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Position Paper

Hidden Wealth – the Right Sort – and International Financial Centres

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Hidden Wealth – the Right Sort – and International Financial Centres

1. Why do countries or cities aspire to be International Financial Centres? What are the benefits or disadvantages to this? How is it that today's international financial centres are London, New York, Hong Kong, Singapore and arguably Dubai? The first two achieved their status early on and have continued to scale. Dubai is the newest in managing to attract financial services firms and ancillary services to locate in that territory. All are in different timezones save HK and Singapore which have no time difference, yet manage to co-exist albeit competing with each other. In order for a financial centre to thrive, there are a few prerequisites. None on their own are definitive, but lack of them will mean the odds of becoming and remaining a financial centre are remote. The centre or city must be known for a robust legal framework conferring commercial certainty on contracts and business, a robust financial services regulator and laws benchmarked to global standards effectively enforced, and efficient registrar services facilitating the establishment of commerce.

2. All these factors are a magnet for wealth. Assets tend to seek out international financial centres as there is expertise there to generate a higher return on assets, the rule of law in such financial centres provides higher commercial certainty that they will be safeguarded and that the financial institution those assets are entrusted to will continue to be safe and sound assuring preservation of capital, in addition to growth desired.

3. Given that wealth seeks out international financial centres, the source of wealth could come from many places, legitimate, illegitmate or dubious from a reputation perspective. In order to preserve this status, it is important that financial centres implement and adhere to global standards on international finance, including AML (anti-moneylaundering), sanctions, CFT (countering financial terrorism), anti-bribery and corruption standards, including requiring all intermediaries operating in them to screen source ofwealth. This article focusses on financial institution intermediaries, but there are clearly other intermediaries and agents that should be considered eg law firms, real estate agents. A scandal on source of wealth on any of such financial crime indicators would leave especially an emerging financial centre vulnerable and less likely to be well positioned to scale its ambitions. Reputationally, this would also be very unpopular among the public, and politicians and regulators would face tough questioning on what they could have done to enforce high standards.

4. Financial crime standards are rising every day. In addition to ensuring that source of wealth is not derived from illicit or illegitimate activity such as drug trafficking, prostitution, arms dealing, smuggling, nor from a host of prohibited sanctioned activities such as dealing with SDNs (specially designated nationals from a sanctions perspective), dealing with prohibited classes of goods in or from specified countries, increasingly in several jurisdictions tax evasion is a predicate AML offence. Furthermore, particularly post the financial crisis, tax avoidance is viewed with public odium and a source of reputation risk.

5. In order for a financial institution to be satisfied that it truly knows its customers, shareholders, ultimate beneficiaries, authorized signatories, risk profile, type of activities it conducts, the counterparties it deals with, the financial institution has to put in place a slew of processes. These include at the client onboarding stage, a comprehensive questionnaire seeking all of the above information, an independent background search where warranted or information cannot be confirmed, or enhanced due diligence if the client is in a high risk industry, high risk activities, high risk geography or engaged in high risk products. In some cases, even after comprehensive checks including an independent investigator report specially commissioned, there will still be doubts about whether the origin of the source of wealth as stated can be established with sufficient levels of certainty. That it is plausible – yes – but what is the level of confience required? What is the compliance and reputation risk appetite of the institution?In some cases, there will be allegations of human rights abuses in the media, allegations of environment unfriendly activities. These are difficult to substantiate, and the financial institution has to make a decision based on information at hand and its own risk appetite dealing with such classes of client. To-date, there are several models on credit risk appetite, market risk appetite, but few models on establishing compliance or reputation risk appetite

6. Sometimes law enforcement authorities in one country will ask for information about the client of a financial institution located in another country and the financial institution has to decide how to handle these requests. The analysis will typically follow the lines of: is it legally permissible for the financial institution to disclose such information given banking secrecy or client confidentiality laws or

data protection legal requirements. Even if legally permissible, is it legally required as clients usually do not wish their information to be shared with law enforcement authorities and plead client confidentiality and privacy ie typically perceived as being bad for client business. Even if not legally required, should the financial institution do so as not to do so would risk an important regulatory relationship or would be contrary to openness and transparency which are values the financial institution believes in. It will be apparent there are conflicting agendas here, forces that pull decent decision makers trying to do their best for the client and for the institution, in different directions. While it is easy to say one should follow the true north moral compass, things become very foggy when large amounts of money and wealthy influential people or organisations are involved.

