Tenets of Effective Regulation

Monetary Authority of Singapore
June 2010

TENETS OF EFFECTIVE REGULATION

TABLE OF CONTENTS **PAGE**

EXECUTIVE SUMMARY 1

1 INTRODUCTION 4

2 EFFECTIVE REGULATION FOCUSED ON OUTCOMES 8

3 THE TENETS OF EFFECTIVE REGULATION 14

TENET 1: OUTCOME FOCUSED...14

Examples of Application of Tenet 1...16

TENET 2: SHARED RESPONSIBILITY 17

Examples of Application of Tenet 2...20

TENET 3: RISK APPROPRIATE...21

Examples of Application of Tenet 3...23

TENET 4: RESPONSIVE TO CHANGE AND CYCLES 24

Examples of Application of Tenet 4...26

TENET 5: IMPACT SENSITIVE...28

Examples of Application of Tenet 5...29

TENET 6: CLEAR AND CONSISTENT 31

Examples of Application of Tenet 6...35

4 SUCCESS REQUIRES A COLLABORATIVE APPROACH.................. 37

EXECUTIVE SUMMARY

This monograph addresses the regulation function in financial supervision in Singapore and describes the Tenets that guide the MAS in the development and review of its regulatory framework. The term “regulation” refers to the establishment of specific rules of behaviour for financial institutions and licensed representatives and in particular to the creation and application of legally enforceable rules that are implemented through legislation, regulations, directions and notices. This is distinct from “supervision”, which means the monitoring and assessment of the risk profile, financial strength, governance, risk management and control procedures, regulatory compliance and business conduct of an institution.

Section 1 (pages 4-7) describes the background to the monograph, its place within the MAS’ Objectives and Principles of Supervision, and its relation to earlier monographs. It aims to raise awareness amongst stakeholders, consumers and users of financial services of the role of regulation in the supervisory process and of the many competing considerations that the MAS has to weigh when deciding whether and, if so, how to intervene in the market. We expect financial institutions – their boards, senior management, and legal and compliance professionals – to have strong interest in this document. Our intent is to communicate to them our approach towards developing effective regulation, our interest in working in partnership with the industry and our expectations of the respective responsibilities of MAS and industry in pursuing this goal.

Section 2 (pages 8-13) sets out how effective regulation has to be relevant to its stated objectives and desired outcomes, specifically:

- a stable financial system,
- safe and sound intermediaries,
- safe and efficient infrastructure,
- fair, efficient and transparent markets,
- transparent and fair-dealing intermediaries and offerors, and
- well-informed and empowered consumers.

MAS seeks to establish sound regulation of a high standard that allows well-managed risk taking and innovation, and which emphasises the stable and sustainable development of the financial services sector. The effectiveness of a regulatory framework is not determined simply by whether it is of such stringency as to prevent any kind of shortcoming in, or failure of, any firm nor, on the other hand, by how dynamic and innovative the financial services sector is. A regulatory framework focused on the first would impose undue costs and constrain innovation without the assurance that it would be effective. A regulatory framework focused on the second may not offer sufficient protection to investors, depositors and customers, and may experience more disruptive consequences in a crisis. Instead, effective regulation has to be understood against a range of considerations relating to:

- the stability of the financial system as a whole even in the event of the failure of one or more financial institutions,
- whether regulation is consistent with international standards while still appropriate to the local context,
- the degree of shared responsibility for regulatory outcomes among financial institutions and stakeholders,
- flexibility for the exercise of judgement by both supervisors and financial institutions,
- the balance of costs and benefits, and
- the transparency and clarity of regulation.

MAS' regulatory framework is underpinned by six fundamental Tenets of effective regulation which derive from and elaborate on the MAS' principles of financial supervision – "Risk-Focused", "Business-Friendly", "Disclosure-Based" and "Stakeholder-Reliant" [para 2.5]. These six Tenets are set out in para 2.6.

Section 3 (pages 14-36) discusses each of the Tenets in turn and gives examples of how each has been applied in practice.

Tenet 1: "Outcome Focused" requires MAS to uphold sound regulation of a high standard and to give consideration to all of the six Tenets concurrently. Where the Tenets do not pull in the same direction, to exercise appropriate judgement as to how and in what measure the Tenets should be applied in the particular circumstances of each new regulation so that good regulatory outcomes can be achieved [paras 3.2 – 3.7].

Tenet 2: "Shared Responsibility" acknowledges that regulation alone is insufficient to deliver good regulatory outcomes. In many areas, good outcomes are most effectively achieved with the MAS, financial institutions, investors and consumers each taking on specific responsibilities for and shared ownership of regulatory objectives and outcomes [paras 3.8 – 3.12].

Tenet 3: "Risk Appropriate" advocates that, while MAS establishes standard, baseline regulatory requirements for broad application, it should be able to exercise supervisory judgement to set higher standards or to grant exemptions where justified in the particular circumstances of an individual financial institution or transaction. The consequences for regulatory breaches should be proportionate to the risks posed to regulatory objectives [paras 3.13 – 3.16].

Tenet 4: "Responsive to Change and Cycles" recognises the need for the regulatory framework to be updated to keep pace with changes in the industry and as new risks emerge. Regulation should also require the pre-emptive build-up of prudential buffers in financial institutions to weather a downturn or stress events, including financial, operational and business conduct risk events, as well as be able to respond to macroprudential risks across the financial system [paras 3.17 – 3.20].

Tenet 5: "Impact Sensitive" requires that the costs and impact of major new regulatory initiatives be assessed and a judgement made of the balance of costs and benefits. Regulation should be targeted clearly at specific and material risks to the objectives of financial supervision. Regulation should be designed with due regard to its market and cost impact so that it is not unduly burdensome whilst maintaining a high standard consistent with established international standards and practices [paras 3.21 – 3.24].

Tenet 6: "Clear and Consistent" explains that regulation should be clear so that institutions have certainty and predictability as to their legal obligations. Regulation should be consistent over time and not be subject to frequent or sudden change that causes disruption. Where appropriate, there should be consistent treatment of like activities conducted by institutions of different sectors [paras 3.25 – 3.40].

Section 4 (pages 37-38) stresses that, while the Tenets set demanding standards for MAS and while it may not always be apparent to stakeholders that we have given equal importance to each of the Tenets especially when they do not all pull in the same direction, they are, individually and collectively, very much at the heart of our approach towards regulation. This means that, in totality, we strive to achieve a sound regulatory framework which is consistent with international standards, with shared responsibility for regulatory outcomes among financial institutions and other stakeholders, which is sensitive to the risks it is aimed at and the impact it creates, as well as more responsive to changes in the industry, risks and cycles, and which also provides sufficient flexibility to set requirements that are commensurate with the risk profile and unique circumstances of a particular financial institution.

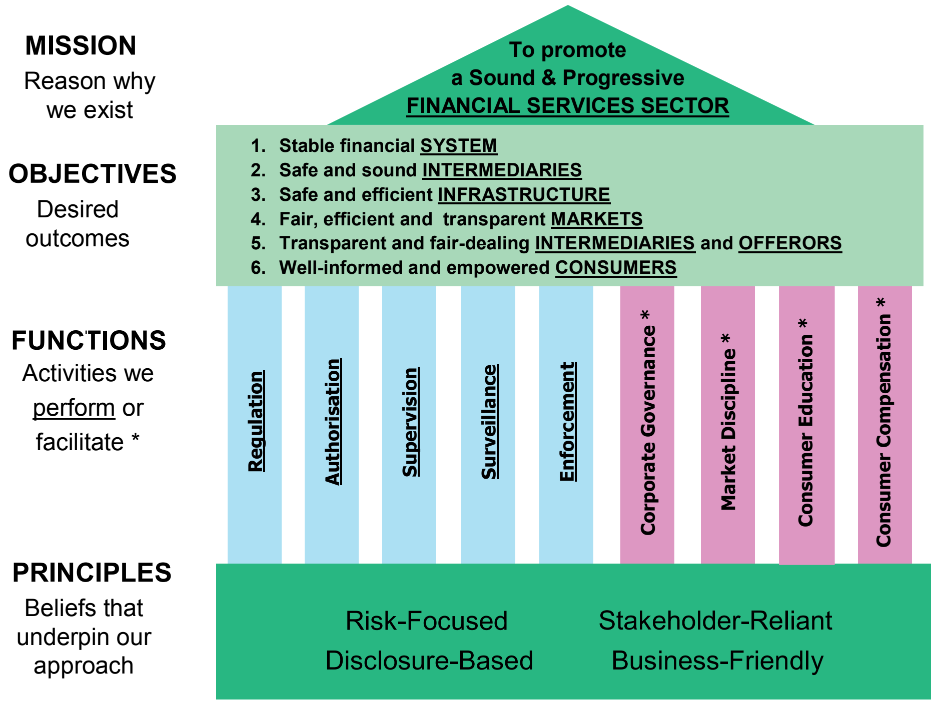
Success in achieving effective regulation requires more than MAS setting demanding standards of itself. Industry has a critical role to play by taking shared responsibility for and ownership of the regulatory objectives and outcomes that MAS has established, by contributing constructively towards regulatory objectives and framework, and by instituting high standards of governance and controls in which MAS can place confidence [paras 4.1 – 4.3].

