The year ahead
Developments, risks, and investing ideas

China’s Economic Policy

The Untold Story of China Banks
Insights of a PRC bank independent director

Motivation
the hidden performance variable
Kaplan congratulates CFA Singapore for Promoting the Highest Standards in Professional Excellence & Ethics in the Investment Profession.

Happy 30th Anniversary!
Dear Members,

CFA® Institute’s Society Excellence Awards recognise CFA Institute member societies across the globe that have made outstanding impact and contribution in delivering member value and furthering the mission of CFA Institute in their communities.

This year, CFA Singapore won the Strategic Initiatives group, Build Market Integrity category on the merits of our 2016/2017 Save and Invest Portfolio Series campaign.

In 2015, when Monetary Authority of Singapore was introducing new retail investment instruments, our Advocacy Committee wanted to address the lack of confidence among retail investors in the local capital markets. The Committee decided to organize a financial literacy campaign in collaboration with MoneySENSE, SGX, and The Sunday Times.

We identified 3 Singaporean individuals each at a different stage of life — a young working adult, a married couple with a young child, and a retiree, to become investors of simulated savings and investment portfolios. By tracking their simulated investment portfolios, we demonstrated professional investing methods applied on personal investing.

The portfolios were tracked weekly and rebalanced monthly by an investment panel made up of CFA charterholders. The simulated portfolios achieved annual returns of 9.3% to 11.1%, far surpassing local fixed deposit rates of about 1.5%. Full-page media spreads analysing the simulated portfolios were published in 22 editions of The Sunday Times. Free public seminars were held every two months where retail investors were given the opportunity to interact with and have their questions addressed by SGX Academy trainers and our investment panel.

The campaign’s realism, practical guidance, extensive media coverage, and public seminars that analysed the simulated portfolios were met with overwhelming enthusiasm from our targeted audience. To-date, 2,815 retail investors have attended the campaign’s seminars.

Many retail investors in Singapore are Mandarin speaking. To ensure that language barrier does not preclude this important community from the benefits of our initiative, we launched a Chinese language equivalent on 8 October 2017. The Chinese language Save and Invest Portfolio Series is featured in Chinese mainstream daily, Lianhe Zaobao’s weekly financial planning column on every second Sunday of the month. The Mandarin seminars will be held from early next year.

The sustainability of the investment management profession is dependent on raising public awareness of both the work we do and the beneficial role that investment management professionals play in society. On behalf of the Society, I wish to extend our heartfelt thanks to following people for their invaluable contribution to the CFA fraternity through this initiative:

- **Tan Lay Hoon**, CFA, and **Daryl Liew**, CFA who jointly chair the Advocacy Committee
- **Campaign investment panel:**
  1. **Simon Ng**, CFA, CEO, CCB International (Singapore)
  2. **Phoon Chiong Tuck**, CFA, Head of Fixed Income, Lion Global Investors
  3. **Praveen Jagwani**, CFA, CEO, UTI International, Singapore
  4. **Jack Wang**, CFA, CA, Partner, Lexico Advisory
- **Other seminar speakers**
- **Volunteers who helped to make detailed calculations, review reports, and coordinate with the newspaper, SGX, and MAS.**

We look forward to delivering greater value to members and having a larger, more effective presence within the investment management industry in the year ahead.

**Jan M. Richards**, CFA
President
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Excerpt from Steen Jakobsen’s presentation

Interest rates have decreased throughout the last 30 years to the extent that the price of money in terms of corporations’ cost of credit has collapsed. The low Baa corporate bond spread shows what unusual times we are in.

Credit growth exceeds nominal GDP growth -- especially in China, but also in the US. In other words, we have borrowed from the future to create the growth that we don’t have today.

Prior to 2000, productivity and labour growth in the US economy was 3.5% to 4%. This has slowed down to no more than 2% since. We have a structural deflationary force in place. In my opinion, energy prices tell us everything about what inflation rates will be. Even core inflation rates are highly correlated with energy prices. Over the past 30 years, the year-on-year change in energy prices has been very similar in structure to the Consumer Price Index (CPI). However, CPI may not be a true representation of inflation.

I believe a better indicator of inflation is the year-on-year change in the price of gold or of WTI crude oil prices. With gold prices coming down year-on-year by 10% and energy coming down from 50% to flat on the year, it is more likely that the US economy will have an inflation rate of 1% than of 2%.

A survey at this year’s CFA Singapore Annual Forecast Dinner found that the audience viewed rising geopolitical concerns and expensive asset market valuations as the greatest risks in markets currently.

