regulatory objectives that I mentioned earlier, we need a regulatory framework that can safeguard financial soundness, and yet be sufficiently flexible to allow firms to respond to market developments.

<u>Institutional Level</u>

5.4 At the institutional level, we need to consider how regulations can be applied consistently across the entire market. This includes licensing as well as ongoing supervision once the institutions are admitted. To have flexibility, regulators should focus on risk-based parameters instead of dictating rigid rules for the conduct of activities and product offering.

5.5 Many new financial entities do not fit nicely into the existing licensing regime. Let me give you one example. In Singapore, if a merchant bank intends to engage in investment banking, securities and futures dealing, it will need to hold three separate licences, one for each activity. We need to ask if there can be a more streamlined licensing regime without compromising prudential standards.

5.6 The British have noted that the logic of a single regulatory framework would point strongly in the direction of a single authorisation process. This will ensure consistency at the licensing stage across all financial activities. The FSA commented that there are at least three methods of implementing the single authorisation process. At one extreme, a firm initially authorised would be able to vary or change the nature of its financial activities without requirement to seek further permission. At the other extreme, the authorised firm must apply for permission to undertake each and every line of business.

5.7 The FSA is inclined to adopt an authorisation approach that falls between the two extremes. Authorised financial institutions would need to apply for subsequent permission if they make substantial changes to their activities. This approach seeks to balance prudential concerns with developmental objectives.

5.8 Our proposed Omnibus Securities and Futures Act is a step in this direction, consolidating regulations in two activities that have the closest linkage. The new Omnibus Act will merge and streamline the Securities Industry Act and Futures Trading Act into one statute. Provisions currently contained in the Companies Act which relate to corporate fund raising, as well as unit trust regulations will also be transferred to the new Omnibus Act. This will have the effect of, streamlining the licensing, prudential and market conduct requirements for the securities and futures industry. We hope to have the Omnibus Bill ready for Parliament debate in the year 2001.

5.9 Prudential regulation should also be consistent across different industries, where possible. One example is capital requirement. Regardless of the nature of business, the objective is to ensure that financial institutions hold adequate capital commensurate with the risks assumed. Banking regulators use the concept of risk-based capital. Securities and insurance regulators, on the other hand, prescribe adjusted net capital or leverage limits. Regulators are now studying the feasibility of adopting a common risk-based capital framework for all these businesses.

5.10 MAS' adoption of risk-based supervision has been timely. It is a more effective and efficient way to oversee larger and more complex institutions. The focus is on the review of an individual firm's risk management processes and control systems. But MAS examiners will have to equip themselves to understand the nature and source of risks in different activities, how these risks interplay and can get transmitted across activities.

5.11 In particular, we need to examine the guidelines for intra-group exposure. This addresses the concern of contagion within a conglomerate where the operations of individual entities may affect the liquidity and profitability of the entire group. Silo regulation may overlook this. Ownership and corporate governance rules need to be tightened.

Consumer

5.12 Regulators have always been concerned with protecting consumer interests. But we realise the increasing difficulty of shielding consumers from risks in the new environment. Financial products are becoming more complex, and unlicensed service providers can reach them using new channels such as the Internet. The best means to protect them is to raise consumer awareness and professional standards. Where the risks to consumers are alike, it is sensible to give consumers the same degree of protection across the board.

5.13 In Singapore, many consumers expect the regulator or government to take care of them. We have to moderate this expectation and shift the responsibility for making financial decisions onto themselves. In this regard, MAS has been raising disclosure standards across all industries. For disclosure to be meaningful, they need to be consistent, comparable and comprehensive. We will continue to work with the industries to educate the investing public, including raising the financial literacy.

5.14 Another step is to harmonise risk disclosure for different products. This will allow consumers to compare substitutable products. As integrated products become prevalent, disclosure is even more important, so that consumers can understand the risk-return profile.

International Co-operation

5.15 Today, having a strong, well-regulated domestic market no longer guarantees a sound night's sleep for the regulator. The Asian financial crisis and LTCM debacle illustrate the reality of a global market, and its contagion effect. Singapore was not spared even though we were fundamentally sound. Furthermore, with the Internet allowing ready and easy cross-border access, there is a need for greater regulatory co-operation. This includes the sharing of information and ideas, and working towards a harmonisation of standards across countries.

5.16 Regulators have entered into bilateral agreements to share information, and to render assistance for regulatory purposes. International forums, such as the Joint Forum and the Financial Stability Forum have put in much effort to address some of these issues. MAS participates actively in these discussions.

6 CONCLUDING REMARKS

6.1 Looking ahead, the increasingly integrated financial landscape will bring about greater complexity as well as uncertainty. Yet no matter how radical we see the transformation, the principles that guide the regulator remain clear. The regulator must also continue to maintain high standards of integrity and impartiality.

6.2 Regulations will have to keep pace with market reality. It will take great skill to define the targets of regulation and to draw lines within the regulatory framework that are at once clear and yet sufficiently flexible. There is no final solution, we have to update and adapt continuously.

6.3 We have to work hand in hand with market players and legislators to ensure that our regulatory framework continues to achieve these ends in a changing environment. We have benefited from the insights of the legal profession in crafting rules and regulations and shaping our policies. We will continue to consult you.

6.4 Institutions and consumers will also have to play a bigger role. We expect high standards of corporate governance from the board and management of financial institutions. They should stay on top of changes and put in place sound risk management practices. Ultimately, they have the primary responsibility for managing their institutions' risks and are accountable to their stakeholders. Consumers will also have to take on greater responsibility for making their own investment decisions. MAS will continue to work towards greater transparency in our markets, raise disclosure standards, and foster market discipline in the financial services industry. We would also work with and encourage industry groups to develop and enforce standards of good market practice.

6.5 The new millennium holds invaluable opportunities for Singapore's financial sector. There is much work to be done in creating a forward-looking and dynamic regulatory environment for Singapore to thrive as a financial hub. Such an environment would accommodate new business models like Internet-only banks. MAS intends to introduce the regulatory framework for Internet only banks in a few months. So long as we gear ourselves up to meet new challenges, we can look forward to an exciting and prosperous future.

7. Thank you.

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