# CROSS-BORDER FLOWS HERALD NEW ERA FOR CUSTODY

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Asset Benchmark Research
Asset Benchmark Research conducts in-depth, product-specific surveys on Asia's financial markets. Part of the group that publishes The Asset magazine, the research team specializes in accessing senior corporate decision-makers and institutional investors to provide accurate quantitative and qualitative data to assist in management decisions.

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# Cross-Border Flows Herald New Era for Custody

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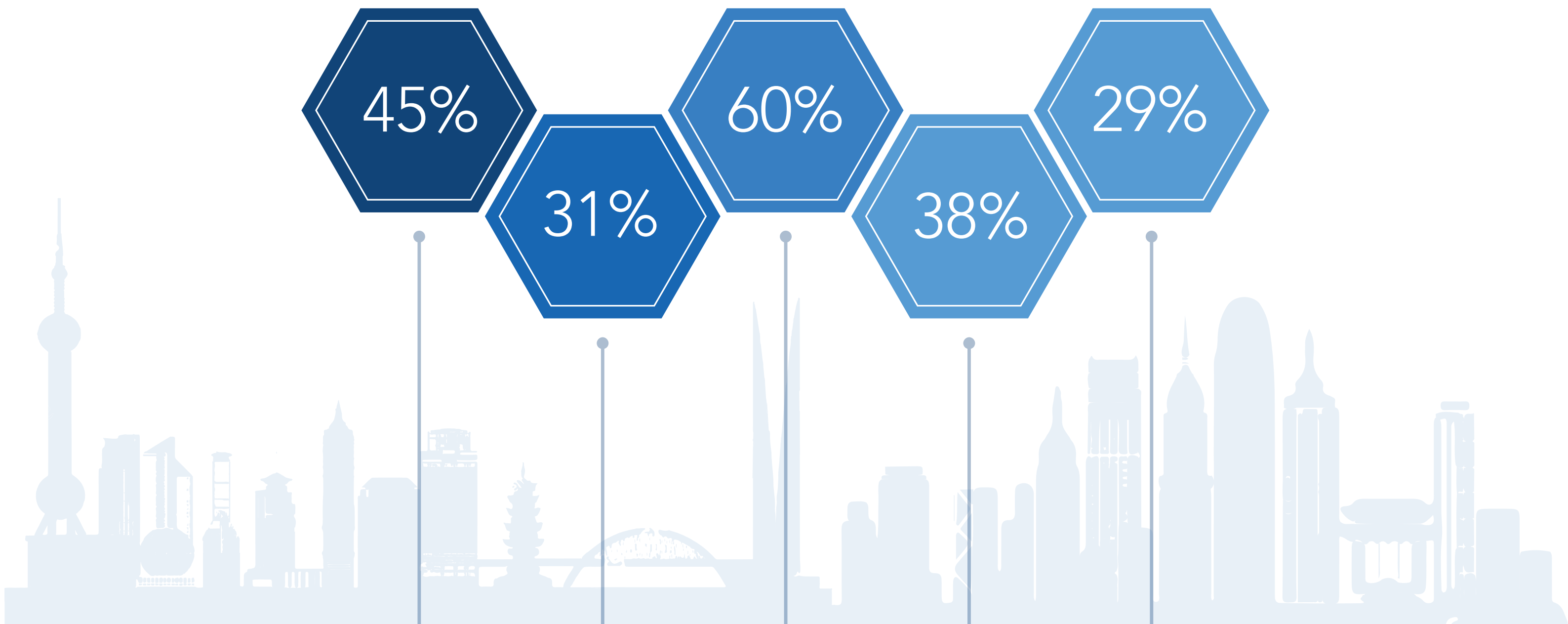
# I. Executive summary