Steen Jakobsen, Chief Economist of Saxo Bank Group, was keynote speaker that evening. The expert panel that shared their best investing ideas and what they viewed to be key risks included:

- Freddy Lim (Co-founder of robo-advisor StashAway)
- Jean Chia (Managing Director, Bank of Singapore)
- Vivek Ahuja (Portfolio Manager, Templeton Global Macro)

Arun Kelshiker, CFA, CAIA, Co-Chairperson of the Society’s Professional Development Committee, was event moderator. The event was sponsored by Saxo Capital Markets and held at Capital Tower on 13 July 2017.
What are your best ideas for investing in the current market given the weighing deflation, and central banks’ respective policies?

**Freddy Lim**: Invest in emerging market bonds.

The Federal funds rate is currently targeted at 1% to 1.25% and the FOMC member’s Dot projections has a median of 2.13% and 2.94% by end of 2018 and 2019, respectively. However, from Janet Yellen’s recent references to inflation, I think the Fed does not have much conviction on the normalization of interest rates. The Fed is going to sometimes sound some warning shots and the market is going to respond as though the Fed is not going to take action. This type of world is going to make very modest, boring markets.
So, my main scenario is: The US dollar is probably going to retrace some of its upside. And the relatively undervalued emerging market bond segment is the best way to play it.

**Vivek Ahuja:** I agree with the emerging markets story.

G3 bonds look very expensive when we compare the valuation of different sectors in the fixed income market. From a fundamentals perspective, the default rates of high yield bonds are at a historical low. The spreads of global high yield corporate bonds today are about 275 basis points over Treasuries. If you take out the energy sector, the spread becomes about 225 basis points. With the potential liquidity risk, this segment doesn’t sound as exciting as what it was 2 years back.

Hard currency bonds appear to be overbought and expensive plays. If you actually believe the US Treasuries can move up from here, they might do well on a relative basis but maybe not on an absolute basis.

**Low Valuation of EM Bonds**

The JP Morgan Emerging Markets Currency Index is below financial crisis levels. Emerging markets local currency bonds are currently the only sector within the entire fixed income market where the valuations are cheaper than during the financial crisis. Some people may say that emerging markets as an asset class may not make sense because you have Venezuela and Turkey. But you also have economies that are doing reasonably well. We need to discern each emerging market and identify the couple of economies within the emerging markets world where cheap discount is available.

Many places like Indonesia, India, and Mexico can potentially yield double-digit returns a year from now. In a world where opportunities are getting narrower, liquidity is flush, and about 7 trillion dollars of bonds are in negative territory, emerging markets bonds are seeing huge flows. It is the one single best idea which we have.

**Volatility Will Return**

**Jean Chia:** Highlighting that my comments represent my personal view and not that of Bank of Singapore, in my capacity as a capital markets professional and observer of life in general. In investments, rule 101 is to get out of crowded trades. and to avoid what will become a crowded trade in time and not be the last man standing.

Steen Jakobsen was appointed to the position of Saxo Bank Group’s Chief Economist in March 2011. Mr. Jakobsen returned to Saxo after two years’ absence. During that time he has been Chief Investment Officer for Limus Capital Partners. Prior to his departure in early 2009, Mr. Jakobsen was with Saxo for almost nine years as Chief Investment Officer. Mr. Jakobsen has more than 20+ years of experience within the fields of proprietary trading and alternative investment.

In 1989, after finishing his studies in Economics at Copenhagen University, he started his career at Citibank N.A. Copenhagen from where he moved to Hafnia Merchant Bank as Director, Head of Sales and Options. In 1992, he joined Chase Manhattan in London as VP, Head of Scandinavian Sales, and then the Chase Manhattan Proprietary Trading Group. 1995-1997 he worked as a Proprietary Trader and Head of Flow Desk at Swiss Bank Corp., London. In 1997, he became Global Head of Trading, FX and Options at Christiania (now Nordea) in New York until he joined UBS in New York in 1999 as the Executive Director in the Global Proprietary Trading Group.
Vivek Ahuja is a portfolio manager and research analyst for Templeton Global Macro. He is responsible for analysis of macroeconomic trends and developments in Asian emerging market economies and financial systems. He joined Franklin Templeton Investments in 2006 and has over 17 years of investment and research experience in the fixed income markets.

Prior to joining Franklin Templeton, Mr. Ahuja has worked in various financial institutions in India in the area of Fixed Income Investments and macro research.

Mr. Ahuja earned his bachelor of commerce and master’s degree in finance from Mumbai University.

Volatility has been in the headlines lately. Many investors and even the Fed have pointed to low volatility with concern. Global investors including sovereign wealth funds are looking into what is amiss and why volatility is so low for both equities and credit markets while correlation between asset classes has been high.

Goldman Sachs recently published a research paper that traces equity markets all the way back to 1928. The period of study included 14 regimes of low volatility. These periods were somewhat like what we are now experiencing – benign growth inching up with no major tail risk. Each period did not last long, averaging 22 months each. This means we are now smack in such a period. It is not yet late in the period, and not many people are in the game. When yields and inflation expectations are low, that is a period when volatility remains low. But the principle of mean reversion implies that volatility will return.

