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CHALLENGES OF THE NEW FINANCIAL LANDSCAPE: *EMERGING TRENDS AND IMPLICATIONS FOR REGULATION*

1 THE CHANGING FINANCIAL LANDSCAPE

1.1 I am grateful for LawAsia's invitation to address the Conference this morning. I will begin by highlighting a number of fundamental trends that are shaping the financial landscape, globally and in Asia, before discussing the challenges that they pose for the regulation and supervision of financial services. I will also provide some insight into MAS' thinking as an integrated supervisor of financial services, and what we are doing to reposition ourselves in the light of these broader developments.

1.2 Technology, the convergence of financial services and the consolidation of institutions are transforming the financial landscape. I will start with technology. The internet is bringing about newer and more efficient ways of conducting the entire chain of financial services, from the manufacture of financial products to marketing, delivery, payments and risk management. It is providing platforms to link multiple providers and consumers globally, seamlessly and quickly, and with great convenience to consumers.

1.3 Technology and the internet have opened up vast new opportunities, that are probably overstated in the near term, but almost certainly understated in the long term. Yet it is also difficult to avoid the conclusion that the very same forces unleashed by the internet will reduce the profitability of financial services. There are a few reasons for this. First, consumers are becoming more sophisticated as they gain access to a rich array of information previously available only to financial intermediaries, or to large, sophisticated players. Consumers will increasingly exercise choice, in saving or borrowing. They will seek out the best product for their needs, and will often want to do so with little advice. Fundamentally, therefore, the internet is shifting sovereignty from the producer to the consumer in financial markets. What economists have called 'information asymmetries,' that were intrinsic to the advantages of financial intermediaries, are diminishing.

1.4 Second, competition in the financial industry has increased. Deregulation and technology are bringing a variety of new players into the financial industry, often targeting specific segments of what was previously an integrated value chain in financial intermediation, and sometimes engaging in 'loss-leader' strategies to win customers. Banks and other traditional financial players are responding to the competition by investing in new technologies and systems, new channels of distribution and in some cases altogether new business models that compete with their existing operations. But the record to date suggests that the high up-front costs of technology investments, particularly in internet banking, may not be matched by adequate revenue gains over the short or medium term. Customers in traditional banking services have by and large been 'stickier', or slower to move, to new online channels than has been the case in securities trading, for example.

1.5 There will be winners, and potentially big winners. But profitability in the industry as a whole will be at risk for some time. The internet offers great promise in finance, but like other disruptive technologies we are likely to see significant <u>restructuring</u> of the industry and some shake-out of weaker players, before we see the winners, or those with viable and profitable strategies, emerge.

1.6 Which leads me to my next point. Technology, competition and the drive for profitability are leading to unprecedented <u>convergence in financial services,</u> restructuring and consolidation among financial players. Boundaries are blurring as financial institutions enter each other's markets. In the US, the Gramm-Leach-Bliley Act has erased the last vestiges of the legislative boundaries between commercial and investment banking. Reinsurers are moving beyond their traditional boundaries of property and liability reinsurance and into credit enhancement for highly-rated securities, and weather derivatives. Securities brokerages are offering deposit substitutes, and insurance companies are offering substitutes for securities products. New hybrid financial products are emerging with characteristics that cut across traditional business lines. Some risk management products are being offered as 'alternative risk' products that fall outside of traditional insurance and reinsurance, often for the purpose of exploiting tax and regulatory asymmetries.

1.7 The process of consolidation is only beginning in Asia, but is well advanced elsewhere. Financial institutions are merging or acquiring one another so as to reduce costs, and to diversify their earnings by providing customers with a broader array of services. Financial institutions are exploiting opportunities for cross-selling of products, just as customers themselves are beginning to diversify their assets and seek greater choice. Asian households and corporations still maintain a disproportionate share of their savings in bank deposits. Bank deposits amount to 120-140% of GDP for countries like Singapore, Taiwan and Hong Kong Source: CEIC., compared to 44% of GDP in the US, where banks have been losing their share of savings for decades. The shift of savings from deposits into other investment instruments will transform Asian financial systems over the next decade and beyond.

