

“THE COMMUNIST PARTY WILL GET CHINA RIGHT”

Are investors in the West wrong to compare China’s shadow banking problem with the sub-prime crisis and do they worry too much about broader uncertainty in the second largest economy? Fund chiefs in Beijing think so. Chaired by Nick Fitzpatrick.

THE PANEL

Dr King Lun Au

Chief executive, BoCHK Asset Management

Zeid Ayer

Special assistant general manager, CCB Principal

Tian Rencan

CEO, HFT Investment Management

Philippe Seyll

Head of investment fund services, Clearstream



» I’M FULLY CONFIDENT THE COMMUNIST PARTY UNDERSTANDS HOW TO TAKE THE ECONOMY TO THE NEXT STAGE. GROWTH WILL RELY MORE ON QUALITY RATHER THAN ON QUANTITY. «

Tian Rencan, HFT Investment Management

Funds Europe: There is concern about a slowdown in Chinese growth and potential systemic problems, such as the amount of non-performing loans in the shadow banking system. What is the outlook for its economy?

Tian Rencan, HFT: After three decades of very fast growth,

China needs a new way of developing its economy. China is facing some structural problems, but the most important thing is the Chinese leadership’s awareness of this. These issues are discussed and debated in newspapers.

I followed the last congress [National Congress of the Communist Party of China] and I’m fully confident they understand how to take the economy to the next stage. Economic growth will rely more on quality rather than on quantity; we have to clean the air, we have to clean the water, and we have to find new economies to grow.

Stemming from the old economy

you may find important industrial restructuring that will create value through consolidation among SOEs [state-owned enterprises] and other companies. But there is also a huge market for new economies with very dynamic innovative entrepreneurs.

Dr King Lun Au, BoCHK: We are at a critical juncture, but we have every potential to become the largest economy in the world and the largest consumer market in the world. Renminbi internationalisation has been so successful it now puts pressure on China to open up its capital account to maintain momentum. China wants to do this. Hence we have seen interest rate deregulation and the first bond default in China in 30 years. It is a miracle that the fastest growing emerging market economy in the world over the past 30 years did not have a bond default until now. All these are very positive changes and will create many investment opportunities.

Zeid Ayer, CCB Principal: In summary, the outlook is good for the economy. A slowing economy is a natural consequence of growing at a very fast pace over the last three decades. Capital market liberalisation, particularly of interest rates, together with better pricing of credit risk – there has been a lack of proper pricing – and the internationalisation of the renminbi, are factors that will open up huge opportunities for investment. These changes will level the playing field between banks and other finance sources. Now banks tend to dominate.

There are a really low percentage of non-performing loans on bank balance sheets and while these will continue to increase the situation will just

have to be managed. Defaults would be somewhat selective and you just hope that the entities that default do so because of either bad business models or something the market can learn from. We would not want them to be random selected failures.

Tian: Recently the government again indicated that issues in the financial market would not lead to a systematic risk. Things will be dealt with in the proper, gradual way so that change does not create bigger problems.

Au: There's a big misconception about China in the West. You cannot compare the shadow banking problem in China with that of the subprime crisis in the US. The US economy was

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highly leveraged and ran into a severe liquidity crunch during the subprime crisis. The shadow banking system in China may seem to be highly risky but here in China we don't actually have any liquidity issue. Instead, we have a misallocation of capital problem. Capital has not been efficiently channelled to the right market opportunities, but now with more market liberalisation, such as interest rates deregulation, and with the market learning how to price credit risk properly, there will be a more efficient deployment of capital going forward.

And there's also another major difference between the shadow banking problem in China and the subprime crisis, which is that the banking system is effectively owned by the government, unlike in the West, where the free market means that if you have a bad loan, you have to deal with it immediately. In China, there are various ways of dealing with that situation and that's why we managed to not have a bond default over the past 30 years until recently. I'm actually very >



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encouraged by the first bond default. It means the government is now recognising that there's a problem we need to deal with in a traditional Chinese manner, very controlled, very selective. Hopefully the government would not allow systemic risk to be triggered by uncontrolled defaults. We expect to see more M&A where less efficient businesses are taken over rather than allowed to default. There will be opportunities for both equity and fixed income investors as the market should become more efficient in price discovery.