My trade is to long volatility, while it is inexpensive It’s like insurance, which you buy when you don’t think you need it. But the day comes when you look over your shoulder and are glad that you did. However, volatility ETFs may not be the best instrument to express this view.

South Korean Equities

Arun Kelshiker: I would like to suggest South Korean equities. The first reason being that they have a new administration. Historically, the performance of equities in a market with a new administration has been over 20%. There is normally strong double-digit performance in the first couple of years after a new government takes office. Its market valuation is cheap, trading at around 9 times earnings.

Chaebol reform has been on South Korea’s agenda year in year out. I recently spoke with people on the ground in Korea, and found they are now far more optimistic about it. There may be some political tensions between South Korea and its neighbours, but to the people on the ground, business is normal.

What are the major risks for markets?

Steen Jakobsen: The only way you are going to lose significant amounts of money or get a significant increase in volatility is when there is a recession. A recession in the US will cut your returns by 25% to 55%, with an average of 30%. You need to ask yourself: What is my probability of
recession? If like me, you think the probability of a recession is 60% and apply that to the average shortfall in return of 30%, you have to add a risk of 18% to your portfolio. If the probability is only 10%, then the risk should be added by 3%.

The world today is so much into an extended period of low volatility, with passive investment overtaking active investment (which is a negative convexity trade). Every single quant strategy designed today, including ETFs, is negative convexity. A minute change to the market environment will have incremental exponential impact on the market players. The market itself is the biggest risk today.

**Watch China’s Credit Risk**

**Freddy Lim:** Given its size, credit risk in China is something to watch. Globally, most of the growth that we’ve seen in the last decade has come more from an expansion in sovereign credit rather than pure productivity gains. The real risk in a world with bloated balance sheet is that: When you have such a huge amount of credit exposure, any monetary policy mistake could compound exponentially. During the 2008 US financial crisis, we have witnessed a rapid decline in the money multiplier (e.g. M2 versus M0). This means that every dollar created by the Fed was taking a lot longer to multiply itself over the coming months and to be transmitted into the real economy.

One may think that the economy is currently doing well, and that the world is a better place when compared to 2008. The money multiplier number has improved since 2008 but it is a double-edged sword. If central banks continue to base decisions on antiquated frameworks such as the Fed model or the Phillips curve, and if they tighten monetary policy too aggressively, the faster velocity of money would also mean that the tightening in monetary conditions could be larger than expected.

With traditional definitions of money rapidly changing (dizzying arrays of things like crypto currencies and mobile wallets), the impact of monetary policy could be harder to understand. Its impact could also get around faster and hence monetary policy mistake is the biggest risk.

**Disruption Impact to Labour Market**

**Jean Chia:** For me, the biggest risk today is disruption. Disruption had happened through the ages, like what
happened with Nokia phones and the obsolescence of industrial equipment. But today, disruption has resulted in lower demand in the labour market. For instance, headcount requirement in any one organization is reduced due to what the technology enablers can do today. Yet, there is a rise in young, educated, intelligent, and skilled individuals graduating with fewer jobs. Globally, the youth may experience an expanding gap between the haves and have-nots. We are now confronted with a potentially disenfranchised young and educated population in many countries, including in emerging markets which could result in unrest and populism. Then, what we see is national decisions in some jurisdictions becoming unsound.

This affects not only the young people, but older people who are also concerned about job security. The impact is not only socio-economic and political. Freddy and I are competitors but we agree that there will come a day banks are seen as not just financial services provider but a data providers and also data providers. For example, Asian banks have a deep history of customer data ranging from wage growth trends to consumer behaviour and are at the forefront of rethinking our value proposition because of the threat we have seen (in China for instance) of non-financial companies trying to eat our lunch. My hope is that just as Alibaba has transformed the game in the retail industry growth, the next leg of growth will come from innovation by Asian banks.

Arun Kelshiker drives investment solutions across Standard Chartered Bank’s global centers. He is a voting member of the Global Investment Committee and Asian Investment Committee which communicates the “House View” for cross asset allocations.

He was with Allianz Global Investors and Allianz Group, where as a senior equities portfolio manager, and later Country CIO, he successfully set up and managed European, Emerging markets, global and absolute return mandates. He was also formerly the Head of Investment Research and a senior portfolio manager at one of Singapore’s private wealth managers.

He began his investment career in the nineties, and has gained experience with a number of investment firms including ING Barings, Lehman Brothers and Allianz Global Investors.

