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CHINA REAL TIME REPORT

## U.S. Banker to China: Hold Off on Those Reforms

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Few U.S. banking experts in China boast Frank Newman's resume. Chief executive of Bankers Trust. Deputy U.S. Treasury secretary. Five year-stint as CEO of Shenzhen Development Bank, which ended in 2010.



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"I was, intentionally, the only Westerner among the 15,000 employees of the (Shenzhen) bank," he says.

With the Communist Party is poised to discuss economic strategy for the coming decade at a major conclave in Beijing starting Saturday, Mr. Newman has the following advice: Scratch some of the reforms being pushed for the financial sector.

"China has done well with plain vanilla banking," says Mr. Newman, who is now nonexecutive chairman of Promontory Financial Group China Ltd. in Hong Kong.

Bank deposit insurance? Don't bother. "Right now, we have implicit full deposit

insurance, which works pretty well," says the 71-year-old Mr. Newman. If deposits are guaranteed only up to a certain amount – 500,000 yuan (\$82,000) is most likely, say banking officials—rich Chinese may pull their deposits from smaller institutions and put them in China's Big Four state-owned banks.

Why? Because they may figure that the government will never let any of those deposits take a loss.

"Deposit insurance could lead to more concentration (of assets), not less," he says. China's largest state-owned banks favor the big state-owned companies that dominate the energy, transportation, electricity and other markets. Making them even more flush with cash could frustrate plans to diversify lending.

It's also hard to know whether Chinese depositors will look at deposit insurance as a security blanket or as a sign that the government is willing to let depositors take a hit in a banking crisis. If it's the latter, chaos could ensue, he warns.

He says Shenzhen Development Bank was hit with a bank run when some wealth-management products took losses.

"The customers wouldn't accept it even though the documents they signed said (the wealth-management product) wasn't a product of the bank," he says. "They surrounded branches."

Eventually the bank worked out a deal with the affected depositors by offering them the chance to invest in a new financial instrument "that wasn't offered to others," Mr.

Newman says.

Another proposed reform — letting banks compete on deposit rates— could also backfire, he warns, as it has in many countries, including the U.S. In the 1980s and 1990s, U.S. savings-and-loan institutions went bankrupt by the hundreds. S&L execs competed for deposits by offering higher and higher interest rates and invested the proceeds in real-estate projects that went bust. The result: a government cleanup that cost taxpayers hundreds of billions of dollars.

“I believe interest-rate deregulation should be done very slowly, over a very long time, to allow banks and markets to adjust and learn to manage the risks,” he says.

Mr. Newman agrees with China’s economic reformers that there should be more competition in the banking sector. He also agrees that there should be more lending to smaller, innovative companies, not just to state-owned behemoths. But he says the way to get that isn’t to open China’s banking sector further to capital flows. Instead, the Chinese financial system needs to change incentives.

“There are old traditions of finding someone to blame when loans go bad,” he says. That has to be replaced by a culture of analyzing credit, bringing in new business and realizing that some loans will lose money. Bonuses are important, he says, but the system has to be changed so that bonuses are “more clearly linked to measurable performance.”

“The biggest risk to the economy of China comes from potentially adopting too many Western approaches, accepting too much Western economic dogma,” says the former senior U.S. banker and government official.

—*Bob Davis*

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