TOWARDS BETTER REGULATORY OUTCOMES
- TENETS OF EFFECTIVE REGULATION -

1 INTRODUCTION

1.1 The mission of MAS is to promote sustained and non-inflationary economic growth, and a sound and progressive financial services sector. To discharge its mission, MAS undertakes several functions, which include the conduct of monetary and exchange rate policy, and the supervision of the financial services sector. MAS set out its approaches to financial supervision and exchange rate policy in its monographs of 2004 and 2007 respectively. The objectives, functions and principles of MAS' financial supervision mandate that were set out in our 2004 monograph are represented schematically below.

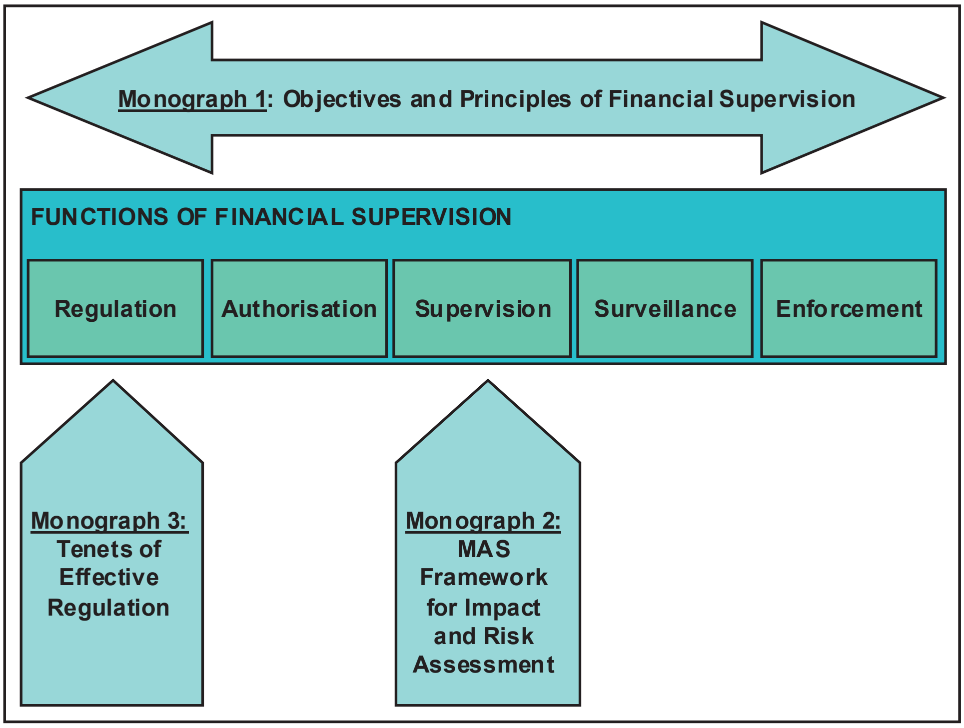
Exhibit 1: Objectives and Principles of Supervision [1]



[1] In the chart and in this paper as a whole the term **regulation** refers to the establishment of specific rules of behaviour to which financial institutions are required to adhere and **supervision** means the monitoring of the behaviour generally of financial institutions, including compliance with rules and regulations. When the term **"supervision"** is used in isolation, we intend it to mean the broad oversight of the financial services sector, including both regulation and supervision.

1.2 From time to time, MAS will issue focused monographs setting out detailed approaches underpinning specific functions that come under the broad rubric of financial supervision. In this regard, MAS has developed two focused monographs. The first, on "MAS' Framework for Impact and Risk Assessment of Financial Institutions" was issued in April 2007, and this monograph on "Tenets of Effective Regulation" is the second. The April 2007 monograph describes the methodology MAS uses in assessing the risk and impact of individual financial institutions through offsite and onsite supervision, explains how MAS prioritises and allocates its supervisory resources, and touches on the supervisory tools available to MAS to require remedial action by financial institutions. This monograph addresses the regulation function in financial supervision. By regulation we refer to the establishment of specific rules of behaviour, in particular the creation and application of legally enforceable rules that are implemented through legislation, regulations, directions and notices. It does not refer to the activities of on- and offsite supervision aimed at assessing a financial institution's risk profile, financial strength, governance, risk management, control procedures and business conduct, and at providing recommendations for improvement. Although it is not their primary subject, both monographs touch on some of the issues relating to the enforcement function.

Exhibit 2: MAS Monographs



1.3 In this monograph on the "Tenets of Effective Regulation", we discuss the Tenets or principles that guide the design and formulation of regulation. It explains our regulatory approach that we believe enables us to achieve the outcome of a sound and progressive financial services sector. Here, we do not discuss in detail the role or objectives of financial supervision, as these have already been addressed in the 2004 monograph on financial supervision. Instead, we focus on the "how" of regulation rather than the "why" or "what". The "how" is important because, firstly, the outcome we seek to achieve – a sound and progressive financial services sector – requires considerable care in the design of regulation and the exercise of judgement and, secondly, because MAS utilises a full tookit of regulatory instruments to achieve our desired outcomes. The Tenets guide the selection and design of the appropriate regulatory instrument under each set of circumstances. MAS' regulatory toolkit includes:

- Risk-based measures such as those pertaining to capital and liquidity;
- Bright lines to restrict activities and risk-taking so that overall risk profile and business models are kept within bounds;
- Powers for MAS to exercise supervisory judgement to impose higher or lower requirements when these are appropriate in the particular circumstances of a financial institution;
- Requirements to build up prudential buffers ahead of a downturn or crisis, such as in provisioning, and to address macroprudential risks;
- Prescriptive and detailed rules for compliance as well as statements of principles that financial institutions can implement in their own ways to achieve the desired outcome;
- Institutionalised requirements for good corporate governance in financial institutions;
- Regulation which lays down responsibilities for financial institutions to observe and deliver, including responsibilities for accurate and timely disclosure, fair dealing, risk management and controls;
- Incentives in regulation for financial institutions to contribute towards regulatory outcomes;
- Safety nets for depositors and investors that balance moral hazard with considerations for stability; and
- Powers for MAS to intervene effectively in individual financial institutions when supervisory objectives are at risk, and to administer appropriate sanctions for regulatory non-compliance.

1.4 We expect financial institutions – their boards, senior management, and legal and compliance professionals – to have strong interest in this document because they are the most directly affected. Our intention is to communicate more clearly to this group our approach towards developing effective regulation, our interest in working in partnership with the industry and our expectations of the respective responsibilities of MAS and industry. With regards to consumers, users of financial services and stakeholders generally such as external auditors, rating agencies, analysts and investors, this monograph is intended to raise awareness of the role of regulation in the supervisory process, the competing considerations that MAS has to weigh, and the Tenets that guide our work when determining how to intervene in the market.

2 EFFECTIVE REGULATION FOCUSED ON OUTCOMES

2.1 Effective regulation has first and foremost to be relevant to its stated objectives and desired outcomes. The objectives of MAS' financial supervision are set out in Exhibit 1 and these apply fully to the function of regulation.

2.2 Following the 2008 global financial crisis, the importance of regulation to a stable financial system has taken on renewed importance and international regulatory standards are being reviewed and tightened. Distinct aspects of the international regulatory standards for banks have been found inadequate, particularly in the areas of capital, liquidity and resolution. More fundamentally, there has been a recognition that too much reliance had been placed in some jurisdictions on financial institutions themselves to manage risks and on markets to be self-correcting. The perceived benefits of financial industry innovation may have been over-estimated and those of regulation and stability, under-appreciated. The tightening of regulatory standards internationally will require real shifts in such jurisdictions. In Singapore, our longstanding approach has been to establish a prudent regulatory framework and a stable financial system, so that these form the basis for a progressive financial services sector. MAS believes our balanced regulatory approach – sound regulation of a high standard which allows well-managed risk-taking and innovation - remains relevant. By sound regulation of a high standard, we mean regulation with a high degree of consistency with international standards and good practices. International standards and practices are adapted appropriately to our local context and in some instances, regulation in Singapore exceeds international standards. This ensures a high level of confidence among stakeholders that regulatory objectives are being met and good regulatory outcomes (e.g., safe and sound, fair dealing financial institutions and a stable financial system) are being achieved.

2.3 How do we know our regulatory approach has worked and continues to work? The effectiveness of a regulatory framework can seldom be practicably judged against well-defined performance indicators. The absence of financial crises is not conclusive evidence of a stable system nor of safe and sound intermediaries. On the flip side, the occurrence of an isolated incident of distress or an instance of unsatisfactory regulatory and customer outcome are not in themselves evidence of an unstable system. Consideration also needs to be given as to whether the financial services sector provides customers and the economy with a wide choice of financial services delivered efficiently at a competitive cost. We do not aim to run a supervisory regime of such stringency that it guarantees there will never be any kind of shortcoming in behaviour or failure of any firm. Such a tight regulatory regime would impose undue costs directly on the industry and indirectly on users of financial services. Furthermore, it would constrain innovation and choice without the assurance that it would be effective in achieving its intended objective. We do however expect our regulatory regime to be sound and underpin the stability of the financial system as a whole, as well as support sustainable development of the financial services sector through efficient and responsive regulation that is not unduly burdensome.