Tian: There has always been a government desire to promote a system of direct financing instead of relying on banks, but it hasn't happened because the banks benefit from their monopolistic situation. Their interest rate margin is very substantial; they want all the financing because that's where their huge, fat profits come from.

When interest rates will be liberalised – which means deposits will cost more to the banks – banks will automatically think twice before lending money because whenever there's a bad loan, they will be hit and their margins will get smaller.

Ayer: Most of the state-owned banks lend to SOEs. It's the safe way out because there's no real credit risk involved. This is partly why the shadow banking industry has come about: small companies, property developers and even local governments need funding and are willing to pay higher rates. Savers stuck with artificially low deposit rates below the rate of inflation will lend to these trusts and other vehicles. There are proposals to issue bonds directly by creating a municipal bond market. This would be hugely beneficial because it would require additional scrutiny – such



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as from ratings agencies – and more transparency.

Philippe Seyll, Clearstream:

But for people on the outside, the difficulty is in understanding how to grab the opportunities in China. In Europe we have seen single-country funds become fashionable.

We had to add Hong Kong and Singapore funds on to our platform three to four years ago when people needed the infrastructure to invest in them, and we have many requests for China funds. People ask frequently how they can get access to China.

Funds Europe: With that in mind, how do you anticipate the continued development of

the Chinese asset management market, particular with regards to winning foreign investors?

Ayer: The RQFII [renminbi qualified institutional investor] programme has been a popular way of accessing China. Perhaps Luxembourg will be a major RQFII centre next.

Tian: The QFII, which preceded the RQFII, is more of an equity product, while RQFII is encouraged as a fixed income vehicle. They have evolved step by step and the next question will be whether we could access OTC markets in the RQFII. Gradually, there will be a wider access to RQFII and it will not only be about fixed income.

Seyll: Might Europe's Alternative Investment Fund Managers Directive offer a solution for European access to China assets? The directive offers a regulatory regime for investors accessing certain assets and strategies, and perhaps as some emerging markets, including the BRICs [Brazil, Russia, India and China] lack a suitable regulatory regime,

it is something China asset managers could utilise to attract foreign investors.

Au: RQFII is a window for China-based managers like ourselves to expand overseas. RQFII quotas have been granted in London, Paris, and Frankfurt and more cities will join the scheme going forward. RQFII has already created a lot of opportunities for us, but now with Luxembourg approving China's interbank bond market as a recognised market, another door opens through which we can launch fully fledged China bond market products in Europe.

Ayer: RQFII yields if invested in bonds are much more attractive than in the developed world and there is no real credit risk with bonds issued by policy banks and other fairly safe SOEs.

Au: The tax situation with RQFII has been clarified. The capital gains tax has always hung over QFII, but now there is an RQFII pocket meaning securities, except for land-rich securities, in RQFII

products are now capital gains tax-free. That's a big incentive for people to buy into RQFII.

Ayer: The several trends we have mentioned – interest rate liberalisation, credit risk pricing, and the internationalisation of the renminbi – will create more investment opportunities and products. Locally, the mutual fund market is very retail driven, but there will be more institutional involvement as it evolves, and this will force discipline on a lot of companies, causing greater transparency and better corporate governance. It will help the market to move away from a short-term mentality and look at the full market cycle, as is the case in the developed world.

Tian: When I set up HFT 12 years ago, I did not realise how difficult this market would be.

» THE BRICS LACK A REGULATORY REGIME, AIFMD IS SOMETHING CHINA ASSET MANAGERS COULD USE TO ATTRACT FOREIGN INVESTORS. «

Philippe Seyll, Clearstream

If you look at the turnover in the stock market, more than 80% of it is due to individual speculators. We can hardly say there are any institutional investors involved. Consequently, fund houses are under pressure from intermediaries, such as banks, to produce new funds with star managers. That is dangerous, so we have tried to build an institutional standard platform. I helped Fortis win the first qualified domestic foreign institutional investor fund licence and we immediately got €365 million. We subsequently won a corporate pension fund licence and this means today, only RMB 23 billion (€2.7 billion) of our RMB 92 billion of assets under management are mutual funds.