He has an MBA from the University of Chicago Booth School of Business, US, and a Masters in International Economics and Management from SDA Bocconi University in Milan, Italy. He is a CFA Charterholder and a CAIA Charterholder. His undergraduate degree is from UMIST, UK.
The Chinese economy is clearly a lot more resilient than what most people had anticipated it to be. It grew 6.9% during 1H2017, much higher than the official target of 6.5%.

The current growth rate in China is too high. I believe a more sustainable growth rate in the medium to long term should be around 4% to 5%.

There are several reasons for China’s strong consumption demand:

1. **Developed digital market**
   China has one of the world’s most developed digital markets, particularly in digital payments. There are some PRC cities where you actually don’t need to use money no matter what you do -- shopping, taking buses, taking taxis, buying things at a convenience store. Globally, the best fintech companies are from China.

2. **Aggressive young consumers**
   Among the younger generation, taking a loan to buy luxuries like cars and expensive watches has become pervasive.

3. **Pent-up consumer demand**
   History shows that when an economy achieves a per capita GDP of US$8,000 to US$10,000, its people suddenly start to want to buy things.

Demand in China’s housing and auto sectors is not being met. I believe China’s consumption demand will remain strong. In major Chinese cities, it is very difficult to buy a car and almost impossible to buy a second car. One can wait for 4 to 5 years for a car in Beijing if he goes through the lawful process.


This article is an excerpt of his presentation.
4. Strong international trade data

Major economies like China, US, Europe, and Japan have done exceptionally well in the volume of international merchandise trade this year.

There are two economies in China – the new and the old. The new economy refers to anything related to the services industry and includes IT, healthcare, and consumer services. The old economy includes energy generation, materials, and the industrial sector. I believe consolidation in the old economy could last a very long time.

China is good at making small things big, such as creating special economic zones. When it joined the World Trade Organization, the entire country began transforming into a landscape of specialized economic zones. On the other hand, China is not good at making big things small, such as reforming state-owned enterprises.

I think the ideal scenario for China would be to have a thriving new economy and a struggling old economy. The growth of the new economy with job creation from the services sector, would to a certain extent offset the impact of the consolidation of the old economy. On balance, I think economic moderation will continue.

Finance sector risk

When looking at the Chinese economy, it is important to examine the risk in its financial sector.

China’s double-digit growth of debt over the past 5 years is worrisome, and I expect it to continue to grow. It is now more than 250% of GDP. How does this compare with other vulnerable economies?

Italy’s debt levels have been drawing much attention. Its economic growth is near zero. The magnitude of GDP growth is not enough to pay its interest burden. The consensus view is that Italy would be the leading cause if the Eurozone collapses within 5 to 10 years.

One other vulnerable economy is Australia, which has a consumer debt to GDP ratio of 120%. If its unemployment...
stays low, Australia will be fine. But a rising unemployment situation will implicate its housing market.

The key players in China’s economy are: The central government (Beijing), the municipal governments in Shanghai, Shenzhen, and Guangzhou, etc. There is no difference between Beijing and the local governments because Beijing always mobilizes resources when dealing with local government debt. So, we can conclude that government debt will not cause a problem. There is also much room for growth in consumer debt.

Corporate debt in China is largely the debt of state-owned enterprises. This is under control because unlike in Italy, China’s economic growth is still high, and unlike in Australia, consumers still have much room for leverage. However, China has a big state-owned sector and that is difficult to reform without first going through a crisis.

To reform its state-owned sector, China has to increase the equity issued in its economy. It has to reform its capital markets and use the savings of foreigners. This means state-owned enterprises need to be privatized.

Avoiding a financial crisis

Deleveraging is very difficult. We see this from the history of the Asian financial crisis in 1997. As late as 2002, Thai banks were still in very bad shape and raising money from the capital markets to repair their balance sheets.

Here are some lessons for China from the Asian financial crisis.

Manage Your Foreign Currency Debt

The experience of Thailand and Indonesia tells China that it must not have excessive foreign debt in foreign currencies. In 1997, about 5 to 6 months before the devaluation of the Thai baht, people in this part of the world were still betting on the appreciation of the Thai baht because at that time, the Thai baht was managed against a basket of currencies. It didn’t take sophisticated mathematics to figure out the baht’s exposure to the USD and other currencies like the yen.

Today, foreign currency debt in China is managed at relatively low levels.

Enough Foreign Reserves

Would speculators have left Thailand alone if the Bank of Thailand had 6 months of foreign reserves in 1997?

Xu Sitao spearheads Deloitte’s economic and industry research. Prior to Deloitte, he was Chief Representative of China and EIU forecasting director at the Economist Group from 2004 to 2014.


Mr Xu has written for YaleGlobal Online, the Asian Wall Street Journal, Financial Times, Caijing, Caixin and 21st Century Business Herald. He appears regularly on CNBC, Bloomberg, CCTV, and other TV shows as a commentator on China. He is on the Speaker Retainer Program for the Virginia-based CFA Institute, and is often invited by leading MNCs to their board rooms, to present key issues on China.