2.4 The effectiveness of a regulatory framework therefore has to be understood against a broad range of tests or considerations that include the stability of the financial system as a whole, the transparency and clarity of regulation, the balance of costs and benefits, and the needs, often competing, of the various stakeholders. These include:

- Is the financial system as a whole stable even in the instance of the failure of one or more financial institutions?
- Is the financial system serving the needs of customers and the economy efficiently?
- Are regulatory standards of a high quality, consistent with international standards and best practice, yet appropriate to the local context?
- Is there shared ownership of the desired outcomes of regulation among stakeholders?
- Does the balance of benefits and costs weigh in favour of regulation?
- Are market incentives alone likely to deliver a desired outcome?
- Are the obligations imposed by regulation on regulated entities clear?
- Does regulation take into proper account market practices and legitimate commercial considerations?
- Does regulation provide regulated entities with legal certainty and predictability where it is needed and, where appropriate, flexibility to apply their own practices to meet regulatory objectives?
- Does the regulation provide a level playing field for potentially competing activities and institutions?
- Does regulation recognise that some institutions may have lower risk profiles and stronger governance and controls? Does it provide differentiated treatment where appropriate and can it adjust in a timely fashion if the risk profile changes?

- Is the regulatory framework able to adapt to fast-changing practices and products as well as to new risks in the financial services industry so that it can continue to be effective in respect of its intended regulatory objective and impose obligations that remain appropriate?

2.5 To be effective amidst and with regard to these various considerations and stakeholder needs, regulation has to observe and uphold fundamental Tenets. These Tenets of effective regulation are explained in this monograph. The Tenets draw from key themes presented in the four principles of financial supervision mentioned in Exhibit 1. These four principles are “Risk-Focused”, “Business-Friendly”, “Disclosure-Based”, and “Stakeholder-Reliant”.

- By “Risk-Focused”, we mean that MAS will evaluate the risk posed by institutions and activities to our supervisory objectives and will give a supervisory and regulatory response that is proportionate and appropriate to the risk posed.

- “Business-Friendly” expresses our approach to give due regard to the impact of supervision and regulation on competitiveness, business efficiency and innovation in the financial services industry, and calls for MAS to be responsive to the changing business environment and to adopt a consultative approach to regulating the industry.

- “Disclosure-Based” advocates the disclosure of relevant information by financial institutions and product providers in a timely, accurate and adequate manner so that consumers, investors and stakeholders can make their financial decisions in as well-informed a way as possible.

- By “Stakeholder-Reliant”, we acknowledge and encourage the contribution that financial institutions individually, the financial industry collectively and other stakeholders, such as shareholders, creditors, counterparties, depositors, investors or policyholders, as well as external auditors and rating agencies, can make in achieving outcomes that are aligned with MAS’ supervisory objectives.

2.6 These four broad principles – Risk-Focused, Business-Friendly, Disclosure-Based, Stakeholder-Reliant – which guide MAS’ work in all functions of financial supervision are certainly relevant to the function of formulating and reviewing regulation, but need greater articulation if they are to be applied to practical effect. Hence the need for a set of Tenets of effective regulation that extends from these four principles and which speaks specifically to the function of regulation:

Tenet 1: "Outcome Focused" commits MAS to uphold sound regulation of a high standard[2] but also acknowledges that there is no one way to do this. Good regulatory outcomes can sometimes be best achieved by prescriptive and clear rules, and at other times by laying down broad principles and placing responsibility on financial institutions to deliver the regulatory outcomes. There are also different circumstances when one-size-fits-all rules or alternatively, differentiated rules are more appropriate. Sometimes, regulation is aimed specifically at impacting market practices in a significant way and even changing them, and at other times the impact of regulation is more appropriately calibrated and mitigated. An outcome focused approach calls on MAS to give consideration to all of the six Tenets and to exercise appropriate judgement as to how and in what measure the Tenets should be applied in the particular circumstances of each new regulation so that good regulatory outcomes can be achieved. Tenet 1 flows from all four of the broad principles of financial supervision – "Risk-Focused", "Business Friendly", "Disclosure Based" and "Stakeholder Reliant".

Tenet 2: "Shared Responsibility" describes our belief that regulation alone is insufficient and that in many instances, regulatory outcomes can be more effectively achieved with the MAS, financial institutions, investors and consumers each taking on specific responsibilities and shared ownership of supervisory objectives and outcomes. In addition to MAS' prescription of specific behaviours through regulation, reliance and responsibility can also be placed where appropriate on financial institutions individually, their boards and senior management, through their governance, and on the industry collectively, to address supervisory concerns directly. Where appropriate and effective, we will also consider, as an alternative to regulating an activity, placing reliance on disclosure of timely and adequate information so that informed consumers, investors and other stakeholders may exercise choice and market discipline. The design of regulation should wherever appropriate provide for rather than take away from financial institutions and stakeholders' responsibility and incentives to contribute towards regulatory outcomes. Tenet 2 flows from the principles of "Disclosure-Based" and "Stakeholder-Reliant".

[2] By sound regulation of a high standard, we mean regulation with a high degree of consistency with international standards and good practices, and which are adapted appropriately to our local context (and in some instances, exceeding international standards), so that overall there is high level of confidence among stakeholders that regulatory objectives are being met and good regulatory outcomes achieved.

Tenet 3: "Risk Appropriate"

Regulation should set standard, baseline requirements of broad application and provide for the exercise of supervisory judgement to set higher standards or permit exemptions when merited by the particular circumstances of a financial institution. For example, more demanding regulation may be appropriate for systemically important financial institutions whose failure can cause widespread disruption to the financial system compared to a small institution in the same licence category with simple operations. Tenet 3 flows from the principle of "Risk-Focused".

Tenet 4: "Responsive to Change and Cycles"

Regulation should be updated expeditiously as industry and market practices change and as new risks emerge. Regulation should also require the pre-emptive build-up of prudential buffers in financial institutions to weather a downturn or stress event, and to effectively address macroprudential risks. Tenet 4 flows from the principle of "Risk-Focused".

Tenet 5: "Impact Sensitive"

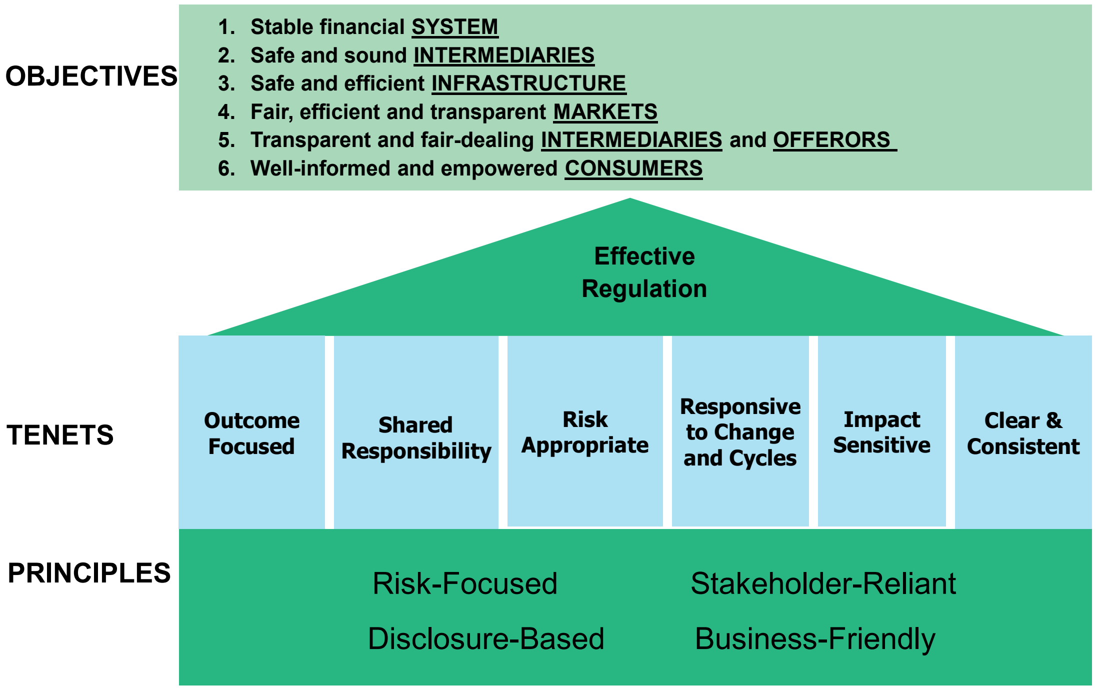
The costs and impact of regulation should be considered alongside the benefits and desired outcomes of regulation, so that the costs are not disproportionate to the benefits. Regulation should be targeted clearly at specific and material risks to the objectives of financial supervision. The design of regulation should take into account market realities so that unintended and unnecessary disruption to market practices is minimised. Even in instances where regulation is specifically aimed at changing market practices, care will be taken to avoid placing undue burden. Tenet 5 flows from the principles of "Risk-Focused" and "Business-Friendly".

