1 INTRODUCTION

For many years, there have been differences in regulatory regimes and rules for banking, insurance and securities activities. These have resulted in largely separate markets developing within national jurisdictions. International regulatory barriers have also hindered the emergence of a truly global financial services industry.

Banks could leverage on their size and local knowledge to dominate their domestic markets. They did not feel serious competitive pressure from outside their industry.

However, this situation has changed rather drastically in recent years.

Several factors have contributed to this change: the liberalization and deregulation of the financial sector; the greater use of financial engineering techniques and models; significant advances in information technology and telecommunications; and growing consumer demands for better pricing as the Internet enhanced consumer information.

The result has been greater competition and finer pricing. As a consequence, banks have found it more difficult to meet the return on equity demanded by shareholders on net interest income alone, and have had to review their strategies for generating more fee-based income, and income from non-traditional sources.

Other financial intermediaries have also experienced significant downward pressure on profit margins. In Singapore, for example, commission rates for brokerage services have fallen sharply since MAS liberalized commissions in October 2001. So, like banks, other intermediaries have felt pressure to look for other sources of income.

This intense and accelerating competition has driven banks to seek new business models and laid the groundwork for growing convergence among the
various financial sector players. This is a reality not only for financial firms but also their regulators.

Before I offer you an assessment of what convergence means for bankers and their supervisors today and what MAS is doing in response, I am going to briefly review the state of convergence around the globe.

2 WHAT HAS HAPPENED TO DATE?

The American Experience
Until recently, the US has been one of the most fragmented markets for financial services with separate regulatory frameworks for banking, securities and insurance. The Glass-Steagall Act, with which many of you are familiar, imposed strict legislative restrictions on affiliations between commercial banks, securities dealers and insurance.

Regulation at the state and federal levels divided financial markets along geographical and traditional product lines. It also gave rise to duplicative and sometimes conflicting requirements for financial institutions.

Despite these legislative impediments, the barriers have been crumbling.

In insurance, companies increased their emphasis on sales of short-term annuities, which competed directly with bank deposit products. The Office of the Controller of the Currency successfully fought State legislation prohibiting national banks from selling insurance products.

In securities, the Federal Reserve gradually loosened the Section 20 prohibition on member banks affiliating with any organisation that is “principally engaged” in underwriting or dealing in securities. This allowed bank holding companies to establish so-called Section 20 subsidiaries within the limits of Glass-Steagall to conduct securities activities that were prohibited within banking organisations.

Besides convergence through direct cross-sectoral participation, the growing use of risk transfer techniques such as securitisation and financial reinsurance also increased the inter-linkages among banks, insurers and securities dealers as counter-parties of one another’s positions.

Another phenomenon that we might place under the heading of convergence is disintermediation, a growing trend in the nineties. Major corporate clients of traditional banks found that they could reduce their borrowing costs by using the services of investment bankers and securities dealers to go directly to capital markets. On the other side of the balance sheet, banks were losing deposits as depositors were drawn to the higher returns on mutual funds and equities.
In November 1999, the Gramm-Leach-Bliley Act was finally enacted. It substantially reduced formal regulatory barriers and introduced the concept of a financial holding company, which could own banks, securities dealers and insurance companies.

This change was long overdue. In 1998, in anticipation of the repeal of Glass-Steagall, Citicorp and Travellers merged to form Citigroup Inc, the first true US-based conglomerate, complementing banking with investment banking, securities dealing and insurance worldwide. The re-alignment of antiquated banking statutes to the dynamic realities of the financial landscape recognized, somewhat retrospectively we might say, the emergence of a converging financial services industry in the US.

Since the repeal of Glass-Steagall, nearly 600 financial holding companies have been formed to undertake new activities in insurance and merchant banking.

But industry expectations of waves of "mega-mergers" forming large financial conglomerates proved excessive. With the exception of the Citicorp-Travellers merger, most of the major mergers were within markets, such as BancAmerica Corp and NationsBank Corp in September 1998.