1.8 Asian banks also remain heavily reliant on loans and interest income, just as Asian corporates are dependent on banks for a large part of their funding. In Asia, bank loans are between 100 to 150% of GDP while the same ratio in the US is 33%. Source: CEIC, Morgan Stanley Dean Witter Research. The growth of Asian capital markets, still relatively underdeveloped, will be driven by this shift of savings from bank deposits into new investment instruments, and the need for Asian corporates to deleverage and tap new sources of funds.

1.9 Deeper and more liquid debt and equity markets will put Asian financial systems on a more stable footing. They will help inject market discipline, and bring greater efficiency to financial intermediation. They will also help avoid the concentration of risks on bank balance sheets, and the large and unstable flows of external bank credit that precipitated the Asian crisis. But it will take time to develop credible and robust capital markets - depending as it does on a willingness by governments to introduce laws and regulations to ensure transparency and fairness, and to develop institutional capabilities to enforce the rules. I will return to this later.

2 TOWARDS GREATER HARMONISATION AND INTEGRATION IN REGULATION

2.1 The sweeping changes we are seeing in the financial landscape, with new technologies, new players and new business models emerging in a more competitive market, have strengthened, not diluted, the need for sound systems of regulation and supervision. The purpose of regulation must after all be to maintain confidence in the financial system, and confidence is necessary for markets and institutions to grow and innovate. How we achieve this objective, however, requires rethinking in light of the new financial landscape.

2.2 The first challenge is to adapt our regulatory and supervisory approaches for an environment of continuous change, and greater uncertainty than in past decades. New business models, financial products and risk management practices are continually being tested and challenged in the marketplace. Their implications for the safety and soundness of financial institutions, and the resilience of the financial infrastructure, will be uncertain. Regulators must continuously seek to identify and address new or accentuated risks, with less certainty than before as to how they are best addressed. What is critical is that they do so without inhibiting the innovation and dynamism that underpins the development of the markets.

2.3 The challenge then is to fashion a framework of broad principles that will allow us to continually modify, adapt and update specific supervisory practices and methodologies in line with industry developments. We have to think of regulation and supervision, therefore, as work-in-progress, not work that is ever completed. Flexibility and adaptability will increasingly be the hallmarks of a sound supervisory regime. It must also mean a much closer degree of collaboration in shaping supervisory responses, between the supervisor and the supervised, than has traditionally been the case, with an active dialogue whenever new risks surface or when new business strategies are adopted.

2.4 The second challenge is to better harmonise and integrate regulations and supervisory practices across financial activities. Traditionally, regulation has been organised along distinct, product-based silos. Banking, insurance, and securities have been treated as distinct financial businesses and were usually carried out by different institutions. In many countries, they have been, and still are, regulated by different watchdogs. With the trend towards convergence of products and activities, and consolidation of institutions, a silo approach poses several problems.

2.5 First, there will be regulatory gaps, where unsupervised activities fall through the cracks. Second, there will be regulatory arbitrage arising from unequal treatment of increasingly similar products or activities. Third, risks arising from different activities, each regulated separately, may be aggregated in ways that could undermine the safety and soundness of institutions as well the financial system as a whole. A more harmonised and integrated regulatory regime therefore is necessary to address these potential risks and supervisory gaps, as well as to provide greater clarity and a level playing field for market participants.

2.6 Harmonisation and integration do not mean uniform regulation and supervision of banking, securities, and insurance. Despite convergence, there remain differences in the nature of these activities and different risk considerations. Consider banks. Banks' liabilities are mostly in the form of deposits which are repayable at par on demand, while their assets are mostly in the form of loans, which are typically illiquid. This makes banks particularly susceptible to sudden perceptions of a deterioration in the value of their assets, which in turn can lead to bank runs and a liquidity crises. And illiquidity can threaten the solvency of even healthy banks. These risks are accentuated by the fact that depositors typically lack the resources to assess or anticipate the risks a bank faces in its assets in advance of any problems that arise.