Tenet 6: "Clear and Consistent"

Regulation should be clear so that institutions have reasonable certainty as to their legal obligations. Regulation should not be subject to frequent and sudden changes that cause uncertainty and disruption to business and market practices. Where appropriate, like activities conducted by regulated institutions from different sectors should be subject to similar and consistent regulation. Tenet 6 flows from the principle of "Business-Friendly".

2.7 We show schematically below that the four broad principles express the fundamental beliefs underlying MAS' approach to all the different functions of financial supervision. These principles form the foundation on which we elaborate a set of Tenets that are more focused and specific to the function of regulation. These Tenets guide MAS' work in developing and constantly reviewing the regulatory framework so that it remains effective. Effective regulation, together with the other financial supervision functions detailed in Exhibit 1, contributes towards the six objectives of financial supervision.

Exhibit 3: Tenets of Effective Regulation



3 THE TENETS OF EFFECTIVE REGULATION

3.1 We discuss below each of the six Tenets of effective regulation in turn and give illustrations of how we seek to uphold them.

Tenet 1: Outcome Focused

3.2 The financial services sector performs an important role in the economy, intermediating credit and allowing the real sector access to capital and offering investors a range of products that span the risk-reward spectrum. A stable, competitive, innovative and efficient financial services sector yields benefits to the real economy. However, because of its functions in maturity and risk transformation, leverage and risk-taking activities, the financial services sector can from time to time experience significant losses and crises. Too little regulation and too much emphasis on market discipline has proven to offer poor assurance for stability. Neither is tight regulation the answer, as overly strict regulation can stymie innovation and lower efficiency in the financial services sector, as well as raise the cost of credit and capital to the economy. **A balanced regulatory approach is needed; one focused on delivering good regulatory outcomes and that best advances our mission to promote a sound and progressive financial services sector**.

3.3 We eschew a polarised or ideological view of the efficacy of regulation relative to market discipline. When sound regulation, market discipline and corporate governance are used in combination and in the right measure, this can lead to better regulatory outcomes than a reliance on either tight regulation or market discipline alone. **MAS' regulatory approach is fundamentally outcome focused**. The regulatory outcomes we seek pertain to MAS' mission of promoting the sustainable and stable development of the financial services sector and the six supervisory objectives set out in Exhibit 1. Our outcome-focused approach has two components which will be discussed in turn below:

a. a prudent and credible regulatory framework of a high standard;
b. the exercise of judgement in the application of all six Tenets in the review, development and design of regulation.

3.4 **Regulation should be of a high standard, consistent with international standards and practices**. This does not mean that standards elsewhere are adopted wholesale into Singapore. Frequently, international practices differ substantially, and even where international standards exist, MAS will consider the appropriateness of any regulatory design in our local context. In some instances, an activity may not be material in Singapore and therefore the prescriptive rules in some jurisdictions may not be needed and appropriate here. In other areas, it may be appropriate for regulation in Singapore to exceed international standards and practices on account of the specificities of the risk exposures and market structure here. For example, minimum capital adequacy ratios for banks incorporated in Singapore are set higher than international standards on account of the less diversified and emerging market focus of their balance sheets. There will also be occasion for Singapore to take our own approach if there are no international precedents, or if experiences elsewhere are not relevant or useful for our purposes.

3.5 MAS considers it important to apply appropriate regulation according to the risk profile of a financial institution. This is discussed further under **Tenet 3** “**Risk Appropriate”**. Even so, experience has demonstrated that risk measurement and management methodologies are not able to quantify and address tail risks well, nor do risk mitigation and hedging work fully as intended in times of stress. Should these tail risks materialise or if risk exposures turn out higher than estimated, they can have dramatic and disruptive consequences for the financial system and economy. Thus, regulation has a role in laying down some bright lines and clear limits to financial institutions’ risk-taking activities. With respect to each licence category, regulation may need to disallow certain activities, or allow these activities only within specified limits, so that the overall risk profile of financial institutions in that licence category remain appropriate to the nature of their liabilities, fiduciary responsibilities towards customers, their role in the financial system, their significance to financial stability, and more generally the expectations of customers, shareholders, creditors and stakeholders.

3.6 **Even as we hold steadfast to delivering sound regulation of a high standard, judgement is often needed as to how sound regulation is to be implemented in each set of circumstances (viz type of institution, activity and risk)**. There will be circumstances that demand clear prescriptive rules, particular if industry incentives are not aligned with regulatory objectives; but there will also be circumstances where laying down broad principles and placing responsibility and reliance on financial institutions to deliver regulatory outcomes can be more effective. This may be the case in instances where there is sufficient alignment of interests and incentives, and where behaviours and practices in the industry vary substantially and may not be readily observable for compliance checks and enforcement. These are discussed in greater detail under **Tenet 2 “Shared Responsibility”** and **Tenet 6 “Clear and Consistent”**. Judgement will also be called upon to determine when regulation should seek to level the playing field with one-size-fits all rules so that a set of common minimum standards is established across the industry, and when regulatory outcomes may be better achieved by varying the regulatory treatment to particular circumstances and institutional risk profiles. This idea of bright lines has been discussed in the prior paragraph and differentiated regulatory treatment is discussed under **Tenet 3 "Risk Appropriate"**. Judgement is also needed on how the unintended impact of a regulation should be mitigated. Typically this would either mean sharpening the precision of rules so that unintended effects are avoided, or it may mean calibrating the severity of the impact that the regulation seeks to achieve. Such a judgement will involve consideration of both **Tenet 1 "Outcome-Focused"** which calls for a high standard of regulation, and **Tenet 5 "Impact Sensitive"**.

3.7 Simply put, an outcome-focused approach to regulation requires MAS to uphold sound regulation of a high standard and give consideration to all of the six Tenets concurrently, and where the Tenets do not pull in the same direction, to exercise appropriate judgement as to how and in what measure the Tenets should be applied in the particular circumstances of each new regulation so that good regulatory outcomes can be achieved.

Examples of Application of Tenet 1

1.1 Anti-commingling

In 2000, MAS introduced a policy to separate the financial and non-financial businesses of banks. The intent of this "anti-commingling policy" was to limit the risks posed by non-financial activities to the soundness of banks. Such risks may arise from contagion from non-financial activities or non-arms-length transactions between banks and their non-bank affiliates. Responding to market developments, MAS proposed in March 2010 to allow banks to conduct activities that are related or complementary to the bank's core financial business but which may not be clearly financial or appear to be prohibited under the anti-commingling policy. Such permissible activities could include certain Islamic finance structures that may be akin to trading or other non-financial businesses through the use of tangible assets and risk-sharing structures, but are fundamentally financing instruments. Banks may engage in these activities within specified limits if the activities meet the qualifying criteria, thus improving time to market, without coming to MAS for case-by-case approval. The risks from these activities will be mitigated by conditions, limits and requirements, including a requirement that banks must demonstrate they have the requisite expertise and risk management capabilities before commencing such businesses, and a cap on the aggregate size of the businesses to limit the impact of any potential losses. The anti-commingling policy lay down bright-lines in regulation, while being risk-appropriate.

1.2 Property Lending Limits

In line with financial stability objectives, and the Singapore Government's policy intent of promoting a stable and sustainable property market, MAS' housing loans rules serve to encourage prudent lending and proper credit assessment by financial institutions. The 80% loan-to-value regulatory limit, for example, requires financial institutions to maintain a prudent buffer in their housing loan portfolios, and encourages greater financial prudence among property buyers.

Commercial banks' property sector exposures are also capped at 35% of Total Eligible Assets under the Banking Act. This is to prevent an undue concentration of loans in the property sector and minimise the vulnerability of the banking system to a property downturn. As a land-scarce country with fairly volatile property prices, bubbles in the property market here may have a sizeable impact on our small and concentrated banking system. These systemic risks call for tight control over property lending to achieve our desired outcome of financial stability, and such control may be exercised effectively through a fixed diversification limit.

1.3 Borrowing Limit for Property Funds

MAS introduced a borrowing limit as part of the regulatory framework for property funds in May 1999. This was a prudential requirement to prevent unitholders from being subject to undue risk as a result of excessive borrowing for investment purposes. MAS considered that as a stable, income generating investment vehicle, a property fund should be able to service its debt and not be forced to liquidate its assets, especially at the bottom of property market cycles, to the detriment of unitholders. MAS reviewed the borrowing limit in Dec 2002 and again in June 2005 to provide real estate investment trusts in Singapore (S-REITs) greater flexibility in managing their capital structure while retaining appropriate safeguards. As a result, S-REITs maintained manageable levels of debt. This stood S-REITs in good stead during the global financial crisis in 2008 and 2009 when S-REITs faced significant challenges in refinancing due to the global credit crunch and adverse conditions in the equity markets.

Tenet 2: Shared Responsibility

3.8 In many circumstances, direct prescriptive regulation of specific behaviours and processes for compliance by financial institutions may not be the most effective means of achieving the desired regulatory outcomes.