However, Citigroup's recent decision to "spin-off" its property and casualty insurance might suggest to the outside observer that the benefits of bancassurance model in the US were not as great as initially expected. Moreover some of the merged entities experienced financial difficulties, reducing the appetite for further consolidation.

The Canadian Experience
In Canada, convergence occurred earlier than in the US and more extensively. The major banks control some of the largest securities dealers and investment bankers. Banks also own insurance subsidiaries, and some insurance companies offer banking services through subsidiaries.

Banks, insurance companies, fund management companies compete aggressively in the wealth management market and, as in the US, inter-linkages and risk transfer among financial institutions is significant.

There is not yet full convergence in Canada. Politically, there is still resistance to mergers between major banks. As a policy, banks may not merge with or acquire major insurers. There is also a legislated prohibition against the sale of insurance products in bank branches.

The European Experience
The pace if not the shape of convergence in the UK has roughly paralleled the Canadian experience.
Banks and insurance companies have been very active in the wealth management field and have diversified into other markets. For example:

- Lloyds TSB acquired Scottish Widows, one of UK’s largest life insurers.
- Prudential Insurance Company not only bought a large asset manager in M&G but also started an Internet bank called EGG.

On the continent, universal banking has been well established. Commercial banks in Germany not only offer securities dealing and investment banking services, but also traditionally held major long-term equity stakes in non-financial businesses, although a welcome overhaul of tax legislation may encourage a reduction of these holdings.

Bancassurance models have enjoyed a measure of success across Europe. A significant example of the ‘Allfinanz’ model combining banking and insurance was the acquisition of Dresdner Bank by Allianz, the largest general insurer in the world, in a deal worth nearly US$20 billion. It was the largest European financial sector acquisition in 2001.

There are several variations of these bancassurance models in Europe, including:

- Fortis, which has forged a successful financial conglomerate in the Benelux countries;
- Credit Suisse Group and Winterthur, a major life & reinsurance company, which merged in August 1997 to form a "balanced" global financial service provider;
- The Dutch ING Group which is active in banking, insurance and asset management in 65 countries.

**The Asian Experience**

Convergence has been less pervasive in Asia for a number of reasons.

Historically, many banks were and still remain family-owned with less interest to expand into new financial businesses in which they did not have the expertise. This of course is not a uniquely Asian phenomenon and nor is it the case in every Asian country. There are several other reasons for the slower pace of convergence in Asia.

First, disintermediation has been somewhat less of a threat here as Asian corporate clients preferred the flexibility and predictability afforded by long-established banking relationships to the strict disclosure and compliance rules governing the debt capital market. Also, most Asian consumers kept their money in their bank accounts, rather than joining the rush to equities seen in other markets.
Second, the development of financial markets and sectoral linkages in many Asian countries has lagged that in other financial centers. Bond, equity and derivative markets in Asia are still at an early developmental stage compared to those in Europe and North America. The credit derivatives market in Asia currently accounts for less than 10% of the total global credit derivatives market.

Third, the aftermath of the East Asian financial crisis has kept many banks and financial supervisors pre-occupied with managing non-performing loans, improving corporate governance, making legislative changes to recapitalise the banking sector and increasing the effectiveness of prudential regulation. But the impact and response has not been uniform across Asia, and some countries, like Singapore, which were relatively unaffected by the crisis have been able to move on.

But the potential for convergence across Asia is enormous.

Universal banking models incorporating commercial banking, insurance and securities activities already exist in many Asian countries and the remaining restrictions on financial conglomerates operating across sectors are bound to diminish.

Increased competition should encourage Asian banking groups to seek new income streams and consolidate their activities to match or better the performance of these Anglo-American and European financial conglomerates that have significant Asian presence.

Here in Singapore, commercial banks are already able to own and operate subsidiaries engaging in electronic banking, insurance underwriting, asset management and securities activities.

Other Asian economies are following the same path. Taiwan has recently introduced its Financial Holding Company law to encourage consolidation of the island's fragmented financial services sector through the formation of financial holding companies that can group banking, insurance and securities subsidiaries.