He holds a B.A. in Economics from Peking University, a M.A. in Economics from the University of Connecticut, and a M.S. in Finance from Boston College. He was a visiting scholar at Hoover Institution at Stanford University in 2012. He is also a guest professor at the School of Economics and Management of Tsinghua University.
China has an ultra-conservative view on the level of reserves, maintaining it at about US$3 trillion. That is far more than what China needs.

**Strong Regulatory Framework**

You don’t want rapid financial liberalization before your regulatory framework is well-developed. China’s stance on capital markets liberation is to first open its fixed income market, followed by its equity market. The rationale is that the fixed income market tends to be less volatile as the players tend to be long term investors like pension funds. The stock market tends to be more volatile.

**Flexible Exchange Rate Regime**

You don’t want an overly rigid exchange rate regime like what the Thai baht and the Malaysian ringgit had in the 1990s.

China has a more flexible RMB exchange rate today.

**Deal with Corruption**

Indonesia’s collapse was far more spectacular than Thailand’s. It was a society with serious income disparity. There was cronyism where state-owned companies colluded with state-owned banks. China has learnt to deal with corruption.

**Capital Controls**

When Mahathir introduced capital controls in Malaysia at the end of the Asian financial crisis, most Asian currencies including the Malaysian ringgit, were already oversold.

This is where China did not learn well. When China devalued the RMB by 1.8% in 2015, the world was shocked.

**Manage Consumer Debt**

In South Korea, consumer debt was getting out of control. In China today, the younger generation has lost its debt aversion. Deregulation of consumer finance has contributed to rising household debt. The older generation is still quite conservative, which is why household debt is still relatively low at less than 50% of China’s GDP.

**Policy choices**

My policy recommendation for China in the past 3 years has been to have a one-off devaluation of the RMB as soon as possible. If you devalue the currency early, you bring down the economic growth rate. The ideal scenario for China when it reduces its debt would be to have inflation. An inflationary environment will make the paying down of debt less painful.

In the medium term, China needs a certain amount of inflation, a weak currency, and business friendly policies for foreigners.

**RMB Devaluation**

For the World Trade Organization or the International Monetary Fund, the most reliable measure of exchange rate competitiveness is the market share of Chinese products. The market share has been relatively constant, suggesting that the RMB is not overvalued.

Another view on the RMB outlook is: Property markets in first tier cities like Beijing, Shanghai, Guangzhou, and Shenzhen are highly overvalued. The long term trend is that investors will continue to diversify their investments overseas since local property markets are so highly overvalued.

The RMB is likely to stay weak. My view is that the RMB will depreciate over the medium term against the USD as well as other regional currencies like the SGD. As a creditor to other nations, currency devaluation does not affect China negatively. On balance, I believe the RMB should be devalued by another 10% to 15%.

**Open Door Foreign Policy**

The Belt and Road initiative is currently an important national policy that affects most of the ASEAN economies. During the Belt and Road conference in Beijing this year, Chinese leaders made it very clear that all countries are welcome to join this development effort. The Belt and Road initiative is a confirmation of China’s open door policy.

In order to make this initiative a success, China must work with developed nations like the US, Germany, Italy, Australia, and Singapore. China must work with multinational companies. Otherwise, there will be a lot of backlash against Chinese investment.
How does motivation increase an organization's outcomes?

To answer this question, CFA Institute's Future of Finance team and State Street Center for Applied Research (CAR) recently conducted a joint study that lasted 18 months. In-depth interviews were conducted with more than 200 global industry leaders. This was combined with a survey of nearly 7,000 respondents: 3,600 individual investors and more than 3,300 investment professionals across 20 countries.

As in quantum mechanics, where a “hidden variable” is an element missing from a model that leaves the system incomplete, the study found the same situation in investment management.

The hidden variable found to have a statistically significant relationship to long-term organizational performance, client satisfaction, and employee engagement was referred to as Φ (Phi) by the research team. "Phi" is also the acronym derived from the motivational forces of purpose, habits and incentives that govern our behavior and actions.

The study was based on one of the best regarded theories of motivation: Self-Determination Theory (SDT). SDT assesses motivation on a scale ranging from extrinsic (low Phi) to intrinsic (high Phi).

**Extrinsic measures**
- Emotional pressures
- Bonuses
- Status
- Competition

**Intrinsic measures**
- Doing something important
- Doing something right
- Having a calling
- Doing something you love

Robert Stammers, CFA (Director, Investor Engagement, Future of Finance, Standards & Advocacy, CFA Institute) was in Singapore to share with CFA Singapore members the Future of Finance's research findings on employee motivation.