Often, the prescription cannot be sufficiently detailed to address different scenarios. More fundamentally, the financial institution will be seeking only to avoid non-compliance with regulation rather than to contribute positively to regulatory outcomes. Where there are sufficient incentives and hence shared ownership of regulatory outcomes on the part of financial institutions, it may be both feasible and more effective to rely on financial institutions to address these issues either individually through internal practices not prescribed by detailed regulation or collectively through industry initiatives as an alternative to regulation, such as industry rules and codes of practice. Regulation in these circumstances could do one or both of the following. **First, regulation could place explicit responsibility on financial institutions to institute processes to achieve specific regulatory outcomes. Second, regulation could support industry-driven initiatives by giving recognition to sound internal practices in financial institutions** and/or allowing financial institutions the flexibility to achieve regulatory outcomes through consistent adherence to statements of principles in regulation or through meeting standards set out in guidelines which are recommended practice but not legal obligations. Regulation should also avoid taking away incentives and responsibility to contribute towards regulatory outcomes from financial institutions and stakeholders. We elaborate on our approach by discussing two specific areas below.

3.9 First, we consider that the area of governance, internal control and risk management of financial institutions is more effectively addressed directly by the board and senior management of individual institutions than by prescriptive regulation. **MAS' Guidelines on Risk Management Practices (February 2006)** places clear and explicit responsibility on the board and senior management of financial institutions to establish policies and procedures for the institution's business activities and the management of risks inherent in these activities. Controls and risk management practices need to be relevant and appropriate to the nature, scale and complexity of the institution concerned. No single set of prescriptive rules laid down by the regulator will be comprehensive or flexible enough to address the dynamic combination of characteristics that may exist for any institution. **The regulatory framework should recognise and provide incentives for good governance, controls and risk management practices by institutions**. This recognition can take the form of relief or exemption from regulatory requirements or a substitution of regulation for the internal practices of the institution. The regulatory framework can also support this effort by setting high corporate governance standards such as mandating the establishment of various board committees and requiring independent directors for the board and its main committees. The regulatory framework can also establish a basis for MAS to enter into an ongoing dialogue with individual institutions to continually improve and strengthen their governance, controls and risk management.

3.10 Second, the area of market and business conduct, which pertains to how financial institutions transact with each other and with their customers, is one in which we may not always be able to legislate good outcomes through formal rules effectively. Compliance with ever more prescriptive rules is a second best solution to a situation in which a financial institution takes ownership of positive conduct outcomes and embeds the processes and organisational culture that consistently delivers such outcomes. **MAS' Guidelines on Fair Dealing – Board and Senior Management Responsibilities for Delivering Fair Dealing Outcomes to Customers (April 2009)** specifically sets out board and senior management responsibilities for fair dealing outcomes in the selection, marketing and distribution of investment products and the provision of advice for these products.

3.11 Generally, if the industry has clear market incentives as well as sufficient shared ownership of regulatory outcomes to take effective steps to secure these good regulatory outcomes, and if industry associations have the capacity and mandate to take on larger roles in setting standards of good practice, **principles-based regulation or non-legally binding guidelines can work provided they are complemented by the industry setting and maintaining high standards of practice**. Clearly too, the board and senior management of financial institutions have a pivotal role to play in establishing policies and procedures within their firms that contribute towards positive regulatory outcomes. MAS therefore places considerable emphasis on good governance and the quality of board directors. Over the years, MAS has sought to raise standards of corporate governance through regulation and the issuance of guidelines on board governance, director independence and the development and assessment of skills of board directors.

3.12 In addition to reliance on the industry to contribute towards regulatory objectives through internal practices or compliance with industry standards of practice, MAS also places reliance, where appropriate and relevant, on disclosure of timely, accurate and adequate information by financial institutions and product providers to consumers and investors to encourage market discipline. For market discipline to be credible and effective, the disclosure must clearly communicate product and risk information in a manner easily understood by target investors. Furthermore, consumers must be confident that financial institutions deal with them fairly, have access to unbiased advice if required, and have recourse to a convenient and affordable means to seek redress for their grievances. MAS is vigilant against practices that could dilute market discipline, including measures that impede the market for corporate control, and will continue to work in partnership with industry stakeholders to promote high standards of corporate governance and business conduct as part of the corporate culture of all firms and market participants in Singapore.

Examples of Application of Tenet 2

2.1 Conduct & Market Practices for Treasury Activities

The Singapore Foreign Exchange Market Committee (SFEMC) is an industry group comprising representatives from financial institutions actively involved in Singapore's foreign exchange market. As part of its objectives to recommend appropriate standards and codes for use in the market, the SFEMC issues the Singapore Guide to Conduct and Market Practices for Treasury Activities (or "Blue Book"), an example of industry self-regulation. Provided self-regulation remains effective, there is no need for MAS regulation to address the areas covered by the Blue Book. The Blue Book is applicable to all wholesale dealings in the over-the-counter markets for foreign exchange, money market instruments, debt securities, derivatives products and other emerging market instruments. It sets out the principles which should govern the conduct of management and employees at all institutions engaged in these wholesale markets, covering topics such as ethics and behavioural standards, risk management principles, general dealing principles and market conduct, back office practices, and handling market disruptions. For example, the chapter on ethics and behavioural standards sets out the standards dealers and brokers should observe in the discharge of their functions, relating to issues such as confidentiality, dealing for personal account, gifts and entertainment, rumours and false information. The Blue Book is the result of an industry led effort to foster a high standard of business conduct and good market practices for transactions in the relevant financial products and to ensure equitable and healthy relationships between market participants. By setting a benchmark, the Blue Book also seeks to facilitate market efficiency, minimise disputes between counterparties and set an objective basis for arbitration between disputing parties.

2.2 Guidelines on Fair Dealing - Board and Senior Management Responsibilities for Delivering Fair Dealing Outcomes to Customers

On 3 April 2009, MAS issued the "Guidelines on Fair Dealing - Board and Senior Management Responsibilities for Delivering Fair Dealing Outcomes to Customers" (Guidelines). The Guidelines require Board and Senior Management to take ownership of the change process for delivering fair dealing outcomes to customers, including charting the corporate policy and strategy, setting the culture and direction of the financial institution to align business practices with fair dealing outcomes, and monitoring the implementation of the institution's fair dealing strategy.

Since the issuance of the Guidelines, financial institutions have increasingly recognised the importance of dealing fairly with customers and the need to incorporate fair dealing principles into their organisational culture and practices. Some financial institutions have formed fair dealing taskforces or assigned senior members of management to oversee fair dealing initiatives, and have incorporated fair dealing concepts into their business practices. While the industry's implementation of the Guidelines is still at a nascent stage, these are steps in the right direction. Underscoring the important role industry plays in setting standards of good practice, the Life Insurance Association, Singapore, has embarked on a review of its industry guidelines to ensure that they remain relevant and effective in delivering the fair dealing outcomes. The Association of Banks in Singapore has also announced that its member banks have committed to reinforce their focus on achieving the fair dealing outcomes in their sale of investment products and will embed the Guidelines into their sales culture.

MAS will continue to work with the Board and Senior Management of financial institutions to implement fair dealing strategies within their organisations and to steer their organisations towards full attainment of the fair dealing outcomes.

Tenet 3: Risk Appropriate

3.13 Regulation sets down rules of broad application to a particular class of financial institutions so that financial institutions in a given licence category carrying on like activities would generally have to meet the same set of regulatory requirements. This sets a level playing field and ensures that like institutions and like activities are subject to the same regulation. MAS recognises, nevertheless, that one-size-fits-all regulation can often be too blunt. We appreciate that the risk profile, governance, controls and risk management capability of each institution is different. MAS' approach is therefore to rely as much on risk-focused supervision and on ongoing dialogue with individual institutions as on regulation. **Our approach towards developing the regulatory framework is that it should set standard, baseline prudential and market conduct standards for broad application** to a class of institutions or a common regulated activity performed by different classes of institutions. At the same time, **the regulatory framework should empower MAS to exercise supervisory judgement to set higher standards or to grant exemptions for particular institutions or transactions where these are justified**.

3.14 MAS has begun to incorporate features in some areas of regulation that permit a sliding scale of requirements that would depend on our supervisory assessment of an institution's risk profile and governance, control and risk management capabilities. For example, MAS already differentiates the liquidity and capital requirements, subject to a minimum, for specific banks depending on our assessment of their risk profile, governance, and risk management. As the international discussion of macroprudential risks to financial stability progresses, we could in the future potentially include macroprudential assessments such as credit growth or the systemic importance of a financial institution in the determination of the appropriate regulatory treatment.

3.15 A necessary aspect of the regulatory regime is the consequence for the financial institution of non-compliance with regulation through enforcement of remedial action or the imposition of penalties. For institutions, this is an area that may pose legal and regulatory risks, and there is substantial interest that the consequences for regulatory breaches are clear and proportionate to the offence. **MAS considers that consequences for regulatory breaches should be clear and proportionate to the risks posed to regulatory objectives.** This supports the communication of the importance of regulatory obligations to regulated institutions and of the accountability to which they will be held. In promulgating each rule or requirement, whether it is in the nature of legislation, subsidiary legislation, directions, notices, guidelines, codes, practice notes, circulars or policy statements, we aim to be clear as to whether such a rule or requirement would impose legal obligations on affected persons or institutions. To communicate to the industry the nature of each of the instruments promulgated by MAS and the effect of non-compliance with the requirements they embody, we have made available on the MAS website the document entitled **"Classification of Instruments Issued by MAS"**.