- 45% of respondents use the Shanghai-Hong Kong Stock Connect. The scheme is more popular among China-based respondents, of which 57% use it to trade Hong Kong listed stocks
- 31% of respondents actively use the Shenzhen-Hong Kong Stock Connect
- 60% of respondents plan to launch new products, including new funds
- For China-based investors, increasing repo transactions (38% of respondents), third party clearing (18%) and third party collateral management (12%) follow in the list of priorities
- For overseas investors, securities lending (29%), electronic trading (26%) and FX hedging (21%) are the other important goals for the coming 12 months



- In 2017, overseas asset managers of local currency portfolios with existing exposure to mainland markets allocate roughly a quarter of their assets under management to CNY, down from a near 40% high in 2015

- Though a third of China-based respondents say they are QDII license holders, their average allocation to overseas assets is just 2.2% of their entire portfolio

- 40% of respondents have used the same primary custodian for more than 10 years and 60% of respondents have been with the same provider for at least six years

- 50% of China-based respondents prefer a Chinese custodian bank, 11% look to work with both international and Chinese custodians and only 6% prefer international banks when investing overseas

# II. Partner business overview

FOLLOWING the launch of key integration schemes that connect both fixed income and equity markets, 2017 will be remembered as a year of consolidation for Asian-based investors and their custody service providers. Taking stock of how well new market integration projects are accepted among investors is an important element in gauging their success. Bank of Communications (Bocom) therefore commissioned Asset Benchmark Research (ABR) to measure the impact new initiatives are having on the investment community.

In this report, ABR presents findings of a survey of about 100 institutional investors based in China and abroad to understand the opportunities and challenges facing them. Bocom has long tracked their journey and set up integrated operations to provide custody services for both international investors accessing China's exciting markets as well as local investors looking to diversify globally.

As one of the first batch of five commercial banks that have custody licenses in China, Bocom started its custody business in 1998. Having carried out the business for more than 10 years, Bocom's assets under custody and its revenue have steadily increased year-on-year. In the face of increasingly fierce external competition, Bocom achieved strong results in both domestic and overseas custody markets.

In March 2013, Bocom established its asset custody business centre in Hong Kong. It was the first professional custody platform set up by a Chinese bank outside mainland China, integrating the functions of marketing, custody operations, product development, and customer services in one go. This platform marked

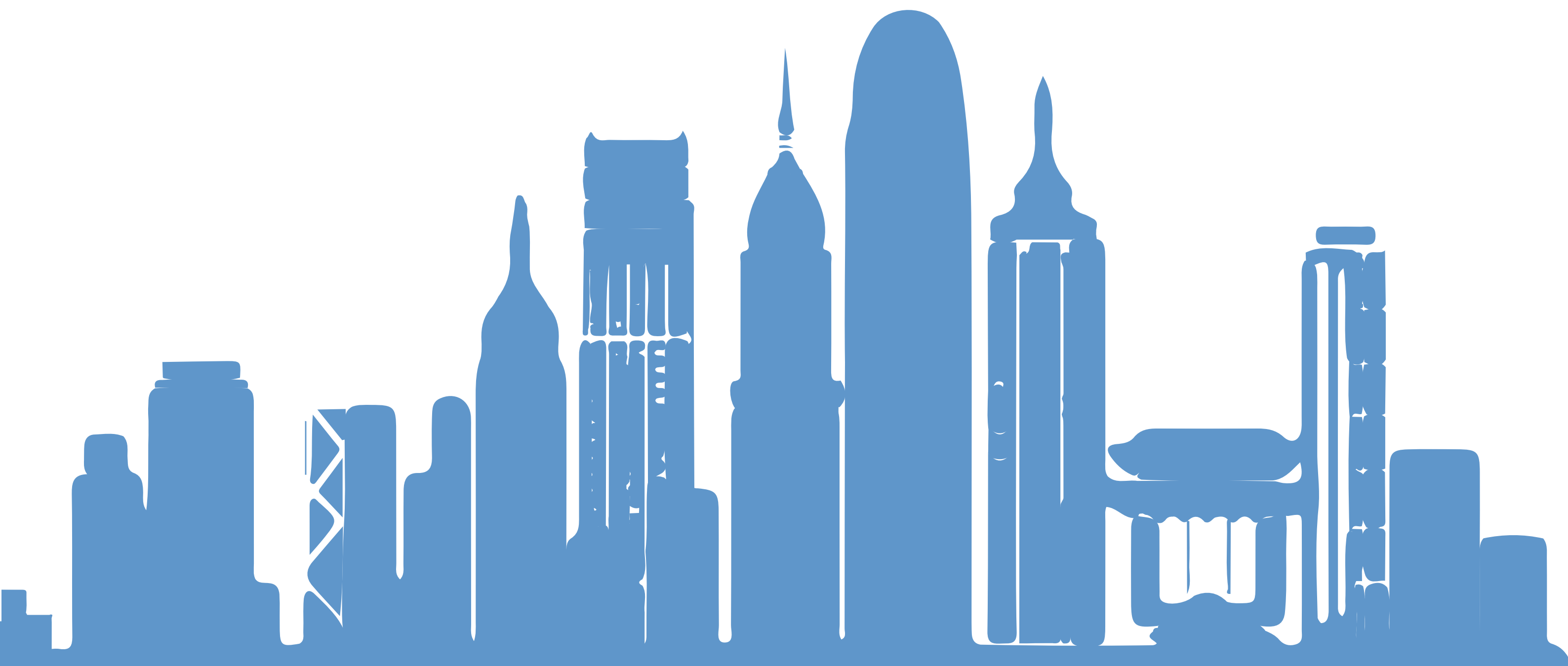
an important milestone for Bocom in the development of its cross-border custody business.