2.7 There is a further distinction that differentiates banks. Supervisors have to take into account the impact a major bank failure could have on systemic stability, which is typically more so than the failure of other financial intermediaries. Problems in a single bank can be transmitted quickly through the payments system to pose a systemic threat. Banking supervision thus tends to be more pre-emptive, more active, and often more discretionary in nature. While bank supervisors are placing considerably greater emphasis on the need for internal systems of risk management and external discipline exercised by shareholders of a bank, no supervisor I have met believes that a run on a bank by its <u>depositors</u> is a salutary form of market discipline.

2.8 Securities regulators, on the other hand, are concerned with ensuring fair, efficient, and transparent markets. The principle of *caveat emptor* is widely applied, with investors expected to understand the product they are investing in and its risks and assume full responsibility for their decisions. Disclosure standards, fair market practices, and strict enforcement of laws are therefore at the core of securities regulation. Rules, not discretion, define securities regulation.

2.9 To summarise then, integrated supervision must rest on a clarity of understanding of the distinct risk considerations in different financial activities, and the distinct assumptions that have to be made about users of financial services. Expert knowledge of specific types of financial business is necessary, even within an integrated supervisory framework.

3 WHAT TO HARMONISE AND WHAT TO INTEGRATE?

3.1 The MAS was the first integrated financial supervisor internationally, acquiring oversight responsibilities for the banking, securities, futures and insurance industries since 1984. We recognised at that time that there were synergies in bringing together under one roof the supervisory responsibility for all financial activities. It was common for our local banking groups, for example, to own subsidiaries or affiliates carrying on insurance and securities businesses. However, the linkages among banking, securities, and insurance were not the only reason why we moved to becoming an integrated supervisor. In a small country, with limited human capital and potential supervisory resources, it was sensible to bring the various supervisory functions within one agency. The Scandinavian countries did likewise in the late 1980s and early 1990s, and it is only in recent years that larger countries like the UK, Japan and Australia have also adopted a model of integrated financial regulation.

3.2 MAS is now seeking to progressively achieve greater harmonisation and integration of its regulations and supervisory practices. I will touch briefly on four key pillars in the framework of integrated regulation that we are working towards - namely licensing, capital, risk-based supervision, and corporate governance.

A Licensing Requirements

3.3 First, licensing requirements. The principle underlying a sound regulatory framework should be to impose similar prudential and market conduct requirements on <u>like</u> activities, regardless of the type of institution carrying out the activity. We should also minimise the complexity of the licensing framework. Institutions undertaking several different activities should not need to hold multiple licences where possible, but should nevertheless be subject to the prudential and market conduct standards that govern each activity.

3.4 Let me summarise our current licensing framework. Currently, we license Singapore banks to undertake universal banking, namely commercial banking, underwriting, corporate finance, and distribution of insurance and securities, and asset management. Apart from banks, all other financial institutions have to obtain separate licences for the specific classes of financial activities that they would like to undertake. Taking banking, insurance and capital markets together, MAS currently issues a total of nineteen different classes of licences.

3.5 We do not envisage a single licence for <u>all</u> financial activities anytime soon. But we want to move towards a licensing framework that is flexible enough to allow financial institutions to undertake broadly similar classes of financial activity under a single licence. We envision a modular approach, where institutions granted a single licence can be given greater flexibility to conduct a range of related activities.

3.6 I will illustrate this with regard to the capital markets, where we will be bringing <u>securities and futures trading activities</u> under a <u>single, modular licence</u>. The existing Securities Industry Act and the Futures Trading Act will be streamlined into one omnibus Securities and Futures legislation, which will be introduced next year. The proposed modular licensing approach is expected to lower entry barriers, enhance competition and accommodate changes in the business strategies of market players. They can approach MAS if they wish to expand into new activities without the need to apply for and obtain a separate licence. More importantly, besides consolidating the licensing framework, the Act would also streamline regulatory requirements in the securities and futures markets, including provisions governing the conduct of business, and the implementation of a common risk-based capital framework for securities and futures brokers.

