CEO reflections

Piyush Gupta shares his thoughts on asset quality and the outlook for 2017.

Asset quality was the biggest headwind DBS faced in 2016. The increase in NPLs from 0.9% to 1.4% and doubling of allowances to SGD 1.4 billion were higher than the guidance provided at the beginning of 2016. What caused the worse-than-expected deterioration?

The headwinds were related to two key areas.

First, over the past five years, we built up capabilities to provide risk management and hedging solutions for our exporter clients in Greater China. In essence, exporters tend to be disadvantaged when their home currency strengthens versus the dollar, so they were hedging against a consistent appreciation of the RMB.

For the vast majority of our customers, the hedge worked as it was meant to. However, in some cases, the benefit of the hedges did not accrue as intended because of two reasons – either the importer (our client's counterparty) forced a renegotiation of terms, so that the benefits of the currency weakness did not pass on to the exporter, or the tenor of the hedges did not foresee and factor the reversal of the business cycle.

Overall, over the five-year period, this business has proven to be beneficial for our clients. However, we have learnt the need to have a better understanding of the dynamics of the contract between the buyer and seller, and perhaps hedging at a transaction level rather than at a portfolio level for certain segments of our customer base.

Second, our biggest challenge was undoubtedly in the oil and gas support services sector. This is a big industry for Singapore, in which we have a meaningful market share. Exposures had built up in the 2012-2014 period, when consistently rising oil prices caused several of our clients to take an expansionary view of their business. The crash in prices from USD 130 to USD 30 per barrel in the second half of 2014 put strain on the sector, which was to be expected. We took comfort in the fact that our customers generally had long-term contracts with their counter-parties, our exposures were generally well secured against vessels and the loan-to-value was conservative.

In hindsight, the extent of the liquidity squeeze on the industry was unexpected, as major oil companies renegotiated contracts and new contracts dried up. This had the biggest impact on a small sub-segment of our portfolio – the contractors. We have taken away several lessons from this episode, including revisiting our credit policies for contractor financing.

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Overall, I believe that the management of our portfolio continues to be quite robust. Our more recent target market selection, customer origination, and credit underwriting have not been cause for concern. In fact, we have strengthened our industry framework, so that industry experts now participate in the selection and underwriting process more consistently. We have reviewed our approval authority matrix, with clearer accountability in both origination and credit teams. The one area in which we could do better is that of early warning triggers. By and large, banks still tend to be driven by financials that they obtain from clients periodically.

Unfortunately, these tend to be lagging indicators. Our forward looking assessment tends to be very judgmental, leaving too much scope for variance in quality. I think that we could do much better using a big data driven approach to this. This is something DBS has started experimenting with.

What do you think will be the outlook for Asia in 2017 given the uncertainties related to a Trump administration in the US, a more complex geopolitical situation globally and a slowing China?

While 2017 will continue to be challenging, my base case is that the global economy may well surprise on the upside, backed by stronger growth in the US economy. This positive momentum should spill over to Asia, benefitting the region.

I base my views on two broad considerations.

First, the US economy has a lot more momentum and strength than is currently being forecasted, and contrary to popular belief, growth is not a zero sum game. A strong US economy lifts a lot of boats around the world. This is further coupled with short-term resilience in Europe (Germany in particular is quite strong), and a degree of stability in China, where there is every incentive to cushion the economy going into the year-end Standing Committee elections.

US President Donald Trump has inherited an economy that is looking pretty good. In recent quarters, consumption has improved notably. Consumer confidence is at a high. Retail sales continue to move upwards, and housing prices in many large cities have rebounded to pre-financial crisis levels. This has a wealth effect, so despite the deleveraging in some areas, consumers feel wealthier and this should support consumption.

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The labour market is near full employment. This is showing up in rising wages, which is a catalyst for continued robustness in consumer demand.

So far, the only fly in the ointment is business investment. This is likely to get positive impetus if President Trump does end up pushing through tax reforms, which will spur domestic investments. Fiscal stimulus, albeit small, should also create investment in the economy. Taking all this into account, the US economy may finally break through the shackles of the 2% GDP growth we've seen for the past four to five years. We're likely to see a GDP growth rate this year of 2.5% to 3%. Historically, a strengthening US economy also eventually results in significant outbound investments, which will benefit Asia. The correlation between a higher USD and Asian equity is very positive, for example.

Second, while President Trump has been difficult to predict, and markets will likely see-saw through the year in reaction to his tweets, many of the officials that he has appointed so far are pragmatic and business friendly. His team's early engagement with Europe and Asia has been encouraging. It is more balanced and constructive than was expected.

Uncertainty will be a main driver in 2017

What could go wrong?

- **Trade protectionism.** A general border tax, if implemented, will have significant implications on Asia. But trade protectionism hurts the US more than many people think, and my own bias is that a pragmatic view will eventually prevail, and any controls implemented will likely be on selected industries.

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- **A much faster interest rate hike cycle in the US** than people are taking into account right now. This could create liquidity and credit challenges in Asia.
- **Geopolitics.** Europe faces growing uncertainties in 2017, with upcoming elections in France, Germany and the Netherlands. In the face of China's increased regional interests in Asia, there could also be rising tensions with the US.

On balance, however, I believe we will see the US economy continue to gain momentum, and if so, this year will offer opportunities for us in Asia. The risks, however, are real. We will need to be very careful and thoughtful.