The establishment of the Bocom Asset Custody Business Centre (Hong Kong) has allowed Bocom to take advantage of the opportunities offered by qualified domestic and foreign institutional investor schemes and become one among the first batch of custodians to acquire the custodian qualification for qualified domestic and foreign institutional investors.

Currently, Bocom provides custody services on a wide variety of products, including Hong Kong authorized fund and overseas private funds, Bond Connect, Mandatory Provident Fund, insurance and offshore assets, Qualified Foreign Institutional Investor (QFII), RMB Qualified Foreign Institutional Investor (RQFII), Qualified Domestic Institutional Investor (QDII), securities investment assets, bond trustee, Hong Kong third-party Stored Value Facility (SVF) asset, Share Award Scheme and third-party escrow accounts services. Bocom also provides custody services for foreign institutions to directly invest in the China Interbank Bond Market (CIBM).

In the highly competitive cross-border custody business environment, Bocom actively responds to new challenges and difficulties. Bocom is committed to becoming the most reliable custodian bank for foreign investments made by mainland Chinese investors, and also strives to become the major primary custodian and sub-custodian in the Greater China region for foreign institutions.

The group's internationalization strategy has also accelerated the pace of the globalization of Bocom's custody service network.



# III. Investor survey

## a. Respondent profile background

98 institutional investors in Asia were asked between June and August 2017 about their use of cross-border investment schemes including Shanghai, Shenzhen and Hong Kong equity market links as well as the new Bond Connect programme. About half of the respondents are based in China, shedding light on southbound flows, while the remainder is spread across key Asian financial hubs. A majority (58%) of those surveyed describe themselves as asset management companies, with the rest falling primarily under the securities (14%), trust company (9%) and insurance/pension fund (9%) categories.