Financial institutions in Asia can expect demand to grow for financial products such as mutual funds, investment-linked insurance products, alternative investments and other wealth management products, since much of Asian household wealth still remains in low-yield deposits or pension schemes. In Japan, 716 trillion yen (S$9.8 trillion) stays in bank accounts bearing just 0.02% per annum. The upper middle affluent market in Asia, now becoming a particularly attractive target for financial institutions, is expected to grow by 7 - 14% annually for the next decade.
3 LESSONS LEARNED FROM EXPERIENCE

What are the Challenges for the Industry?
Convergence is real and will continue. It cannot be ignored.

However, the extent and pace of convergence will not be homogenous for every economy and legal jurisdiction. It will depend on the needs of the local market, the stage of development of the economy, various macroeconomic factors and the extent to which regulatory reforms permit banks to adapt to face growing competition from foreign institutions and non-bank institutions.

What are the core issues for banks in response to convergence?

First, diversification. Banks are diversifying into a wider range of financial activities, leveraging on their customer relationships and utilising more efficient and effective distribution channels to cross-sell more profitable financial products and win more lucrative clients.

'Bancassurers' selling banking, insurance, and investment products at their branches, via their ATM networks, and through the Internet, appears to be a dominant model for accomplishing this so far. The Life Insurance Association has even projected that banks in Singapore will contribute 30 percent or more of new sales of insurance policies in 2002, compared to 15.2 percent in 2001.

Wealth management is another area of growing industry interest. For a long time, private banks were alone in providing specialized financial asset management services for high net worth individuals. But the market is growing rapidly. Approximately 7.2 million people worldwide have more than US$1 million each in investible assets for a total of approximately US$27 trillion in wealth in 2000. This is expected to grow by 8% annually to US$39.7 trillion by end of 2005.

So banks and other financial institutions are rushing in to services this market, and are creating new products and specialised asset management services to appeal to these wealthy individuals, as well as to the second tier market referred to as the so-called mass affluent market.

The distinction between private banks and commercial banks is blurring, as the latter expand their range of services beyond deposit taking and lending to include investment management, financial analysis, securities brokerage, and legal, tax and accounting assistance.

Second, the emergence of multinational financial conglomerates. Banking, securities and insurance firms are forming multinational diversified financial
groups, which are managed on an integrated basis from the head office where
the mind and management of the group resides. This allows them to locate their
businesses where it is most efficient from a business perspective and to reap
economies of scale and scope, as well as managerial efficiencies.

Third, risk management. Financial institutions are finding new and complex
financial products to actively manage their risks and reduce regulatory capital
requirements. For example, credit derivatives and asset securitisation allow
banks to buy protection to mitigate severe concentrations and correlations of
found that the notional principal of outstanding credit derivatives was
approaching US$1 trillion globally.iii

The threats of convergence may be more tangible than the opportunities.

The immediate reality for bankers is that you have more competition for a share
of your customer’s wallet from insurance companies and securities dealers
offering deposit-substitutes, annuities and wealth management products.

You have no choice but to raise the level of your game to compete. This means
employing well-qualified and well-trained staff to innovate and market new
financial products, improving systems and controls for better risk management,
and seeking opportunities for mergers and acquisitions.

Another threat, disintermediation, is also real but the good news is that it seems
to have been overblown. Corporate clients want access to capital markets, but
they also want packages of funding that include traditional bank loans. Often
they are able to negotiate better loan terms with a friendly banker than the capital
markets can offer, particularly when risk premiums in capital markets rise, as
they have done recently. The recent fall in equity markets has helped arrest the
other side of disintermediation, which is the flight of bank deposits to equity-
linked mutual funds.

The “Holy Grail” of convergence remains elusive. Financial intermediaries want
to be the first place that customers look for their financial needs but customers
want to deal with the perceived specialists for each service. To date, no one that
I know of has created a successful “one-stop shop”, winning a 100% share of
financial services purchased by their customers.

The most successful strategy seems to be to look for incremental gains in share
of customer’s wallet, while positioning the bank as the “aggregator” of all financial
services used by customer. But that remains to be proven in practice.