If the market is short term, there are many issues with that. For example: are listed companies accountable to shareholders? Most of them are large SOEs, so managers may have a short-term horizon because they do not need to fight for a share price.

I believe that due to a lack of reform in the financial system so far, interest rates will go up, and in such a case demand for investment products will slow down. We do not have real asset management in China – it is a funds industry. But in the past year a revised fund law allows individuals, if they have a proper track record, to set up a sunshine [start-up] asset management business and so we are now seeing the start of an asset management industry. I believe that there will be a big reshuffle in the industry in the next five years as people with a captive distribution network move towards retail, while others with strong processes, discipline and track records move towards institutional asset management.

Seyll: So you think that funds are for retail investors, while asset management, or mandates, is >



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an institutional offering? In the rest of the world this is not the case. There are high-net-worth clients using mandates and large pension funds using mutual funds. Are you saying it's different here?

Tian: No, funds have been vehicles for large insurance companies. What I mean is, on one hand, there is the fund business driven by distributors who put pressure on managers for short-term performance. You may adopt this kind of management style, but over the long run it will not suit most institutional customers. In this market you have to think very clearly about what you are building over the long run.

Seyll: That is fair. Funds need long-term investment to function well and be efficient. If you fail to stabilise fund investment, then funds are probably not the right products. However, one solution to handling flows could be ETFs [exchange-traded funds].

Ayer: Institutions sometimes have pretty specific requirements that aren't met by funds. Some institutions require more tailoring, such as restricting investment in some areas.

Secondly, fees are quite high to be attractive to institutions. Institutional share classes need to be created which are cheaper, with less people to pay, such as distributors. We'll see product development here in future.

Tian: At road shows I come across two attitudes. One is where people want exposure but do not know the managers in this market, so they see passive products as an alternative, though keep in mind that last year's index performance hit passive investors; active managers outperformed the index by more than 10% on

average. I still believe that China is a paradise for stock pickers.

Ayer: There are opportunities in indexation. Whereas a lot of the indices track large-caps which have done pretty poorly, smaller caps returned nearly 75% last year, measured by the ChiNext Composite Index. Investors need to get away from the SOEs. However, active management is where the real value is, in people who know the market.

Seyll: I am not highlighting ETFs for their passive, tracking characteristics, but because they are an example of electronic trading products that offer cheap, quick access to a market. An ETF can also be internationalised as it can list on overseas exchanges. A listed fund can attract institutional investors and it may help fund managers handle the inflows and outflows in this market.

Au: Funds in Asia are sold rather than bought mainly because distribution is heavily dominated by banks and insurance companies. An investment fund is just one of many financial products that banks have on their shelves and frequent product or fund switching then inevitably leads to churning.

In order to raise assets under management (AUM) successfully, fund managers tend to launch thematic products as a herd. However, a lot of these funds will die out or fall out of favour over time, leaving fund managers with non-scalable funds and facing problems of consolidation, and so on. It's a recurring cycle in Asia.

Seyll: Churning is not common in Europe. Fund portfolios churn barely once a year.

Au: On the institutional side, fund managers are chasing after only a very small number of sizeable clients in Asia. The market is

overcrowded with the presence of many international and local fund managers. This means managers in Asia have very little bargaining power, especially when it comes to management fees.

Funds Europe: Fund distribution in China is dominated by large banks. Wider distribution is encouraged. Will Ali Baba, the Chinese e-commerce firm with a large online money market fund, change the market?

Tian: Ali Baba will be a real challenger, at least for basic products that can be clearly defined in terms of expected returns and redemption periods. But once there is risk potential, it will be more difficult. People need face-to-face advice, and there will be compliance issues.

Au: Conducting know-your-client procedures online is a key challenge. How do you know whether clients are giving correct or true information?