Chart 1. Respondent distribution by company type

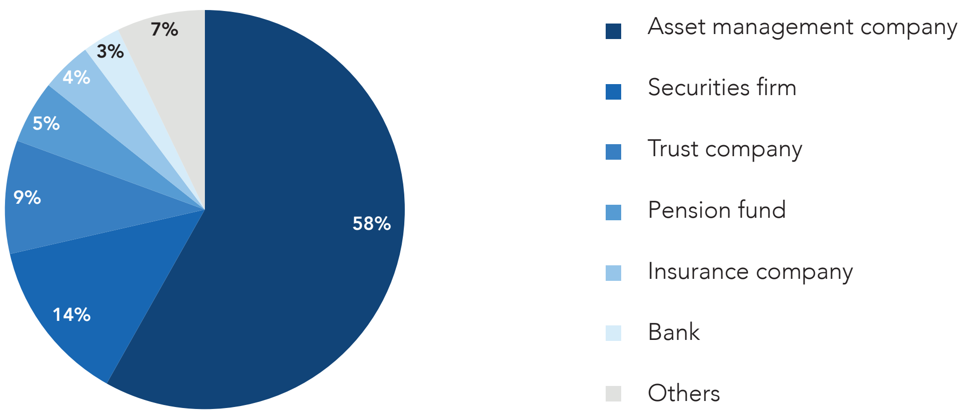
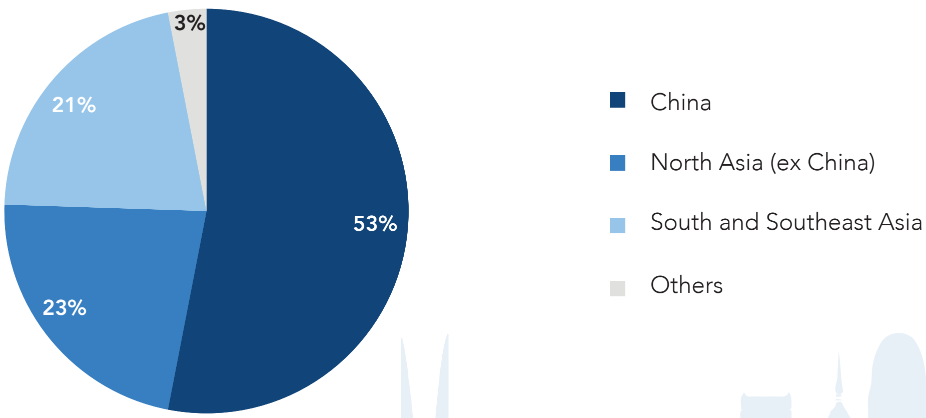



Chart 2. Respondent distribution by location



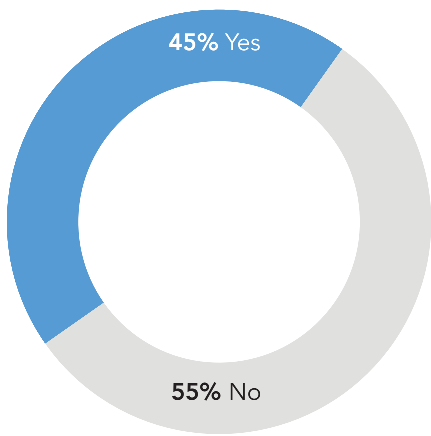
## b. Success of Stock Connect

OVERALL, 45% of respondents say they use the Shanghai-Hong Kong Stock Connect. The survey reveals that the scheme is more popular among China-based respondents, of which 57% use it to trade Hong Kong-listed stocks. That is nearly double the proportion of overseas respondents who currently use it to trade in the other direction (29%).

Among those that trade through the scheme, a narrow majority does so on a daily basis (52%). The remainder do so on a weekly (28%) or, at most, monthly basis (20%).