He spoke at the Singapore Management University, School of Information Systems on 25 September 2017.
The findings showed that investment industry professionals are passionate about financial markets, especially if they are CFA charterholders. However, that passion is often directed at things like beating the market instead of improving investor outcomes and achieving investor goals.

Less than half of retail investors believe financial institutions operate in the best interest of clients. The retail investors have a reason to feel that way: Less than one third of investment professionals say that they stay in the industry to help clients achieve financial goals. Only slightly more than one third of the investment professionals surveyed believe their organization acts in the best interests of clients.

Most investment professionals surveyed considered themselves zero, low, or moderate Phi. Only 17% of respondents were rated high Phi. As with most organizations elsewhere, hardly any of the audience that afternoon responded when Mr Stammers raised this question: “Does anyone here think that their organization uses motivation to the best extent, that people there work for a purpose, have good habits, or that their incentives are well-structured?”
Prior to joining CFA Institute, Mr Stammers was the principal to A2O Consulting where he founded a consulting business to aide real estate owners, lenders, and syndicators, develop and analyze structured real estate investments. There, he developed strategy for obtaining debt and preferred equity capital as well as created finance related marketing materials and research papers for various clients.

Mr Stammers has authored over 100 articles on various financial and investment topics for several investment periodicals such as Forbes and Investopedia.

He served as a senior equity analyst with Long Term Short Term, Inc, where he was responsible for the creation of new investment tools and instructional products to provide the revenues for two new investment education companies.

As a senior executive for several institutional fund managers, Mr Stammers was the portfolio manager for a US$1 billion enhanced real estate fund, a US$1.2 billion private timber fund, and several pension fund separate accounts.

For more info, go to
https://www.cfainstitute.org/learning/future/Pages/motivation_the_hidden_variable.aspx
You cannot understand Chinese banks unless you understand the political economy that they are part of. And you cannot understand the political economy unless you understand the culture in which the political economy is embedded.

An inside story
If you were a journalist from Bloomberg and you wanted an interview with the chairman of Hong Kong and Shanghai Bank, you will probably be granted it. If you wanted to interview the chairman of Bank of China, you probably won’t be.

Chinese banks have a very opaque corporate culture. They don’t communicate with the outside world. The annual reports tell you quite a bit, but that is all.

In the days of Mao Zedong, the Party Secretary told you what to do. They didn’t have boards of directors. In 2003, the founder and chairman of China Minsheng Bank, Jing Shuping, realized he needed corporate governance, a board of directors, and independent directors. He asked the International Finance Corporation to recommend Westerners with long banking experience, resident in China, who could operate at the board of directors level in the Chinese language. That is a very small population of people. That was how I got the job and how this book came to be written.

Transformation of banks
In the 1990s, when China’s economy was beginning to take off and the free markets were beginning to be accepted, Premier Zhu Rongji saw that the banking system was still operating like in the 1970s. It was lending according to quota. It had no concept of risk management. Many of the state-owned enterprises they were lending to didn’t even know they were supposed to pay back a loan. It was like in the old days when the government gives you money and you spend it. The nonperforming loans went up to about 40% to 50%.
The banks were technically bankrupt.

Zhu Rongji, as he did with many other things, sent teams around the world to study global best practices. The teams came back and said, “Prime Minister, if we don’t have a dynamic, well-run, and efficient banking system, we will not be able to support rapid economic growth. Banking systems are core to rapid economic development.

“On the other hand, if we have a bad banking system like what we have seen in Thailand, Indonesia, and in Korea in 1997, inefficiency and poor management can bring the whole economy down.”

Zhu Rongji understood and said, “We are going to transform our banking system.”

Corporate governance

It’s hard to remember just how little they knew just 15 years ago. What does an independent director do? What does an audit committee do? The auditing profession disappeared from China from 1952 to the 1980s. When they resurrected the auditing profession, they had to bring retired auditors who were more than 70 or 80 years old back from Shanghai to teach the young people what auditing was all about.

In 2006, the China Banking Regulatory Commission instructed that every bank was to have a robust internal audit programme, not just external. When I first chaired the audit committee of China Everbright Bank in 2006, the internal audit team couldn’t tell the management in a coherent way where the risks of the bank were. By 2010, they were a very professional, well-managed part of the bank that engaged in very constructive dialogue with the management. The speed of learning was incredible. They now conform to global banking standards and international best practices.

Risk management

Risk management started with credit risk, followed by operational risk. It was only a few years ago that enormous cases of bank fraud would hit media headlines. A particularly notorious example was when Gao Shan, the head of a sub-branch of the Bank of China, was sentenced to jail in a case that involved almost 3 billion yuan (about US$350 million). Such things still occasionally happen, but very rarely. The internal controls of Chinese banks have improved a great deal. The ability of internal audit to pick up deviations from operational controls has improved immensely. Partners who study that particular technical subject tell me that operational controls in Chinese banks are probably at least as good, if not better, than those in European banks now.