Seyll: Similarly, stock exchanges have seen new entrants to their business, like multi-lateral trading facilities, which are less capitalised and pay less attention to know-your-customer risk and credit/compliance risks. This makes them more agile. But my point is, you can't just ignore challengers like Ali Baba, right?

Tian: It is a good development. But for fund managers it would be a big challenge to explain performance. It could lead to a lot of problems. But the Ali Baba model is really strong because it can combine many functionalities, such as payment and transfers.

Ayer: A more complicated product like an equity-based product where there's risk and more disclosures required, that

would be much more difficult to sell, but fund management companies can't sit on the sidelines. They've got to pay attention to what's going on and make sure they don't fall behind.

But the other thing I worry about is if there were mass redemptions from the fund, which settles on a T-plus zero basis. How would liquidity demand be supported? When wealth management products and trust products come close to maturity there is a huge demand for interbank funds.

Au: Yields are coming down, so what you say, could happen.

Funds Europe: How successful has global development of Chinese asset management been? Will mutual fund recognition between Hong Kong boost it?

Ayer: With mutual fund recognition there are huge opportunities for asset managers in both regions. It opens up the mainland market to Hong Kong investors, and opens up the Hong Kong market – and potentially global markets – to mainland investors. From what I've seen, there's more excitement in Hong Kong about the prospect of tapping the onshore China market. The Chinese are more sanguine about offshore investment. Chinese asset managers' expertise and talents are more focussed on Greater China. Chinese investors that invested overseas through the QDII [the qualified domestic institutional investor programme, which gives quotas to China's asset managers to invest client money abroad] has not been a success. When QDII was first launched, four large funds did really poorly and that put a huge cloud over the entire scheme going forward. There is likely to be a bias by the banks to give

money to foreign asset managers for investment overseas. From what I've seen, foreign asset managers have been more successful offering funds that invest offshore.

Au: We know Hong Kong is very keen on mutual fund recognition. But how could onshore China managers benefit from it in light of the limited success of RQDII [which allows the Chinese to invest in offshore renminbi assets] in the retail market?

QDII has not been very successful largely due to unfortunate market timing as the first batch of products was introduced in 2007.

Mutual recognition would provide another opportunity for domestic managers to look for partnerships with overseas managers to offer a wider range of global products.

The market dynamic is changing as China is gradually opening up the capital account and domestic investors have the needs to diversify overseas, and mutual recognition provides the regulatory framework required.

Ayer: The partnership approach is very important for distribution as well. If you're an established manager, you probably have your own distribution platform and with agreements with banks and other channels.

A key point is the need for diversification. Foreign investors need to add China, there's no question about it. There is also the possibility of the inclusion of A shares in the MSCI emerging market index sometime next year.

This is very important for overseas investors. It would have been a huge help to onshore investors had they invested in overseas markets in the last few years because of how well they've done compared with investment in the domestic market.

Tian: In the coming years there will be a fierce battle for talent. There are a lot of locally trained managers who are good and understand A shares. They can visit a listed company and adapt their research, yet it will still probably take years for them to understand how to translate that in a way that overseas investors understand or accept. They may understand A shares, but they have to make A shares into a sellable product overseas.

And foreign managers coming to China have to overcome language and cultural barriers.

People may eventually fight for a handful of high quality talent and those who will do that will be hugely successful, otherwise they have little chance.

European investors don't just care about performance; they care about other issues and need these issues explained in the proper way.

Seyll: We have a different perspective because Clearstream is in a different part of the value chain. Our challenge with China is to understand how we can help raise capital. As an infrastructure provider we are lucky in Europe because there's a tsunami of regulation that pleads in favour of regulated entities protecting the market from the systemic risk, and we are gigantic in that field.

We still want to understand how fund flows will reach China. Is Hong Kong the conduit through which monies will flow into China from abroad? It's just that mainland managers do not appear to see Hong Kong as pre-eminent as Hong Kong does?

Au: China will want some kind of oversight.

Ayer: The Chinese regulators are being very careful. They want to make sure they protect their domestic investors. fe