Among the 55% of respondents that do not use the Shanghai-Hong Kong Stock Connect, most simply do not see a business case. This view is especially prevalent across China-based investors. Five large overseas asset managers also state that their existing QFII status and quota cover their needs. Other respon-

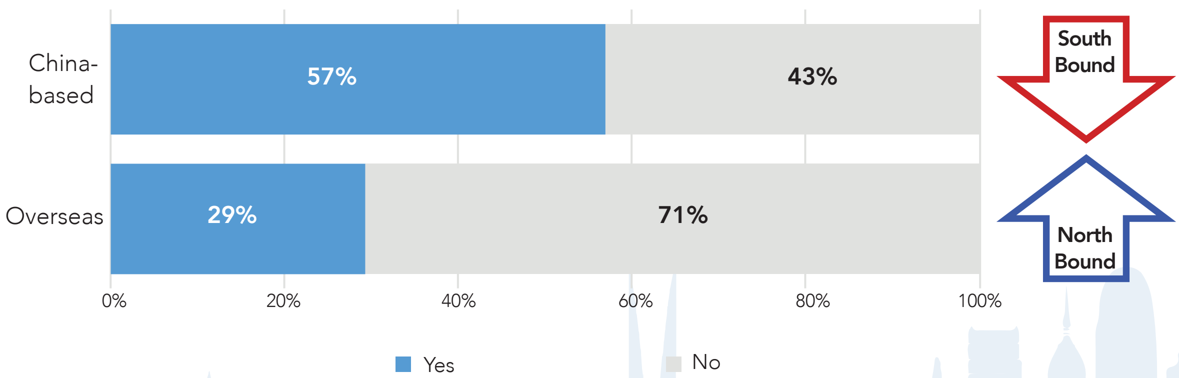
Chart 3. Use of Shanghai-Hong Kong Stock Connect - overall respondents




Top three reasons for not using

| | |
|---|---|
| 55% | No business case |
| 12% | Existing QFII access covers needs |
| 2% | Settlement processing challenges |

Chart 4. Use of Shanghai-Hong Kong Stock Connect - China-based vs overseas respondents



dents bemoan regulatory constraints, including the fact that the Stock Connect only applies to secondary trading and therefore does not allow overseas investors to participate in initial public offerings of mainland companies (and vice versa).

One respondent of a large institutional investor with roots in France says that their remaining RQFII quota has not yet been exhausted, hence they did not see the need to use the link. Another respondent that uses the link on a monthly basis says "opportunities in the onshore market are currently highly valued", which reduces incentive to trade more frequently.

In December 2016, the Shenzhen-Hong Kong Stock Connect was launched, giving overseas investors access to a wider array of technology-focused and privately-owned Chinese companies. Already, 31% of re-

Chart 5. Use of Shenzhen-Hong Kong Stock Connect - overall respondents

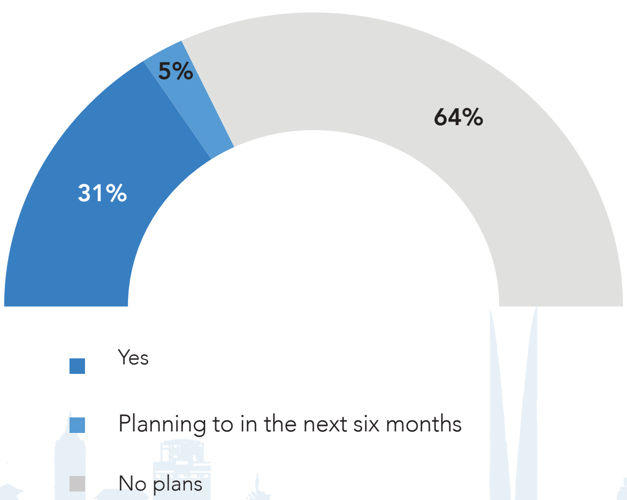
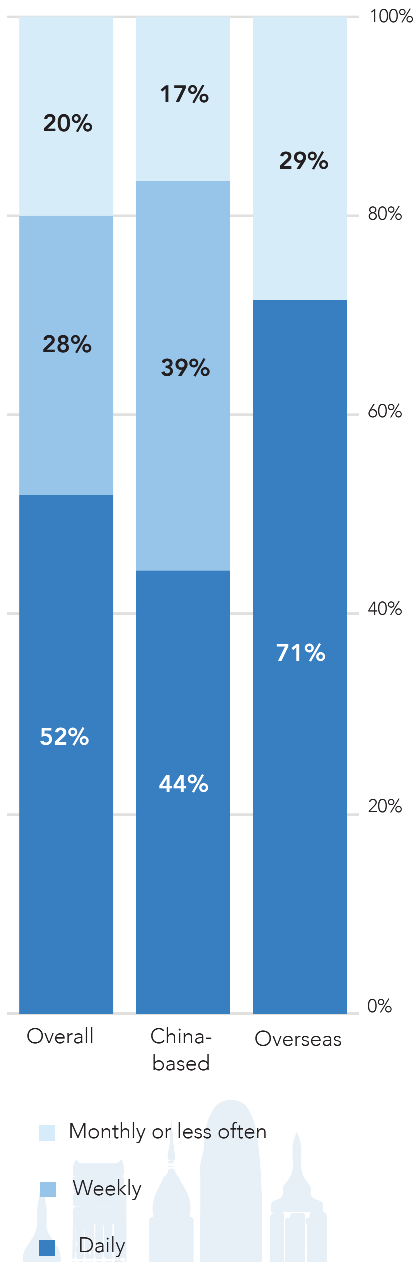