Information technology

In the course of writing my book, I interviewed people from James Stent specializes in economic policy, governance, market entry and financial communications and has a long and distinguished career in financial services in Thailand and China.

Mr Stent worked for 18 years in Bangkok at Bank of Asia, a Thai bank, serving as deputy president of the bank until his retirement in 2002, and thereafter continued as a director of the bank until 2004. He began his banking career with Citibank, working in New York, Manila, and Hong Kong. He then joined Crocker National Bank, working in San Francisco, Hong Kong and Bangkok, before moving to the Bank of Asia.

Commencing in 2006, he served six years as an independent director and chairman of the audit committee of the China Everbright Bank, followed by four years as a member of the bank’s Board of Supervisors. From 2003-2006 he was an independent director on the board of the China Minsheng Bank in Beijing. He is presently an independent director and chairman of the audit committee of the XacBank of Mongolia.

Mr. Stent is a graduate of University of California, Berkeley and holds a Master’s degree in public affairs of Woodrow Wilson School of Public and International Affairs of Princeton University. He speaks and reads Chinese and Thai languages.
The lens through which we see ourselves overstates China’s downside risks and misses the strategic building blocks of its nascent structural transformation.

Stephen Roach
American economist
(former chairman of Morgan Stanley Asia)

IBM and Hewlett-Packard who are the main suppliers of hardware and software to Chinese banks. They told me, “Chinese banks are ahead of New York and the European banks. When New York and European banks merged one after another, they pack the IT systems together without integrating the platforms. They have old legacy systems that they invested in 20 to 40 years ago. Chinese banks invested in much more integrated and much newer IT platforms as they came late into the game.”

Customer Service
When I joined China Everbright Bank in 2006, customer service was awful. During 2009 to 2010, Chinese banks started to promote customer service with campaigns such as Model Worker of the Month. Nowadays, Chinese banks have good customer service.

Fintech
In China, hardly anyone pays with cash. They pay with cell phones. That is way ahead of America. Apple Pay in America has not succeeded. WeChat and Weixin payments are everywhere in China. Most Chinese customers no longer go to bank branches. They do most things by themselves online.

Political and economic culture of Chinese banks
Americans like to think, “Our way of doing things is the gold standard with universal values. You need market capitalism and democracy.” Actually, America is at one end of the spectrum and China is at the other. Chinese understand Americans but Americans don’t understand China’s very different culture of relationships between society, economy, individuals, government, etc.

In America, it is all about freedom, the individual, liberty, and rights. Americans are very suspicious of government. Ronald Reagan, when he was president, said, “Government is not the solution to our problem. Government is the problem.” So, we constrain our government.

Like Americans, Chinese are very competitive. But way back from Confucian times, China has been very much about how you create social harmony -- duties and relating to the society around you starting with the family, then clan, village, province, and eventually loyalty to the emperor. Hu Jintao’s basic slogan when he was head of China was: Harmonious Society.

Structural characteristics of the Chinese economy

Market Socialism
In America, market and socialism are opposites. Xi Jinping said, “We should make good use of rules of both the market (the invisible hand of Adam Smith) and the government (the visible hand).” Deng Xiaoping said the same thing, “I like markets and I like central planning.”

Chinese are very good at handling contradictions and are also very good at trying to find a balance. That is the essential idea of market socialism. The government can do certain things very well. The market does certain other things.

In America, the market is sacred -- The market solves all problems. On the other hand in China, the market is a very useful tool but it doesn’t get everything right. The government has to stimulate the economy, restrain market excesses, and create harmony when there is too much competition. So, there is no ideological reluctance in the Chinese government taking an activist role to affect market outcomes when it wants to.

The result of this is a hybrid banking system. If you asked Jamie Dimon, the chairman of JP Morgan Bank,
“Why do you go to work in the morning?” He would say, “I go to work to create profits for my bank, create shareholder value for the shareholders, and then I get a big bonus.” Bottom line is what American capitalism is all about.

On the other hand, the chairman’s message in the annual report of a major Chinese bank would probably start out by saying, “We effectively contributed to national development plans and delivered X% returns on the bottom line to the shareholders.”

Chinese banks have socialist goals contributing to national development as well as market goals to create shareholder value. They are all ultimately owned by the state, but they compete vigorously because that is how the CEOs of the banks are measured.

If a bank CEO produces 12% ROE when someone else produces 15%, the government is probably going to retire the first guy. Most Chinese banks have the same ROE. The market is a tool to foster efficiency in the operations of the bank.