3.16 We also consider it helpful to regulated institutions to communicate our policy on enforcement action. We use a varied enforcement toolkit with sanctions that span warnings, private or public reprimands, administrative fines, imposition of supervisory conditions, licence suspensions or revocations, prohibition orders, compositions, civil penalties, criminal fines and custodial terms. Over time, we intend to further improve the alignment of our use of various enforcement tools with the seriousness of the regulatory breach, and to communicate this alignment to regulated institutions more clearly.

Examples of Application of Tenet 3

3.1 Minimum Liquid Assets Requirement

In 2002, MAS introduced a risk-sensitive liquidity risk supervision framework. Prior to 2002, MAS required all banks regardless of their individual risk profiles to keep sufficient high quality liquid assets to meet 18% of their Singapore Dollar deposit liabilities. This one-size-fits-all requirement did not differentiate between banks which were able to manage their liquidity risks well from those which did not, nor took into account the varying cashflow profile of different banks.

The 2002 liquidity framework, which has since been further enhanced, contains significant risk-sensitive features. Banks with good internal liquidity risk management practices are permitted to maintain a level of liquid assets that depends on the volatility of their historical cashflow mismatches and forward projections of cashflows. The level of liquid assets required is also subject to a cap that is dependent on the strength and robustness of the bank's liquidity risk management as assessed by MAS. In assessing the strength of a bank's liquidity risk management, MAS will consider the following:

- Liquidity Policy and Management Oversight
- Maturity Mismatch Analysis
- Scenario Analysis
- Contingency Funding Plan
- Diversification and Stability of Liabilities
- Access to Interbank and Other Wholesale Markets
- Management of Liquidity in Individual Currencies
- Intra-group Liquidity Management

Banks with simple liquidity risk management systems which do not qualify for the approach described above will continue to be subject to the flat requirement which was lowered in July 2008 from 18% to 16% of liabilities. This risk-sensitive approach provides an incentive for banks which put in place robust liquidity risk management to benefit from a lower liquid assets requirement, takes into account the actual cashflow volatility and projected cashflow profile of a bank, and yet provides for a simple approach for banks whose scale and complexity of operations may not justify the investment in sophisticated liquidity risk management practices.

3.2 Securities Offering Regulatory Framework

In October 2005, MAS abolished the concept of "offer to the public" in the Securities and Futures Act in relation to offers of all investments that were required to be accompanied by prospectuses. The term "offer to the public" had not been clearly defined. This resulted in practical difficulties for issuers when structuring offerings that would not be accompanied by prospectuses. MAS reviewed this and adopted an approach under which a prospectus will be required for all offers of investments unless they are specifically exempted due to circumstances where the cost of issuing a prospectus outweighs the benefits of greater disclosure and investor protection. Two new exemptions were introduced which allow private placements and small offers to be made without a prospectus. These exemptions provide clarity and legal certainty for capital raising by small and medium enterprises and help them raise funds more efficiently, without incurring unnecessary regulatory costs.

Tenet 4: Responsive to Change and Cycles

3.17 New products and developments in the financial services industry can render regulation inappropriate, ineffective or even irrelevant. New products or activities may defy traditional classifications in regulation. New ways of mitigating and transferring risk may not be sufficiently recognised under current regulation. New risks may not be addressed by current regulation and regulation may need to be updated to address these new emerging risks or to pre-empt a build up of such risks. There is a further risk in consequences of the procyclical effects of financial industry practices (e.g., margining), risk measures (e.g., VAR), accounting valuations and risk-sensitive regulation (e.g., Basel II), all of which may contribute towards an amplification of losses in a downturn or stress event. In the context of the fast-changing and potentially volatile financial services industry, the responsiveness of the regulatory framework to achieve its intended objectives can be considered in terms of the following two perspectives:

a. how well regulation helps a financial institution to ride through the economic cycle and stress events; and
b. how timely and easily policies and regulations are reviewed, and how quickly and thoroughly regulations can be changed.

3.18 With regards to the first perspective, **regulation should provide for prudential buffers in financial institutions against unexpected loss through an economic cycle or stress event**. These buffers should be built up during periods of profitability so that they are available to absorb unexpected losses during downturns or periods of stress. Buffers can include capital, provisions and reserves as well as liquid assets. Regulation can also potentially contribute towards leaning against the build-up of risks in the form of rapid above trend credit growth or rapid accumulation in the financial system of concentrated exposures to particular sectors or asset classes. As an example, the loan-to-value ratio has been used in many jurisdictions to uphold prudent mortgage lending through the cycle and in some instances has been tightened and applied countercyclically. The objective, though, cannot be to require such a high level of prudential buffers that nothing can ever be expected to go wrong with a financial institution. No commercial enterprise can operate on that basis. In determining the level of prudential buffers, MAS will also have regard to **Tenet 1 "Outcome Focused"** and **Tenet 5 "Impact Sensitive"**.

3.19 In relation to the second perspective, MAS recognises **the need for the regulatory framework to be continually and expeditiously updated to keep pace with changes and developments in the industry.** Changes to regulation can be protracted if these involve fundamental principles and policies enshrined in primary legislation. These must necessarily go through a Parliamentary legislative process. Recognising, however, that detailed rule-making is most effectively and efficiently done by the industry regulator, Parliament has delegated to MAS the powers to issue regulations, directions and notices to regulated financial institutions under empowering provisions in the respective Acts administered by MAS. These regulations, directions and notices issued by MAS pursuant to the various Acts administered by MAS have the effect of law and breaches carry enforceable sanctions and penalties. Although these regulations, directions and notices do not need to be passed in Parliament, they go through a rigorous drafting and vetting process. The shorter process allows them to be issued more expeditiously. Clearly, it is not possible or appropriate for all detailed rule-making powers to be delegated to MAS and there remains substantial detail in primary legislation. For example, the crucial areas of defining which regulated activities and entities are to be impacted by regulatory obligations remain in primary legislation as does the basic framework of regulatory obligations imposed on regulated activities or entities. However, detailed rules are elaborated in regulations, directions or notices.

3.20 Both primary legislation and the body of regulations, directions and notices are amended from time to time so that they remain relevant and effective. **MAS welcomes feedback on a continuing basis from industry and other stakeholders, on any and all aspects of the regulatory framework, at both strategic and operational levels, that may be in need of change or improvement**. MAS will continue to deepen and widen its engagement with the industry and other stakeholders through regular dialogue and improvements to the consultation process. While MAS will respond to all reasonable requests for amendment or other feedback, our resources are limited and we may not always be able to attend to all requests for review immediately and will have to prioritize according to the urgency and importance of the issue for review.

Examples of Application of Tenet 4

4.1 Loan Loss Provisions

Singapore adopted the Financial Reporting Standard 39 (FRS 39) on recognition and measurement of financial instruments in 2005. FRS 39 introduced significant changes to the way financial instruments and transactions were accounted for by banks and other institutions. One key change was in the way impairment for loans and receivables were assessed and accounted for. In particular, under FRS 39, a “loss event” must have taken place before an impairment provision may be made. This led to a delay in the identification and recognition of losses when compared to the approach used prior to 2005, where impairment provision may be calibrated using forward-looking elements such as loss expectations.

The implementation of FRS 39 required banks and other financial institutions to revise their credit assessment and loss estimation processes. MAS was concerned then that the application of FRS 39 might not lead to an early identification of loan impairment and recognition of loan losses as a number of banks and other financial institutions may either not have available sufficient high quality historical loan loss data over a full credit cycle, or adequate systems to track and correlate loan loss data to loss events. As a result, MAS issued supervisory guidance for banks and other financial institutions. The guidance sets out requirements for banks and other financial institutions' credit review processes, as well as the basis for establishing appropriate provisions, in conjunction with the requirements under FRS 39. Transitional arrangements were also provided in the guidance for banks that lacked sufficiently robust loss data or were not yet able to adopt FRS 39. Such financial institutions are required to maintain a minimum level of collective impairment provisions of not less than 1% of net loans and receivables. These transitional arrangements are intended to ensure that financial institutions maintained sufficient provisions to cover inherent losses in their loan portfolio. In many cases, such minimum level of collective impairment provisions helped create some prudential buffers that enhanced their resilience in the financial crisis of 2008/09.

Following the financial crisis of 2008/09, we participated in discussions within the Basel Committee of Banking Supervisors (BCBS) to develop an appropriate and operable provisioning model that would incorporate a broader range of available credit information and allow earlier identification and recognition of losses. The BCBS is in active discussion with the International Accounting Standards Board (IASB) on this issue, with the aim of assisting the IASB to develop an operable forward-looking provisioning model.

4.2 Application of Code on Take-overs and Mergers to REITs

In response to market feedback that the Real Estate Investment Trusts (REITs) industry was ripe for consolidation, MAS proposed amendments to the Securities and Futures Act (SFA) to facilitate mergers and acquisitions of REITs. The SFA was amended in 2009 to apply the Singapore Code on Take-overs and Mergers (Code) to REITs and include provisions on compulsory acquisition. The Securities Industry Council also issued practice statements on requirements in respect of mergers and privatisations of REITs via trust schemes. As a result, the regulatory regime for REITs was brought on a par with that for listed companies.