Chart 6. Distribution on the trade frequency in Shanghai-Hong Kong Stock Connect - overall respondents



spondents actively use the Shenzhen-Hong Kong Stock Connect. An additional three asset management companies and one securities firm have plans to trade via the scheme over the next six months.

A respondent at one of China's largest securities companies says that while the Shenzhen-Hong Kong Stock Connect is very appealing, "the entire industry system does not support it yet" and elaborates that "if the industry is ready we can start at any time".

Of the 40 institutions that currently use the Shanghai-Hong Kong Stock Connect, 26 also trade using the Shenzhen equivalent scheme. Only two institutions in the survey were found to be using the Shenzhen Connect but not the Shanghai equivalent.

Chart 7. Users of Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect and the overlapping users

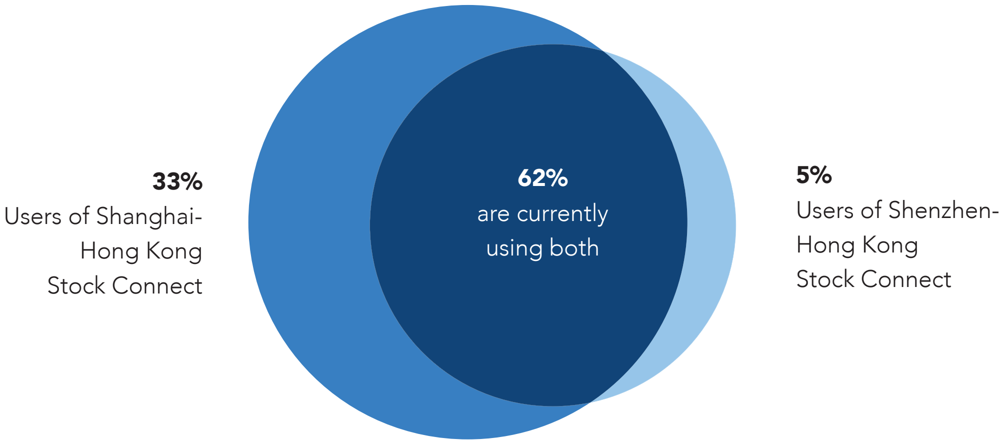
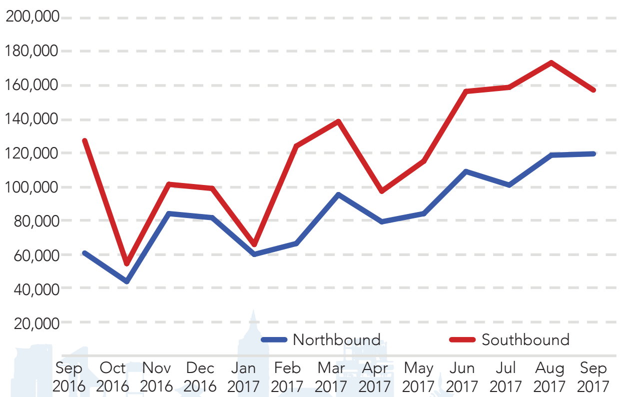
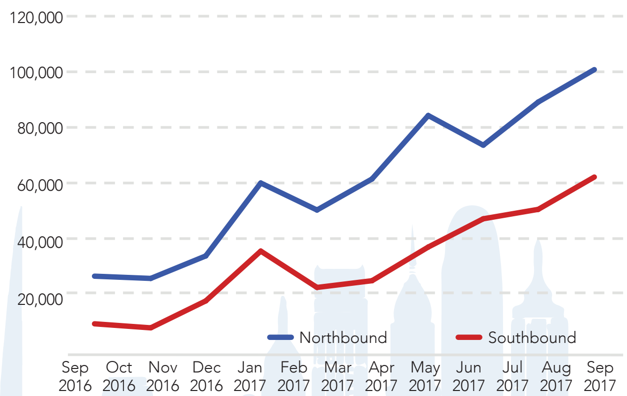