7. These are no easy questions to answer, particularly when large profits are at stake from being the custodians, advisors, intermediaries or agents of such hidden wealth. Textbooks do not teach how to make such decisions. Much of this getting the “smell” test right comes from long, hard, practical experience and a few mistakes along the way. We need to try to condense the amount of time it takes to hone the barameter and make the “smell” test more apparent and accessible. We need the mistakes to be leveraged so others don’t repeat them, rather than covering them up for fear of reputation risk

8. So how has Singapore addressed these issues as an international financial centre? What has its track record been and could it do better? Are there things that other financial centres can learn from Singapore, to do, to avoid doing. Will the same methods that took Singapore to this place, continue to serve it well in the new world of changing, toughening regulations and political rhetoric post financial crisis. Or does Singapore need to modify its act if it wishes to continue to thrive and perpetuate its place as an international financial centre.

9. Singapore is a nation of immigrants with a fighter spirit. It had to be else it would not survive. Singapore is an island state, not much by way of territorial space, lacking in natural resources, but an important factor of production – labour, which it took pains to educate, nurture and harness the talent of. With neighbours with a history of mixed relations, and if international finance and commerce is to continue to be attracted to do business in Singapore, it is important for Singapore to have a strong legal system, qualified and skilled bench and bar, enforcement of contracts, regulations which are benchmarked to global standards. Over the years, Singapore took steps to develop these and is now known for a strong judicial system and civil service marked by a lack of corruption. Singapore has managed to have continuity in its central bank management and senior team. Part of this was due to paying government officials decent salaries so not all were lured to private sector wages. Another important part was progressively investing in their training including overseas attachments to other central banks and international financial organisations so they understand international finance and can make mutual assessment of their central bank and regulator peers.

10. Singapore's central bank, MAS, was founded in 1971 with responsibility for consolidated supervision for the financial sector. It oversees banking, securities, insurance activities. As a nation state, this was considered the preferred way. The Banking Act was enacted shortly thereafter. Supervision of securities companies devolved to MAS from the Registrar of Companies post the 1987 securities scandals. Within the Banking Act is a provision on bank secrecy which reinforces the common law position on client confidentiality. As a nation state with British colonial roots, Singapore relied on English common law particularly in its early days of development as the local bar and bench were also developing expertise in financial and commercial law. As with the common law position in Tournier's rule, statutory bank secrecy required a bank and its officers to maintain confidentiality on any information in relation to a customer of the bank, save where certain statutory exemptions applied. Over time, these statutory exemptions were clarified and expanded to inter alia, define what was a customer eg duties owned to counterparty banks/financial institutions could be different; dealing with foreign regulatory authorities; information sharing among affiliates for cross marketing purposes; outsourcing and risk management. Singapore has had to balance tightly its historic bank secrecy laws contained in the Banking Act which provide confidentiality and confidence to parties placing their assets with Singapore financial institutions, with the wave of transparency that is necessary in order to conduct AML/CFT/Sanctions screening checks. Hence Singapore law does not permit numbered accounts. The financial institution and the regulator need to know whom is the ultimtate beneficial owner of any asset or account. The nature of the underlying obligation remained the same however ie to preserve confidentiality in the banker-customer relationship, unless there is a compelling reason founded in public policy, to permit the disclosure.

11. Over time, the exemptions for risk management particularly in the field of financial crime or AML/CFT risk management were particularly expanded. These moved in pace with international agreements and standards such as FATF and Wolfsberg principles. With such international developments, tax evasion was made an AML predicate offence in 2012 and accordingly an exemption to bank secrecy to file an STR (suspicious transaction report) based on suspicions that there could be tax evasion. Obviously this predicated that financial institutions would take steps to detect whether or not there was tax evasion going on in the customer account, else how would they know to file an STR or not. This proved challenging as historically, a client's tax affairs were his/her private matters and in any case, banks are not in the business of tax advice generally.

12. As an international financial centre, Singapore was also keen to be a centre for private wealth and asset management. These are fee based businesses which do not consume capital. They require trained, educated labour force with skills in managing money and managing assets. Singapore provided incentives, including tax incentives and training incentives for the labour force, for such businesses and was successful at attracting a number of private banks and asset managers to locate operations in Singapore. However, at the same time, Singapore wanted "clean" funds. Financial institutions are required to ensure they do rigorous checks on their clients and their source of wealth. A Private Banking Code of Conduct was developed which stressed among other things, the checks that private bankers had to undertake and due diligence measures for clients source of wealth. To ensure that banking staff had sufficient training and standards, mandatory certification was introduced in certain fields. Together with a certification regime for registered representatives so that employers can receive references on any employee coming from another bank. If a representative fails to discharge his/her duties with one financial institution, this meant there was a lower probability of the person securing a role at another financial institution as records of his/her activities would be maintained on a register centrally with the MAS.