4.3 Code on Collective Investment Schemes (CIS Code)

In May 2010, MAS issued a consultation paper on proposed amendments to the CIS Code. The CIS Code prescribes best practices in the management, operation and marketing of collective investment schemes (CIS) authorised under the Securities and Futures Act. While the CIS Code has been amended several times since its issuance in May 2002, MAS decided to undertake a comprehensive review to ensure that the regulatory regime for CIS keeps pace with product innovation and new investment strategies used in fund management. In conducting the review, MAS took into account the rules and regulatory developments in major fund jurisdictions. MAS also sought to balance the need to keep pace with international developments in fund management while ensuring that the guidelines continue to afford investors confidence in the regulatory framework for retail funds. Under the proposals, several existing investment guidelines will be streamlined, strengthened or clarified. To bolster best practices across fund managers in the management and marketing of CIS, MAS proposed new guidelines to augment existing provisions in the CIS Code.

Tenet 5: Impact Sensitive

3.21 Regulation can have significant impact on market practices, competition, and industry structure. It can impose costs on financial institutions, consumers, investors and MAS. **Regulation is introduced to address existing or emerging risks to our supervisory objectives where such risks are material. The costs and impact of major regulatory initiatives should be assessed, and a judgement should be made of the overall balance of costs and benefits**. This judgement of the balance of costs and benefits will help establish in the first instance whether regulation is merited and subsequently aid in a comparison of feasible alternative solutions.

3.22 Costs and impact can be difficult to estimate and quantify comprehensively and accurately. Benefits are often even harder to pin down. Some kind of broad assessment is implicit in this approach, but it would not be realistic or sensible to expect full quantitative impact studies to be conducted in all but a handful of instances (e.g., in relation to changes in the capital adequacy ratios of banks implementing Basel II). In most instances MAS will expect to make qualitative assessments or rough quantitative estimates of the impact of new regulatory initiatives through a survey of financial institutions, an analysis of their financial statements and regulatory returns, or from feedback arising from the consultation process.

3.23 In the course of analyzing the issue and developing options, MAS will take into account the practicalities and constraints of existing market practices as well as legitimate commercial needs. For example, a regulatory initiative may not have a high financial cost impact, but may require significant changes to existing market practices or simply be difficult to implement in practice. It is important for MAS to take into account commercial constraints and market practices when formulating regulation, and financial institutions can help by giving feedback about these during consultation exercises on new policy and regulation. **MAS will thus give due care to the design of regulation to avoid unintended market impact whilst maintaining a high standard of regulation**. Frequently, regulation will be aimed at changing market practices and under these circumstances, rules should not be more burdensome than necessary and sufficient time should be given for their implementation (see **Tenet 6**).

3.24 Whilst cost and market impact are important considerations, they are not the only criteria that MAS has to consider. From time to time, there may be major new regulatory initiatives which the industry may consider unduly burdensome or even unnecessary, but which MAS has considered necessary and desirable to introduce on the balance of considerations. Industry may not fully appreciate the range of MAS' considerations, such as the need to consider the risks of not introducing new regulation, the distribution of costs and benefits, which may impact different parties differently, as well as the contribution of an individual new regulatory initiative towards the coherence and effectiveness of the regulatory framework as a whole. In such major regulatory initiatives, MAS will seek to mitigate the cost and market impact to the extent feasible and appropriate without undermining the effectiveness of regulation.

Examples of Application of Tenet 5

5.1 Deposit Insurance

A deposit insurance scheme was implemented in Singapore in 2006. In designing the scheme, MAS recognised the need to mitigate the cost impact on banks and depositors. We decided that its size and build up over time should be proportionate to the likely risks, and introduced several features to lower the cost impact. Insured deposits were given priority ranking in claims when a bank fails so that the risk of loss to the deposit insurance fund is reduced. The deposit insurance fund size was determined through statistical modelling so that it reflected the probability and severity of potential loss posed to the fund given the risk profile of Singapore's banking system. In addition, with the banking system in good health, we allowed the fund to be built up gradually over 10 years so that annual premiums levied on banks are kept low.

5.2 Risk-Based Capital Framework for Insurance Business

MAS introduced a risk-based capital (RBC) framework for insurers in Singapore, which took effect from 1 Jan 2005. Prior to this, insurers were subject to a statutory solvency framework that made use of undisclosed margins and approximations. The earlier framework was applied consistently across all types of insurers. MAS worked closely with the industry, conducting a number of rounds of testing with the insurers, to ensure that the requirements of the new framework set commensurate with the potential impact of the risks of the different activities of the insurers. In particular, it was decided that the full RBC requirements did not need to be imposed on certain insurers, such as the specialist risk insurers, captives and reinsurers, given that these entities pose less risk to MAS' supervisory objectives compared to the mainstream direct insurers.

5.3 Review of Participating Life Insurance Business

MAS established a workgroup comprising representatives from the insurance industry to review the management of the participating life insurance business by the life insurers. The workgroup noted that practices in the industry were generally satisfactory, but identified the need to strengthen the internal governance practices of insurers in the management of the participating fund in order to ensure that policyholders' interests are protected. This resulted in the issuance of a new MAS Notice on the management of participating life insurance business in June 2007. The Notice prescribes mandatory requirements for life insurers' internal governance practices on the management of the participating fund, and sets basic minimum standards on disclosure to participating policyholders, both at the point of sale and on a regular basis after sales. MAS agreed with the industry that it was not necessary for MAS to prescribe details of the disclosure requirements in order to meet its objectives and that this should be left to the industry. The Life Insurance Association of Singapore (LIA) therefore issued revised disclosure guidelines on the point-of-sale benefit illustrations.

Tenet 6: Clear and Consistent

3.25 This Tenet addresses three major issues: (1) the need for clarity in the legal obligations imposed through regulation so that institutions understand what is required of them; (2) the need for consistency of rules and policies over time so that there is a stable and predictable regulatory environment; and (3) with innovation in products and business models among financial institutions in various sectors blurring sectoral boundaries, the need for consistency in according similar regulatory treatment, where appropriate, to like activities conducted by financial institutions across sectors.

3.26 **Regulation should be clear so that institutions have certainty and predictability as to their legal obligations.** Regulation achieves its effect of constraining or directing behaviour by imposing legally-enforceable obligations on regulated financial institutions. It is fundamental that institutions are clear about how the legal obligations apply to them and are able to objectively assess under what circumstances they will be in breach of their legal obligations. If regulation is unclear and provides for a wide scope for interpretation, financial institutions will not be able to assess with confidence for themselves under what specific circumstances a breach of regulation can occur, and they take on substantial legal and compliance risk as a result.

3.27 While clear regulation is important to achieving good regulatory outcomes, MAS recognises that both regulation based on principles rather than detailed prescriptive rules, as well as self-regulatory approaches, can be effective and appropriate in some circumstances. There is hence a need for MAS to make a judgement in the particular circumstances of a regulatory issue whether detailed and more prescriptive regulation or regulation that sets out its requirements through more principles-based language will be more effective and appropriate or whether self-regulation may also be an alternative. Self-regulation and regulation requiring adherence to principles rather than rules may be appropriate in areas where there is strong shared ownership of regulatory outcomes among financial institutions and where the culture of self-regulation is deeply ingrained and effective.

3.28 The trade-offs arising from principles-based regulation are well known. While offering institutions more flexibility to exercise judgement in compliance, this may be at the expense of predictability and certainty of an institution’s regulatory obligations. From our regular contact with regulated financial institutions, we frequently hear that they would prefer clarity in regulation over flexibility of interpretation or implementation because of the concomitant unlevel playing field as well as legal and compliance risk that this entails.

3.29 Whilst MAS takes every care when drafting regulation to be as clear as possible, it will not be possible for MAS to prescribe its exact application to every product and market practice. To do so would require such a high level of prescriptive detail that, even if it was possible, would be stifling to industry innovation and initiative.

3.30 We address this issue in two ways. First, we make our draft regulation available in advance for consultation and subsequently remain open after implementation to receive feedback about implementation issues and interpretation difficulties that financial institutions and other stakeholders may face. MAS is ready to refine its regulation in response to feedback about practical implementation issues.

3.31 Second, MAS regularly receives questions from financial institutions relating to regulatory interpretation. These questions will call for judgement, and involve an understanding of market or operational practice in financial institutions. They are not always given to obvious or incontestable answers. In such cases, especially where novel points or arrangements are involved, MAS stands ready to work with the industry in an open and collaborative manner to share our views.

3.32 A financial institution which seeks guidance on a regulatory interpretation, should be fully prepared to present its position supported by reasoned arguments based on the facts of its case and the law. The financial institution needs to understand that whilst MAS can explain the rationale and policy for a regulation, MAS is not its legal or professional adviser. This mechanism for engagement should also not be called upon for routine and straightfoward regulatory issues. Where MAS provides guidance, it is not an endorsement of the proposition of that financial institution. Ultimately, financial institutions, professionals and their advisors are responsible for complying with the law.