3.7 As investment products and distribution channels converge, we also need consistent standards of business practice in the area of financial advice, which is currently governed by distinct pieces of legislation and distinct regulations. We are therefore working towards a single legislation and single licence governing the provision of all forms of personal investment and financial planning advice. This new Financial Advisers legislation will be put before Parliament next year at the same time as the omnibus Securities and Futures legislation. The FA Act will permit licensees to advise on all types of financial products including unit trusts and insurance products under a new, aligned set of licensing requirements, such as minimum financial resources, and "fit and proper" tests for directors, officers and shareholders. MAS will also establish a Code of Conduct, which will be applicable to all persons who provide financial advice on investment products, irrespective of whether they act on behalf of banks, securities advisory firms, stock brokers or insurance companies. This will level the field and help foster uniform professional standards across the industry.

3.8 In banking, where we already have a single licence allowing for different activities, we will ensure consistency of treatment where banks undertake the same activities as non-bank players. Banks will continue to be exempted from licensing requirements for insurance distribution, and securities businesses. But they will have to fully comply with relevant regulations that other non-bank players have to meet under their respective licences.

B Capital

3.9 The second area with scope for requiring convergence in treatment is capital adequacy. The role of capital - to provide financial institutions a buffer to absorb unexpected losses - does not differ fundamentally across banks, insurance companies and securities houses. However, the basis for determining how much capital is adequate has differed across industries for reasons that are as much historical (or institutional) as economic (in the sense that the risks truly vary across the industries). Take banking and insurance. For banks, the realisable value of assets is mostly variable, whereas liability obligations are normally fixed. The primary sources of risk are on the asset side of the balance sheet, mainly credit and market risks associated with their loan and investment portfolios. Where the risk of asset deterioration can be anticipated, banks set aside reserves (or provisions) for the purpose. Capital is then held primarily against unexpected losses on the value of assets.

3.10 For insurance companies, the value of liabilities (ie claims) can be quite variable. The primary risk considerations are therefore on the liability side of the balance sheet, although asset diminution is also a consideration. The traditional concern of insurance regulators internationally has been the adequacy of reserves to meet contingent (expected) liabilities as well as the uncertainties associated with estimating the value of liabilities. Reserves have therefore served as a buffer for insurers to meet both expected obligations and some part of unexpected obligations.

3.11 There is in principle no reason for different paradigms of capital across financial industries. International efforts to achieve greater convergence in capital regulation have centred on applying common risk-based capital concepts to all financial industries. Within any institution, this involves calibrating capital requirements more closely to the specific levels of risk in the institution's operations. A risk-based approach to regulatory capital would help provide institutions with the incentives to better manage their risks. An equal capital treatment of similar risks, across different financial institutions and activities, would also guard against regulatory arbitrage. It can also help achieve a more cost-effective allocation of capital across financial activities.

3.12 In Singapore, we are revising our existing capital frameworks for insurance and securities firms, so as to move toward a risk-based approach not dissimilar to that in banking. The issue of course is not whether it is say a banking approach or insurance approach, but whether similar concepts of risk are being struck, similar measures of capital being adopted, and a similar moving away from 'one-size-fits-all' capital regulation.

3.13 In banking, we will also be revising our capital adequacy treatment once the Basle Committee has agreed on a new, more risk-differentiated view of bank assets, replacing the current, crude and relatively inflexible system of risk-weighting of bank assets. Once we have risk-based capital treatment for all financial activities, we will also be able to adopt a more efficient approach to capital requirements for financial holding companies or banking groups. Each financial activity will be subject to its own capital requirement, with a suitable buffer kept at the level of the holding company.