Chart 8. Monthly trading volumes of Shanghai-Hong Kong Stock Connect




Source: HKEX

Chart 9. Monthly trading volumes of Shenzhen-Hong Kong Stock Connect




Source: HKEX

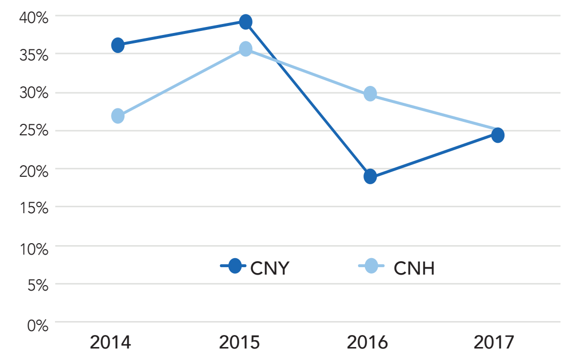
## c. Fixed income: Bond Connect to revive stagnant investment appetite

FOR more than 15 years, overseas investors have been able to leverage the QDII scheme to access China's vast fixed income market. While the regulatory framework is thus much older than the more recent Stock Connect schemes, its acceptance among our overseas respondents is comparable to the use of the Shanghai-Hong Kong Stock Connect. 30% of respondents state they invest in mainland China fixed income securities through QFII and RQFII. One Hong Kong based asset management company invests through the so-called CIBM scheme, launched in February 2016.

QFII was designed as a gateway to the bond rather than the A share markets of China. Inherent complexities of the scheme, including required regulatory approvals from the China Securities Regulatory Commission (CSRC), State Administration of Foreign Exchange (SAFE) and People's Bank of China (PBoC) as well as less transparent FX mechanisms, have meant that the scheme is attractive to larger institutional investors with a good understanding of mainland markets only.

Their allocation to mainland China fixed income securities was hit hard by the devaluation of renminbi in 2016 and has recovered only slightly since then.

Chart 11. Average allocations on CNY and CNH bonds from fixed income investors




ABR has been tracking overseas investors' appetite for renminbi-denominated fixed income securities since 2014. In its latest iteration of the Asian Local Currency Bond Benchmark Review, more than 100 institutional investors with exposure to mainland China markets were asked about their allocations to CNY (and CNH) bonds, among other currencies. Chart 11 tracks their allocations over time and documents the withdrawal from CNY-denominated bonds in 2016. This year, overseas asset managers of local currency portfolios with existing exposure to mainland markets allocate roughly a quarter of their assets under management to CNY, down from a near 40% high in 2015.