Let me now turn to the regulatory environment in which you operate.
What are the Challenges for the Regulator?

How can the regulator best respond to innovation and developments in the financial markets given that convergence is real and will continue?

One thing has not changed. The relationship between consumers, financial institutions, governments and regulators will continue to be an interactive one. Regulators will still rely on:

• self-governance by the board and executive management of the financial institution,
• discipline imposed by well-informed market participants, and
• official oversight to curb imprudent behavior and maintain financial stability.

But it seems to me that the regulator must also facilitate the changes that come with convergence, be responsive to industry needs, and let the market take the lead in mergers and acquisitions and assessing new products and business lines.

I can identify two particular challenges for regulators arising from convergence.

The first challenge is conglomeration and the difficulty of supervising a complex, multi-national, multi-industry corporate group.

Some financial conglomerates offer a variety of financial services beyond the traditional banking and insurance activities and operate in a multiplicity of jurisdictions. Their corporate structures can be highly complex to meet the requirements of various legal jurisdictions, minimize tax, and arbitrage the diverse regulatory and accounting rules that vary between industries and countries. Some entities within the conglomerate may not even be regulated.

It is now generally accepted by banking regulators that financial conglomerates need to be supervised on both a solo and consolidated basis to take into account supervisory concerns such as multiple-gearing, risk concentrations and related party transactions at the group level that may be overlooked at the entity level. At least one supervisor, usually the home regulator, has to have comprehensive oversight of all the operations of the corporate group, wherever the operations are located.

Within countries, impediments to effective consolidated supervision exist, including legislative barriers, and different accounting and regulatory regimes for different industries.

Internationally, regulation is still largely country-based, making it difficult for one regulator to singlehandedly enforce effective supervision of the operations of a multinational group. Closer cooperation must increasingly be built among regulators across industries and national borders.
A related supervisory challenge of convergence is the need to move to functional rather than industry-specific supervision.

Regulators need high levels of expertise in risk-areas common to all financial service industries. But differences between industries remain, and regulators also need a deep understanding of differences between industries and of the converging financial market as a whole.

Second, institutions, activities and products have evolved to create new and more complex risks and closer linkages and similarities among various types of financial institutions.

Banks and other financial institutions now have the capability to strip out risks from a financial asset and package them in different ways for different customers via credit derivatives and asset securitisation. Some financial institutions are seeing themselves as portfolio risk managers with differing risk-return appetites, rather than as banks or insurance companies.

Traditional differences in the balance sheets of banks, insurance companies and other financial firms are slowly eroding, which will make it harder for regulators to regulate banks as banks and insurance companies as insurance companies.

The benefits of risk transfer mechanisms are well-advertised by the investment bankers who structure them. But risk transfer mechanisms can, in the absence of proper disclosures, make it difficult for regulators as well as investors to understand the true financial position of an individual institution, its counterparties, to say nothing of the position of the financial system as a whole.

4 HOW ARE NATIONAL REGULATORS RESPONDING TO CONVERGENCE?

The growing emphasis on cooperation and information sharing among regulators, through “Core Principles”, bilateral MOUs and other initiatives at the international level, and the global trend towards integrated supervision at the national level show that regulators are proactively responding to market developments.

Regulators have played an active role in seeking the harmonisation of accounting, auditing and disclosure standards around the world. These efforts have included the formation of the International Accounting Standards Board, and research into the fair value accounting initiative, which may be the best hope for cross-industry harmonization, even though there are serious issues that would have to be addressed before fair value accounting could be introduced.
Second, regulators are attempting to raise standards of practice through adoption of internationally-accepted “Core Principles” and by implementing voluntary mechanisms to encourage implementation of these principles around the world through the International Monetary Fund / World Bank Financial Sector Assessment Programme. These core principles have included the concept of consolidated supervision, which many see as essential for effectively regulating multinational conglomerates.