13. So Singapore has done a lot of the right things towards the end goal of building an international financial centre with high standards. Is there anything else that Singapore can and should do? As Andy Grove, ex CEO of Intel said "Only the paranoid survive". This is true more than ever for international financial centres where every other nation state aspires to have a city that achieves this status and essentially everyone wants a share of your lunch. Unless Singapore stays vigilant and continues to evolve, over time, it can and will cede ranking to emerging financial centres with not only the will and determination to do so, but the hinterland, population, political will and funding to do so. Dubai and Shanghai for example are hot on the heels of existing international financial centres.

14. There are still a few things Singapore could learn from othe financial centres. These apply not just in ensuring that only the right sort of wealth enters the financial system, but that this financial centre comprises sound financial institutions with managers committed to ensuring compliance with the Republic’s laws, regulations, codes of conduct, values and mores. Which is key to continuing to thrive. A number of them are as follows.

15. Singapore relies on moral suasion historically. It has invested in training and education and groomed Compliance Officers to help financial institutions ensure that laws, regulations and regulatory expectations are adhered to. It has created a separate Compliance category in its financial industry competency standards and established a Compliance segment in the newly established IBF (Institute of Banking and Finance) Academy. While everyone has a responsibility to ensure the Republic’s laws, regulations and regulator expectations are complied with, Compliance is the function whose sole role is to assist and enable Senior Management and the Board to do this. Regulators also view the Compliance function as their “eyes and ears” within the organisation. Clearly this sort of role is not easy – walking that line between two worlds so to speak. And mature, seasoned, capable personnel are required who know how to do this balancing act appropriately and well. Yet, there are no formal approval requirements to have a Compliance officer or function; nor are there formal requirements to have accreditaton for Compliance officers nor ongoing mandatory training requirements for Compliance officers in its financial institutions.We have relied on statements of best practice and intent. Whereas centres like the US, Middle East, China, have formal certification requirements for compliance officers and regulators also regularly convene compliance officers to share their priorities and expectations. In China, for example, the regulator convenes such meetings at least annually and

instructs its financial institutions to ensure that they send adequate compliance officer representation. In Singapore, this is conducted informally. There is merit in the Compliance profession being expressly recognised and supported by the regulators and industry associations. And in formal Compliance accreditation being not just favourably looked upon but required, particularly in senior compliance roles for financial institutions with scale.

16. While there is the argument let the industry evolve, if it is indeed the case that Compliance officers who help to ensure and assure that the institution complies with applicable laws, regulations, codes and expectation on behalf of the Board and Senior Management, and are looked to by the Regulator as part of the regulator within the institution, surely this role is too important to be left to evolution and suasion. The role should be explicitly recognised, provided a mandatory seat at the table for all important discussions given there is a regulation on just about any area of finance today, particularly so on any strategy involving client behaviour, incentivisation, the kind of clients we wish to retain (or not), develop (and if so under what conditions). This group of Compliance officers should be expressly cultivated and supported by regulators, and there should be an industry association for compliance officers to have conversations on matters of common interest and importance to the industry. Such discussions on consultation papers should not merely devolve to industry associations representing financial institutions – these may be well intentioned but always have vested interests and are accountable to institutional masters. Where is that independent voice, regardless of corporate imperative and profit motive, that speaks for what a regulation should do for the industry, as opposed to for the industry association it represents? Where is the equivalent of a SIAS among these trade associations? Independent think tanks such as the newly formed CBFL (Centre of Banking and Finance Law) should be encouraged to provide a non-partisan perspective and lens on such issues.

17. It should not noted that other financial centres are more advanced in this regard. If Singapore means what it says, that it is important that rules, regulations, codes, expectations are followed and it only welcomes the right sorts of wealth, then it will take steps to operationalise this and provide more visible and tangible support to those fields whose job it is to help the institution fulfil this responsibility. Wealth gravitates to financial centres, all sorts of wealth – desirable and dubious. Singapore needs help to differentiate. Ir should buttress an important function whose role is help senior management and the board to assess the onboading of clients, determine the source of such wealth, make a recommendation on whether to accept this or to escalate. And if to escalate, it is important there are appropriate escalation mechanisms, internally but also including presumeably to the regulator. And this will happen only if a decent relationship is cultivated in good times.