C Integrated Risk Management

3.14 Third, risk management. As with capital, we have shifted our emphasis in banking from a 'one-size-fits-all' framework of rules aimed at limiting risk, towards a greater reliance on supervisory oversight tailored to the risk profile of individual banks. MAS is adopting risk-based supervisory frameworks for insurance and securities as well. These frameworks place principal responsibility for risk management on the financial institutions themselves. They also allow the supervisor to use more finely calibrated prudential yardsticks to assess the risk management procedures and control systems of a regulated entity, in consultation with its management.

3.15 Convergence, consolidation, and new business models have not given rise to new risks as such. But certain risks have become accentuated and the management of these risks has become more complex. Two types of risks, in particular, require considerably greater attention across the financial industries: business risk and technology risk. Business risk has become more important with the advent of new, untested models aiming to capitalise on the internet, and the entry of new players into finance. Some of these models may very well succeed, but there is little certainty at the outset as to which these might be. The job of the supervisor is not to judge which models will succeed or fail, but to ensure that the board and management of the financial institution are actively engaged in assessing the costs and viability of the business in question, and to minimise any contagion arising from a failure of the business. Neither should the supervisor seek to protect incumbent players from others that are better able to take advantage of new technologies.

3.16 Technology risk itself is intensifying on a scale and complexity never experienced, although the tendency for media headlines to scream at the slightest glitch may say as much about competition in journalism as it does of public confidence in financial systems. New technologies are profoundly transforming the way financial institutions interact with their customers, counterparties, service providers and vendors. Responsive operating processes, strong internal controls and robust risk management systems are critical to prevent business disruption, and failure in key management units, and to sustain public confidence.

3.17 MAS has developed a common pool of supervisory resources and capabilities to address the challenges posed by technology risk across the banking, insurance and securities industries. We will shortly be issuing technology risk management guidelines for Internet banking. This will set out principles and best practices that apply more broadly to the provision of financial services via electronic networks and delivery channels based on Internet technology, including wireless and web-based applications.

D Corporate Governance and Disclosure

3.18 Finally, corporate governance. As we shift emphasis from regulation to supervision, the onus falls more heavily on financial institutions themselves to ensure strong internal risk management and control systems. A sound risk management culture is in turn heavily conditioned by the quality of corporate governance.

3.19 The Asian crisis tells the story. The Asian financial model was centred on a system of relationship-based banking that worked well for a period of time but eventually lost its relevance. With the exception of Japan, the predominant form of corporate ownership was one involving family-based controlling shareholders. Relationship-based banking was not a bad thing in a system characterised by imperfect information, absence of capital markets and in many instances, absence of rule of law. It relied on proprietary information networks and trust as the basis on which to conduct business. There was always some degree of inefficiency in bank lending, and low returns on deposits as savers lacked alternatives, but the problems in banking were never as severe as they became in the last decade. Several family-based banks in Asia were in fact sound and conservative by any international standards. But with rapid economic growth and an increase in the scale and complexity of the economy, relationship-based banking reached its limits. Trust and internal networks of information could no longer serve as adequate forms of credit appraisal. Indeed, <u>while relationship-based banking was once a response to incomplete and inefficient markets and the absence of rule of law, it had become itself a source of these very problems</u>.

3.20 The unravelling of the relationship-based model of finance in the Asian crisis points to the importance of developing a more rigorous, and arms-length credit culture, and a move towards more explicit rules and standards of corporate governance. The pace of evolution and form of corporate governance structures in Asia will necessarily be shaped by domestic constraints and circumstances. But few in Asia would now disagree with the critical ingredients of good corporate governance – namely laws and rules that protect the rights of creditors and minority shareholders, consistent enforcement of such rights, independent and effective boards, arms-length relationships between any related parties, and timely disclosure to the market.