The purpose of the bank is to support the real economy much like how a water utility provides water and makes a return out of that. Chinese banks make a return for shareholders but its objective is to supply funding to the economy, to provide a store of value to the savers, and to effect payments between people.

Role of Communist Party

I can compare market socialism in China to market capitalism in America but I can’t compare the Communist Party with the Republican and Democratic Party. They are totally different. They are both called parties but that is the end of the resemblance.

The Communist Party sets the general policy for the country, communicates that policy down and enforces discipline, as many people are learning in China under Xi Jinping’s anti-corruption campaign.

The Communist Party Organization Department (中央组织部) controls all the major appointments in the PRC government, in state-owned enterprises, and in the banks (including even the privately owned ones).

You won’t become the CEO of a privately owned bank like Minsheng or Pingan without the blessing of the Party, and you have to be a Party member. I was probably the only non Party member on the board of China Everbright Bank. The significance of this policy is that it allows an alignment of the Party system to what the banks were doing with what the nation has decided it wants to do. This is communicated down through the Party level.

I argue that the Organization Department, apart from being the largest HR department in the world, is also very effective within the banking sector. The people that I have worked with at the board level and in management are very professionally qualified. The China Banking Regulatory Commission has to approve all appointments to the board level, and they often turn down people that they don’t consider as having adequate economic, financial, accounting or other relevant skillsets and experience. Banks are too important in China to leave in the hands of amateurs.

Power of the State

Americans will often tell you, “But the government cannot do that:” The PRC government, if it decides it wants to, can. An example when they did it really fast, decisively and effectively was in 2008 when they routed the RMB 4 trillion stimulus through the banking system. That has resulted in a great accumulation of debt which is worrying. But it accomplished its purpose: At a time when western economies were collapsing and export markets were drying up, there would be new drivers of growth to prevent millions of people from being unemployed.

Economic growth in China continued. The slogan then was: 8% economic growth. In fact, in 2009, it achieved GDP growth of 9.4%. Since then, it has been gradually coming down in a very controlled and planned way. China is on track to double its real per capita GDP between 2010 to 2020 at a time when Europe has stagnated.

China’s Banking Transformation – the Untold Story is available at Alkem and at Books Kinokuniya Singapore.
Advocacy / Asset Management

Forum with National Volunteer and Philanthropy Centre and Centre for Non-Profit Leadership (7 July)
L-R: Simon Ng, CFA, Board Secretary, CFA Singapore | Janssen Ong, Deputy Director, People Search | Victor Lye, CFA, CFP®, Founder & CEO, Pivot | Melvin Tan, CFA, Portfolio Manager, DCG Capital | Dr. Tony Tan, CFA, DBA, Head, Standards and Advocacy Division – Asia Pacific, CFA Institute | Chuin Ting Weber, Chief Investment and Asset Management Officer, Singapore Labour Foundation | Winifred Loh, Managing Director, Centre for Non-Profit Leadership

CFA Singapore received the CFA Institute 2017 Society Excellence Award for Strategic Initiative: Build Market Integrity (19 May 2017 at the 2017 Society Leadership Conference in Philadelphia, USA).
L-R: Frédéric P. Lebel, CFA, Chair, Board of Governors, CFA Institute | Francis Er, Executive Director, CFA Singapore | Jan Richards, CFA, President, CFA Singapore | Tan Lay Hoon, CFA, Deputy President, CFA Singapore | Paul Smith, CFA, President and CEO, CFA Institute
Professional Development

Former banker James Stent (left) autographed his recent book, China’s Banking Transformation, for fans at his presentation to CFA members (29 September at Manchester Business School, Market Street).

Dr. Jason Hsu, Chairman and CIO, Rayliant Global Advisors (left) discussed investor behaviour in the China A-share market (28 September at Manchester Business School, Market Street).

Robert Stammers, CFA, Director of Investor Engagement, Future of Finance, CFA Institute, spoke on motivation as a factor for organization success (25 September at Singapore Management University).
Networking

Networking Drinks with Deepak Natarajan (above, left), technology veteran, venture capitalist and serial entrepreneur (24 July at OSG Bar+). The event moderator to his left is Pearlyn Chiang, CFA.

July Networking Drinks - Thinking Beyond The Box - The Henley Executive Hedge Fund Program - A Primer For Finance Specialists (11 July at Asia Square Tower One).
Career Development


◄ How to Manage Your Career in this New and Disruptive Financial Industry Landscape (9 September at Manchester Business School).
University Outreach

At the kick-off meeting for the 2017/2018 University Investment Research Challenge (UIRC) season (30 September 2017 at Bloomberg):

- Melvin Tan Teck Jin, CFA (top left) and Dr. Mitchell Van der Zahn, CFA (top right) from the University Outreach Committee addressed this season’s participants.
- Participants of the 2016/2017 UIRC shared their experiences.
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