18. Individual accountability of senior managers is another theme that has been identified as important and lacking in many markets as a lesson learnt from the global financial crisis. In Singapore and several countries, regulatory approval is required for the senior positions of Chief Executive and Deputy Chief Executive. It would be wise for regulators to sight the organisation chart, understand who reports to who, and where the real power lines of the organisation are. The real power lines are where compensation and performance are rated and decided. In several global financial institutions, often the only persons reporting to the Chief Executive are the Secretary and Chauffer. Operating units report to their functional heads, who could be based outside the country. Which begs the question who within the location, is really running the institution. The objective of approving these “key” positions is so the regulator has leverage that relevant rules and regulatory missives will be observed. Clearly, this sort of organisation structure may not faciliate this. Rather than trying to change the functional nature of global organisations, which is driven from the top and needs to be changed by the home regulator, or a recognition that current market forces cause the organisation to be so governed, Singapore regulators would be well served to ensure they understand who truly calls the shots, and that is the function which calls the reward decisions, and to have a broader approval or designation regime for all senior managers who have a key decision making role in reward and risk for the entity. This should factor in a recognition that such senior managers need not necessarily be based in the location, given the global nature of business. Regard can be had to the UK Senior Managers Regime, which acknowledges there is a broader role of key functions in a bank than CEO, Deputy CEO, CFO and that all “senior managers” have a role to play in ensuring the organisation is well run for the longer term.

19. Risk and Compliance behaviour having a direct, visible and perceptible link to remuneration is a theme in a number of markets including in Europe. This has been adopted to some extent in Singapore through requiring balanced scorecards for RMs (relationship managers) and statements of best practice in Codes of Conduct such as for private banking. In terms of setting tone from the top and reinforcing the importance of senior management in driving compliant behaviour, Singapore still

has no formal mechanisms for links to remuneration for senior management although there are best practice prononcements of the same. This link bewteen risk and compliance and remuneration can be far more widespread than it is, if we mean what we say and if we are to change behaviour towards desired norms. This is an area that should be looked at if Singapore seriously means business in this field. For example, is there a formal mechanism for risk, compliance and audit personnel to provide feedback into the performance assessments of senior management and line management which impacts remuneration. What are the performance indicators for risk, compliance and audit personnel? Are these sufficiently independent and dissociated from line risk taking profits? What happens to remuneration if a client that was onboarded and risks accepted today by senior managers, only turns pear shaped several years down the road? Are there clawback or deferral mechanisms? Do shareholders end up bearing the brunt of losses and is pain socialised while the individuals have moved on given the rates of turnover in the financial industry? These principal/agency issues continue given the model of the modern corporation and should be addressed.

20. If an organisation means what it says by taking compliance and reputation risk seriously on the source of client wealth, only accepting the right sort of clients – or what is called in the vernacular "walking the talk" - then it will have committees, forums, documentation around what it cares about. For example, many organisations have developed MI (management information) packs on financial indicators, capital, liquidity, risk indicators. Does the organisation have committees or forums chaired by a senior manager with meaningful MI and consistent follow up on actions committed to in relation to client onboarding, reputation risk aspects of continued client behaviour, risk appetite on client activities and source of wealth. Such committees are often Compliance or Financial Crime Committees. Or if the organisation is small eg less than 30 persons in a location, a Risk Committee could be sufficient to address Operational Risk and Compliance Risk issues. The lack of such committees or forums or MI is an indicator that walking the talk may not be as structured and hence not as effective. Or a cynical view might be talking the talk is going on, but not walking the talk.

21. If we want the right tone from the top to be set, the senior managers at the top of the organisation must have not only a sense but a requirement, independently enforced and transparently documented, of their accountability. All parts of the organisation need to be invested in the same culture through the levers that affect behaviour such as remuneration. Training is important given that mostly people want to do the right thing if they know what it is. So training needs to be mandatory on a range of important matters and the ethos of the organisation has to be that training is necessary and desirable, and not an unproductive use of time which could be better spent generating profits or calling on clients.

22. There is the argument that because Singapore is small and needs to be competitive, it should be a follower rather than a leader in this area. As human talent, much needed for the growth of a financial centre, will migrate to those markets with less restraint on their activities and compensation. Yes these are market forces – good or bad is not the point – these forces exist and must be dealt with. At the same time, we must not give up the belief that it is always right to do the right thing, as opposed to the "grey" thing given we all justify our actions. And as an international financial centre, we must be better served by having the right sort of wealth on our shores, as opposed to any sort of wealth. So how to strike the right balance? Steps must continue to be taken in the right direction and Singapore has definitely taken many steps in the right direction. These steps must be visible. The right people must be promoted. The right behaviour visibly rewarded. The wrong sort should be removed from the industry. Pace is also important - we cannot lag other financial centres if we are to maintain our position let alone pull ahead strongly. Speeches and pronoucements must be consistent with the ethos, although formal regulation can come down the road. Communities including risk and compliance professionals should be nurtured across institutions. There are many things that Singapore can and should do to continue to thrive as an international financial centre. And Singapore has done many of these. From the perspective of a practioner who cares, with a lens from public and private sector, domestic and foreign organisations, it is submitted that the above are critical, determinant factors.