3.21 The Singapore banks have remained sound. Their main shareholders have seen it in their interests to ensure the banks are run well, and conservatively. But we have put in place several additional measures to strengthen corporate governance and disclosure in order to prevent problems emerging in the future. We now have nominating committees on bank boards, comprising a majority of independent directors charged with ensuring that persons appointed to the boards and to key executive positions are selected for their expertise, and their ability to contribute to the bank and to the interest of all shareholders. We have also required banking groups to separate their financial and non-financial activities, divest control of all non-financial activities, and remove all cross-shareholdings between the two. This will help focus management attention on their core business of banking and finance. We will also be requiring further improvements in disclosure standards among the banks, including greater disclosure of related-party transactions.

3.22 Corporate governance is not just for the banks. MAS is currently formulating standards of corporate governance for insurance companies with a view to raising standards in the industry. The government has also set up a Committee for Corporate Governance. It will soon issue a consultative document, recommending enhanced standards of corporate governance for all companies listed on the Singapore Exchange. Companies should adopt specific governance practices best suited to their circumstances, and which they see in their interests. But this has to be built on enhanced minimum standards that protect shareholders and creditors and ensure adequate market discipline.

Review Of Insider Trading Laws

3.23 MAS is also reviewing the scope of our present insider trading laws. Insider trading is antithetical to the most fundamental tenets of market fairness and efficiency, and erodes the confidence of investors. Our insider trading laws, Section 103 of the Securities Industry Act (Cap 289, 1985 Rev Ed) enacted in 1986, were based on proof of the accused persons' connection to a company either as an insider or a tippee (a person receiving price-sensitive information from the insider). This has been called a "person-connected" approach.

3.24 We introduced civil fines and a statutory civil remedy for insider trading in March this year to induce greater market discipline. MAS is currently studying the adequacy of the provisions which define criminal and civil liability for insider trading. The current approach makes the insider and the tippee liable for insider trading. There is difficulty in extending liability to others who are further down the information chain, i.e. secondary tippees, who knowingly possess inside information and trade on it. This is unsatisfactory, as these persons would have traded with an unfair information advantage. The core mischief of insider trading is to tilt the playing field unfairly against other market participants.

3.25 We therefore need to prohibit those who knowingly have inside information from trading, whether or not they are connected with the company. We need to redefine our jurisprudential approach to our insider trading laws to deal with the core evil – trading while in possession of undisclosed market sensitive information What has been termed as an "information-connected" approach. - instead of having the offence depend on the person's connection with the company. This approach has already been adopted in Australia, and there is a discernible trend in some other jurisdictions towards it. We are also mindful not to cast the net so wide as to catch unwitting market participants, who trade on inside information without knowing that it is undisclosed. The intent is to make persons who can be proven to have actual knowledge of inside information liable if they trade.

3.26 Whilst we shift the focus of liability to possession of inside information, we also need to tighten up the prohibition on directors, officers and persons connected with the company from trading whilst in possession of inside information. Under the MAS proposal, to prove an insider trading charge against such connected persons, the prosecution will have to show that they have held either actual or constructive knowledge of inside information. Thereafter they would be deemed to know that the information in their possession is undisclosed and is price-sensitive, but this would be a rebuttable presumption. This tightening of the law is necessary to preserve market integrity and efficiency, as well as uphold the strict fiduciary duties owed by directors towards the company.

3.27 MAS will soon issue a consultation paper to the public to seek comments on these proposed revisions to Singapore's insider trading laws.

3.28 We also intend to release the draft of a revised Takeover Code, which takes into account evolving practices in mergers and acquisitions and best practices in corporate takeover rules in a number of other jurisdictions.

4 CONCLUSION

4.1 Let me now conclude. MAS has embarked on an ambitious agenda, in liberalising the financial system, moving towards a system of risk-based supervision, and seeking greater harmonisation of regulations and supervisory practices across financial industries. We need to further streamline our licensing framework, extend risk-based capital regulations across industries, promote integrated risk management in our financial institutions, and strengthen corporate governance and disclosure standards across the board. Put simply, it is an agenda aimed at ensuring continued confidence in the soundness and transparency of our financial system and markets, so that market participants can be encouraged to innovate and take new risks. We have made good progress to date, but it must remain work-in-progress as we adapt to an environment of continuous change and innovation.

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