Third, the regulatory community is attempting to understand differences between prudential rules for different industries and is studying ways of narrowing the differences. A number of international groups of regulators have been formed for this purpose. The Joint Forum in particular has added much-needed analysis to these questions. This has supported the development of core principles and the enhancement of risk-based supervision and capital requirements across the three sectors.

Fourth, at the national level, the practice of integrated supervision seems to be growing. Different models of integration have been employed, in terms of both scope, by which I mean the number of industries supervised by the integrated regulator, and depth, which refers to how extensive is the integration of supervision within the regulator.

MAS was the first integrated supervisor, acquiring powers to regulate the insurance and securities industries in 1971 and 1984 respectively.

Canada and the Scandinavian countries followed shortly. Australia, Japan, Korea and the United Kingdom are also among the members of the international community of integrated supervisors.

Some integrated supervisors are relatively new, having only recently acquired the powers to supervise two or more types of institutions, and are still experimenting with their supervisory models to see what will work to achieve their objectives.

Other regulators that have so far not proceeded along the lines of integration supervision are now actively considering doing so. Examples include Germany and the Netherlands.

5 WHAT IS THE MAS APPROACH TO CONVERGENCE?

MAS’ philosophy is to facilitate the changes that are driven by market realities, and not attempt to lead or hinder them. Our approach is to shape a framework of broad principles that will allow us to be flexible and adaptable as the industry changes.
In the past, it was possible for MAS to set very high prudential standards and to ring-fence weaker players by restricting their scope of activities. We managed to minimize risk successfully and in the process built a strong international reputation as an honest and competent supervisor.

Now, the challenge is to shift the balance towards developing Singapore as a vibrant, dynamic, open, world-class financial center, supported by robust 'horizontal' beams - a strong legal system, good accounting standards, a highly skilled labour force and an efficient state-of-the-art technological infrastructure, while maintaining confidence in the financial system.

We are well-positioned to take on this challenge, having the authority to supervise banking, insurance and securities activities within a single agency and building on almost twenty years of experience. We are now systematically reviewing our regulatory and supervisory policies. We will continue to build expertise and specialist resources to supervise both financial conglomerates and specialized firms better.

So far, we have taken the first steps towards harmonization of the regulatory framework in the omnibus Securities and Futures Act and Financial Advisors Act after much industry consultation. We are still in the early stages of studying the desirability and feasibility of more harmonization across sectors as the industry experiences convergence. Not all rules can be harmonized, as differences between industries will remain. MAS will harmonize prudential rules where there is good reason to do so, and remove rules that no longer have value. In this way, we hope to allow firms to make better business decisions, increase consumer awareness and inspire greater confidence in the integrity of the market.

One of our key initiatives on which MAS has been consulting with the industry is the move towards risk-based capital frameworks for life insurers, and member firms of the Singapore Exchange. Moving towards risk-based capital is a step to make regulatory requirements more comparable, consistent, and closely calibrated to the risk profile of an institution. This will promote a more level playing field for financial firms and discourage regulatory arbitrage. But there are important distinctions that reflect legitimate differences in the objectives of regulatory capital for different types of institutions, particularly as banks still play a very important role in maintaining systemic stability.

6 CONCLUSION

Let me conclude by summarizing what convergence means for banks and regulators:
First, convergence is creating both threats and opportunities for the banking sector that cannot be ignored. Banks will have to become more aggressive simply to preserve market share and even more aggressive to grow and increase profitability.

Second, in this dynamic business and macroeconomic environment, a regard for prudential standards must underpin your business decisions, so that your customers will ultimately benefit from higher standards of service on both a short term and longer term basis.

Third, the rise of financial conglomerates creates opportunities for financial intermediaries to reap economies of scale and scope by expanding into other activities or adopting a more efficient management style. Regulators must ensure that the conglomerate as a whole is adequately supervised and does not pose a threat to our regulatory objectives.

Fourth, financial intermediaries must ensure that risks are well-managed. It will be as important for banks and their regulators to have the right range of tools for risk management as it is to know the limitations of those tools.

Finally, MAS will seek to facilitate convergence and other market driven changes while helping to preserve the safety and soundness of Singapore's financial sector.

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