3.33 There are also instances where our regulatory framework requires institutions to consult MAS in advance or obtain MAS' consent before undertaking a certain course of action, or for certain documents, such as prospectuses, to be registered with MAS. Such requirements are put in place where there is a need for closer oversight by MAS, while not detracting from the principle that the institution is ultimately responsible for complying with the rules. It should be recognised that MAS' involvement in the process does not substitute for the responsibility of the institution to conduct the necessary due diligence to ensure compliance with the law.

3.34 We are also mindful that, especially in transactional matters, time is of the essence and decisions often have to be taken quickly. In such interactions, we are committed to doing the best we can to provide a quick response, wherever possible. However, this will not always be achievable, especially where the issues concerned are particularly complex. Industry can alleviate this by approaching MAS early and by providing adequate and relevant information.

3.35 MAS strives to uphold a stable and predictable regulatory environment, setting regulation of a high standard consistent with international best practices. **Regulation should be consistent over time and not be subject to frequent or sudden change**, even as modification is needed to respond to changes in the market (see **Tenet 4** above). MAS recognises that sudden and major changes in policy or regulation can be disruptive to financial institutions and market practices, and cause uncertainty. Financial institutions may need time to retool their processes and systems to comply with new regulatory requirements, or restructure their balance sheet and business activities. Equally significant, financial institutions generally require a stable and predictable regulatory environment to make long-term investment and business decisions.

3.36 From time to time, nevertheless, there will be a need to make significant changes to regulation that are necessary and desirable to ensure that the regulatory framework remains effective to meet its regulatory objectives and to address the needs of stakeholders. Such significant regulatory changes can arise from various sources or triggers. New international standards are a common source of new regulation. New regulation can also arise from major policy reviews aimed at strengthening the financial system and industry in Singapore**.**

3.37 MAS' approach when significant new regulation is introduced is to ensure that there is **extensive consultation** with industry and other stakeholders including at an early stage on the broad policy proposals as well as in later rule-making stages. We will carefully consider all feedback on the impact of new regulation and the implementation issues, and adjust our proposals where appropriate. We will also consider if it would be appropriate to minimise disruption to financial institutions by having the new regulation apply only on new transactions or activity going forward without requiring institutions to rectify or unwind existing transactions and activity. Generally, we will **allow adequate time for the industry to adjust to new requirements.**

3.38 In addition to consistency across time, a second dimension of consistency relates to the need for **consistent regulatory treatment of like activities conducted by institutions of different sectors**. The regulatory framework comprises broadly two categories of regulation. The first category of regulation applies to the whole of an individual institution and is appropriate to the business model and risk profile of a specific sector. Examples of these are capital and liquidity rules. The second category of regulation relates to a specific activity that is conducted by financial institutions. Examples of this second category include rules on housing loans and consumer credit. It is increasingly common for financial institutions of different sectors, and which are subject to different sectoral regulatory frameworks, to be offering similar products or conducting like activities. While sector-specific regulation which addresses specificities in the business model and risk profile of institutions in a particular sector continues to be appropriate, activity-specific regulation that applies to a common activity across sectors will be appropriate and necessary in many instances. This minimises incentives for regulatory arbitrage and establishes a more level playing field.

3.39 However, it can be counter-productive to pursue uniformity of regulation as an end in itself. The other five Tenets discussed in this monograph are relevant. In some instances, an activity may only be incidental to institutions in a particular sector and it may pose no significant risk to supervisory objectives if such an activity were not subject to the same standards imposed on institutions in a sector that conducts it as a primary activity. Hence a careful and balanced judgement has to be made in each area as to whether consistent, activity-specific regulation should be applied.

3.40 MAS has implemented consistent, activity-specific regulation across sectoral boundaries in several major areas, including through a common legal framework for regulating financial advisory activity across all sectors, corporate governance standards, outsourcing guidelines, risk management guidelines, fit and proper guidelines, and various consumer finance and housing loan rules. As significant new activities or risks which cut across sectors emerge, MAS will consider whether it will be appropriate to put in place regulation that is consistent across sectors in such instances.

Examples of Application of Tenet 6

6.1 Large Exposures Limit

MAS introduced a revised set of rules for banks limiting large exposures to single counterparty groups in 2007. The new rules capture a wider range of ‘exposures’ in comparison to the more straightforward ‘credit facilities’ of the previous regime.

As the concept of exposures was broad, it was not possible to prescribe in regulation all types of financial transactions for which an exposure would arise and how the value of the exposure should be measured. Instead, MAS defined “exposure” in legislation by referring to the principle of “maximum loss”. Financial institutions were to exercise judgement when determining or valuing exposures according to this principle.

Recognising the need to strike a balance between principles-based and prescriptive regulation, MAS set out examples of exposures in regulation to aid financial institutions in their exercise of judgement (e.g., those arising from counter-party claims, the holding of instruments which depend on the financial performance of the issuer, securitization, contingent liabilities or potential future exposures). While not exhaustive, these examples provide some guidance and certainty to banks applying the regulation to less common forms of exposures.

To mitigate the uncertainty and to facilitate a smooth transition, banks were given a two-year grace period to comply with the new regime and make the necessary system modifications.

6.2 AML Notices and Guidelines

In order to provide consistency of treatment across sectors, MAS standardised the Notices on the Prevention of Money Laundering and Countering the Financing of Terrorism (AML/CFT Notices) across the different financial sectors, namely banks, merchant banks, money changers and remittance businesses, finance companies, life insurers, capital markets services licensees, financial advisers, trust companies and CIS trustees. These Notices impose legally binding obligations on the respective financial sectors and incorporated a number of key changes, including, amongst other things, an element of risk sensitivity in performing customer due diligence (CDD) and a more rigorous set of CDD measures. The AML/CFT Notices are in line with the Financial Action Task Force (FATF) Recommendations, the international standards for AML/CFT. Each of these Notices is accompanied by a separate set of Guidelines that provide elaboration and set out the application of the requirements of the Notices relevant to the particular sector. In order to provide consistent application of the FATF Recommendations across the different financial sectors, MAS had reviewed these Notices collectively over two years from 2005-2006. This review was done in consultation with the private sector, which provided useful feedback on the clarity and consistency of the proposed requirements.

4 SUCCESS REQUIRES A COLLABORATIVE APPROACH

4.1 These Tenets are intended to be generally applicable to all areas of our regulatory development work. This means that, in totality, there will be a high standard of regulation consistent with international standards, shared ownership and responsibility for these objectives among financial institutions and stakeholders. The regulatory framework will be targeted at and sensitive to the risks it is aimed at, and more responsive to changes and risks in the industry. It will also be sufficiently flexible to set requirements that are commensurate with the risk profile and unique circumstances of particular financial institutions. Rules will be clear and not subject to frequent disruptive change as well as consistently applied to like activities conducted across sectors. We recognise that the Tenets set demanding standards for MAS and sometimes it may not be apparent that MAS has given equal importance to each of the Tenets. This may be because the Tenets may not always pull in the same direction. For example, when regulatory standards are raised, this may be consistent with or even necessary because of Tenets 1 to 4, but it may not be apparent that MAS has given equal importance to **Tenet 5 "Impact Sensitive"**. This would not be a correct interpretation as MAS would have given due consideration to the impact of new regulation and its design before its implementation. The guidance afforded in each and all of the Tenets is at the heart of our approach towards regulatory development and they indicate the direction we will take.

4.2 MAS is committed to uphold the Tenets of effective regulation discussed in this monograph, including going beyond consultation on individual measures to building meaningful dialogue and engagement with the industry. However, MAS cannot achieve success in this endeavour on its own and the effectiveness of the regulatory framework will depend as much on the industry as on MAS. Individual institutions and the financial services industry as a whole play a critical collective part in securing and maintaining the effectiveness of the regulatory framework, especially in the following areas:

- If MAS is to place greater responsibility on financial institutions, their boards and senior management, the industry will need to have shared ownership of the regulatory objectives and outcomes that MAS has established and be demonstrably effective in achieving such regulatory outcomes. Examples of signs of readiness may be financial institutions each implementing detailed processes that best achieve regulatory outcomes in their own context even in the absence of detailed regulation, an active industry association issuing codes of good practice of a high quality with strong support among financial institutions for these initiatives, and with the exercise of discipline amongst association members in implementing such codes.

- Financial institutions should participate constructively in dialogue and consultation with MAS, not just as a channel to draw attention to problems of implementation, but also to offer ideas to improve the effectiveness of the regulatory framework in achieving regulatory objectives.

- Financial institutions need to maintain and, wherever appropriate, raise their standards of governance, controls and risk management practices, and in the process give confidence to MAS to rely less on prescriptive regulation, as well as foster greater trust with customers, investors and other stakeholders.

4.3 As we have illustrated through boxed examples throughout the monograph, these Tenets are not expressions of new intent. We have already put these Tenets into practice in many areas. Nevertheless, we consider it useful to articulate our guiding Tenets more explicitly to help foster shared understanding and hence shared ownership of our approach and objectives. We intend regularly to engage the industry in exchanging perspectives on what MAS and industry is each seeking to do to improve the effectiveness of the regulatory framework.