ALLEN & OVERY

MAS opens the door to digital banking

July 2019

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The Monetary Authority of Singapore (**MAS**) has announced its intent to issue up to five digital bank licences, comprising:

Up to two digital full bank licences, which will eventually allow the provision of a wide range of financial services and deposit-taking from retail customers

Up to three digital wholesale bank licences, which will serve small and medium-sized enterprises (**SMEs**) and other non-retail segments.

The announcement made clear that firms with no track record in banking but with innovative value propositions are welcome to apply for a licence. All potential licensees must be able to show that they can meet an existing unmet or underserved need; their business model must not simply involve cannibalizing the existing market. As emphasized by Senior Minister and Chairman of the MAS, Mr Tharman Shanmugaratnam, in his key note address to the Association of Banks in Singapore on 28 June 2019, the view of the MAS is that "competition in finance has to be more than a zero sum game".

With this announcement, Singapore joins the growing list of countries that have decided to open up the banking sector to digital banks. For example, in Hong Kong, the Hong Kong Monetary Authority (HKMA) published the Guidelines on Authorisation of Virtual Banks in May 2018, and has to date announced that it will be granting licences to eight licensees, who are expected to commence business within the next nine months.

This note will cover the licensing process and requirements in Singapore, as well as the likely potential challenges in the licensing process and the lessons we can draw from the processes undertaken in other jurisdictions, particularly, the United Kingdom, Australia and Hong Kong.

"Competition in finance has to be more than a zero sum game."

Tharman Shanmugaratnam, Senior Minister and Chairman, MAS – a keynote address of the Association of Banks in Singapore's Annual Dinner, 28 June 2019 – www.mas.gov.sg

Overview of digital banking licensing framework for digital full banks

The digital banking licensing framework for digital banks will be implemented on a graduated basis. The successful applicants will commence business as restricted digital banks. Requirements will be scaled to match, but by the same token, the scope of business will be similarly restricted. This recognises the somewhat experimental nature of the new business. The requirements and restrictions from start-up phase to maturity are set out in the table below.

<table>
<tr><th></th><th>Entry Point</th><th>Progression</th><th>Maturity</th></tr>
<tr><td>Eligibility criteria</td><td colspan="3">– Incorporated in Singapore, with its headquarters in Singapore and controlled by Singaporeans. Joint ventures that meet the headquarter and control requirements are eligible
– Applicants must have a track record in operating an existing business
– Clear value proposition on how it can serve existing unmet or underserved needs
– Sustainable digital banking business model
– Viable exit plan to facilitate an orderly wind-up if necessary</td></tr>
<tr><td>Minimum paid-up capital</td><td>SGD15 million</td><td>To progressively increase</td><td>SGD1.5 billion</td></tr>
<tr><td>Aggregate deposit caps</td><td>SGD50m</td><td>Gradually increased subject to meeting MAS' criteria</td><td>None</td></tr>
<tr><td>Wholesale deposits</td><td>– May take wholesale deposits from SMEs and other corporates
– Wholesale deposits will be included in the aggregate deposit cap</td><td>– May take wholesale deposits from SMEs and other corporates
– If the minimum paid-up capital is SGD100m and above, wholesale deposits will not be included in the aggregate deposit cap</td><td>None</td></tr>
<tr><td>Individual depositor restrictions</td><td colspan="2">– Restricted to a small group of persons, such as business partners, staff and related parties
– Maximum deposit cap of SGD75,000</td><td>None</td></tr>
<tr><td>Capital rules</td><td colspan="3">Same as local banks:
– 6.5% CET1 Capital Adequacy Ratio (CAR)
– 10% Total CAR
– 2.5% capital conservation buffer
– Up to 2.5% countercyclical buffer</td></tr>
<tr><td>Liquidity rules</td><td colspan="2">16% minimum liquid assets</td><td>Same as local banks:
– 100% net stable funding ratio
– 100% liquidity coverage ratio</td></tr>
<tr><td rowspan="2">Business restrictions</td><td>– Offer simple credit and investment products only; no complex investment products
– No investment banking activities
– Banking operations in not more than two overseas markets</td><td>No business restrictions after meeting MAS' criteria</td><td>Full banking functions</td></tr>
<tr><td colspan="3">– One physical place of business only
– No minimum account balance and fall below fees
– Compliance with unsecured credit rules
– No access to automated teller machines or cash deposit machines network
– Allowed to offer cashback services through electronic funds transfer at point of sale terminals at retail merchants</td></tr>
<tr><td>Regulatory requirements</td><td colspan="3">– Required to participate in the deposit insurance scheme provided by the Singapore Deposit Insurance Corporation
– Comply with the same suite of prudential rules as non-digital full banks</td></tr>
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Overview of digital banking licensing framework for digital wholesale banks

The digital banking licensing framework for digital wholesale banks will be implemented in a single phase. This is in line with the fact that customers will be more sophisticated and better able to take risks. The requirements and restrictions are set out in the table below:

Eligibility criteria	– Open to both Singapore and foreign companies – Applicants must have a track record in operating an existing business – Incorporated in Singapore, with its headquarters in Singapore – Clear value proposition on how it can serve existing unmet or underserved needs – Sustainable digital banking business model – Viable exit plan to facilitate an orderly wind-up if necessary
Minimum paid-up capital	SGD100m
Deposit restrictions	– May not take Singapore dollar deposits from individuals except for fixed deposits of at least SGD250,000 – May open business deposit accounts for SMEs and corporates with no deposit caps
Capital and liquidity rules	Same as existing wholesale banks
Business restrictions	– One physical place of business – To only conduct activities within the proposed business scope

"We must take advantage of these opportunities that digital finance brings… We must allow for greater competition and spur greater innovation in finance"

Tharman Shanmugaratnam, Senior Minister and Chairman, MAS – a keynote address of the Association of Banks in Singapore's Annual Dinner, 28 June 2019 – www.mas.gov.sg

Outstanding issues

While the announcement by the MAS has addressed many of the questions and concerns that industry players and potential entrants had, some further matters could be clarified.

Physical presence

As noted above, for both digital full bank and digital wholesale banks in Singapore, only one physical place of business is permitted. It is not clear however whether this means that digital banks will be permitted to operate without any physical office that customers may attend. In Hong Kong, for example, the HKMA has required that a virtual bank that has been authorised should have an office for interfacing purposes. Having such a physical office would allow customers to attend at those premises in the event that they have a complaint or issue that needs resolving. It would also be in line with the requirements that are imposed by the MAS on other capital markets services providers, where the expectation is that the operations in Singapore cannot merely be a shell presence – there ought to be natural persons present servicing the needs of the retail customers.

Ongoing supervision and compliance

Another question that has been raised on the topic of digital banks is the level of ongoing supervision, and compliance obligations that will be imposed on the digital banks. In this regard, the MAS has repeatedly publicly stated that it is technology neutral, and will not seek to favour one form of technology over another. While it has not specifically been addressed by the MAS in public announcements to date, we think it is therefore unlikely that there will be a relaxation of the supervisory approach, or the general compliance requirements that are currently applicable to retail banks in Singapore.

In particular, we do anticipate that the risk management principles, outsourcing requirements and audit requirements will not be adapted to reduce the compliance burden on the digital banks – compliance cost will undoubtedly remain, and we believe that any improvements that the digital banks can introduce to streamline and create efficiencies in the compliance processes and framework will be welcomed.

Technology risk

One area we expect a heightened sensitivity for digital banks would be in the area of technology risk requirements. With digital banks, we envisage that the MAS will be concerned about the risk of cyber-attacks that would affect the retail client base of digital banks, particularly given the heavy reliance on technology for their operations. The MAS has recently said that given the role of banks as "repositories of public monies and conduits for payments, banks in particular must meet higher cyber security standards". This is even more so the case for digital banks and so we would expect additional limitations on unscheduled downtime, enhanced due diligence on service providers' controls on safeguarding customer information as well as shorter timelines for reporting security breaches.

Are there any lessons to be learnt in the introduction of the digital bank regime?

Singapore will not be the first mover in the digital banking scene, and there are examples in other jurisdictions that may prove indicative of how the regulatory framework for digital banks may be introduced.

The United Kingdom in introducing and authorising digital banks has implemented phased approaches to the introduction, a concept which is often referred to as "mobilisation" or "authorisation with restriction". This allowed start-up licensees to build out appropriate infrastructure and other set-up requirements and this allowed banks to limit the business it accepted until the completion of its operational infrastructure, yet allowing the banks to commence business in a staged manner.

The Australian Prudential Regulation Authority, we understand, has also released a phased approach in 2018, allowing new entrants a two-year period in order to meet all the requirements of the prudential framework prior to full authorisation being granted. The two-stage process introduced for digital full banks in Singapore appears to draw from those experiences, and while the MAS has indicated that it will not prescribe a time period within which the restricted digital full bank must graduate to a digital full bank, the applicants are expected to produce a viable plan to meet the requirements applicable to become a digital full bank.

In addition, it is also interesting to note that in Hong Kong, while there were many entities indicating interest in their virtual banking regime, the HKMA publicly stated that they would give priority to applicants who could demonstrate that they:

- had sufficient financial, technology and other relevant resources to operate a virtual bank;
- had a credible and viable business plan that would provide new customer experience and promote financial inclusion and fintech development;
- had developed or could develop an appropriate IT platform to support their business plan; and
- would be ready to commence operations soon after a licence was granted.

Drawing from that, it appears that the MAS' focal point is similarly on those areas – and in particular in respect of the technological innovations the applicants are likely to bring to serve existing unmet or underserved needs and enhance customer experience. This would be in line with the Singapore Government's Smart Nation philosophy.

Next steps

The MAS has announced that it expects to invite applications for digital full and wholesale bank licences in August 2019, and will provide more details on the eligibility and admission criteria at that time. However, as discussed above, apart from the two-staged phased process for digital full banks, we would expect that the same ongoing risk-based capital and liquidity/compliance requirements for existing full banks would apply, while those for digital wholesale banks will also be the same as existing wholesale banks. While the MAS' expectations on compliance and risk management have yet to be fully fleshed out, applicants should be prepared for a high level of scrutiny on their ability to comply with the prudential and compliance requirements. These requirements are unlikely to be a dampener for market players who have been keenly awaiting this announcement, and who view this liberalisation as the next frontier of the Singapore banking sector.

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