Chart 10. Planned usage of Bond Connect - overseas respondents

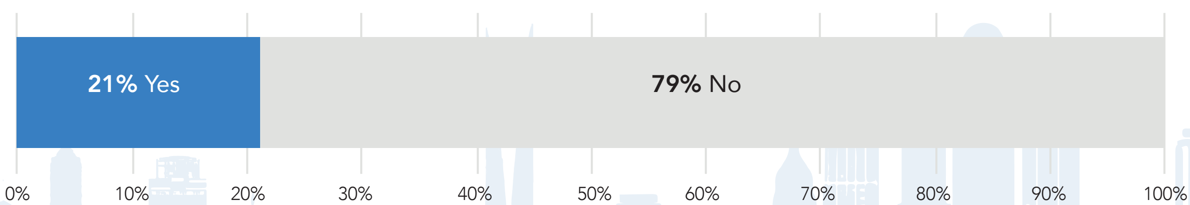


Table 1. Fixed income schemes comparison

<table>
<tr><th></th><th>QFII</th><th>RQFII</th><th>PBOC scheme</th><th>Bond Connect</th></tr>
<tr><td>Regulatory approvals</td><td colspan="2">CSRC: QFII/RQFII license<br>SAFE: QFII/RQFII quota<br>PBOC: Pre-filing for CIBM access</td><td>Pre-filing with PBOC</td><td>Same scope of eligible investors as PBOC scheme</td></tr>
<tr><td>Investment quota</td><td colspan="2">Only needs to pre-file with SAFE if requested quota is within the base quota or obtain approval if the requested quota exceeds based quota.<br>The base quota is calculated according to a certain percentage of asset scale</td><td>Employment of the macro-prudential administration regime to foreign investors.<br>No specific investment quota requirements. Applicant may pre-file with PBOC the anticipated investment value</td><td>No quota limit</td></tr>
<tr><td>Eligible fixed income products</td><td colspan="2">On-exchange market: government bonds, enterprise bonds, corporate bonds, convertible bonds, etc.<br>Interbank market: cash bonds</td><td>Foreign reserves institutions: all cash bonds, repos, bond borrowing and lending, bond forwards, IRS, FRA, etc.<br>Other foreign institutions: all cash bonds and other products permitted by the PBOC, offshore RMB clearing/participating banks can also trade repos</td><td>Cash bonds in CIBM</td></tr>
<tr><td>Foreign exchange management</td><td>Onshore with the local custodian</td><td>Has to remit in offshore RMB (obtain from offshore)</td><td>Offshore</td><td>Onshore/offshore</td></tr>
<tr><td>Lock-up period on principal repatriation</td><td>3 months</td><td>3 months, no restriction on open-ended fund clients</td><td>Nil</td><td>Nil</td></tr>
<tr><td>Frequency of repatriation and restrictions</td><td>Daily for open-ended funds, with threshold limitations</td><td>Daily for open-ended funds</td><td>The ratio of accumulated outward remittance need to meet some basic requirements</td><td>Nil</td></tr>
<tr><td>Appointment of settlement agent</td><td colspan="2">An approved settlement agent</td><td>An approved settlement agent, or otherwise stipulated by PBOC</td><td>Settlement is conducted by HKMA's CMU, through accounts opened at China Central Depository & Clearing Co. Ltd and Shanghai Clearing House</td></tr>
</table>

Source: HKEX, HKMA, PBOC, CSRC, SAFE, Moody's Investors Service, Bank of Communications

Seeing the relatively quick acceptance of the Stock Connect schemes, regulators in mainland China and Hong Kong this year launched the Bond Connect in a bid to revive interest and attract more foreign investors to tap the enormous mainland fixed income market. Easier entry requirements and fewer needs for third party service providers (settlement agents, for example) aim to reduce the complexity for investors. Of the 19 overseas institutional investors who were prepared to answer whether they plan to use the Bond Connect scheme, four said they will.

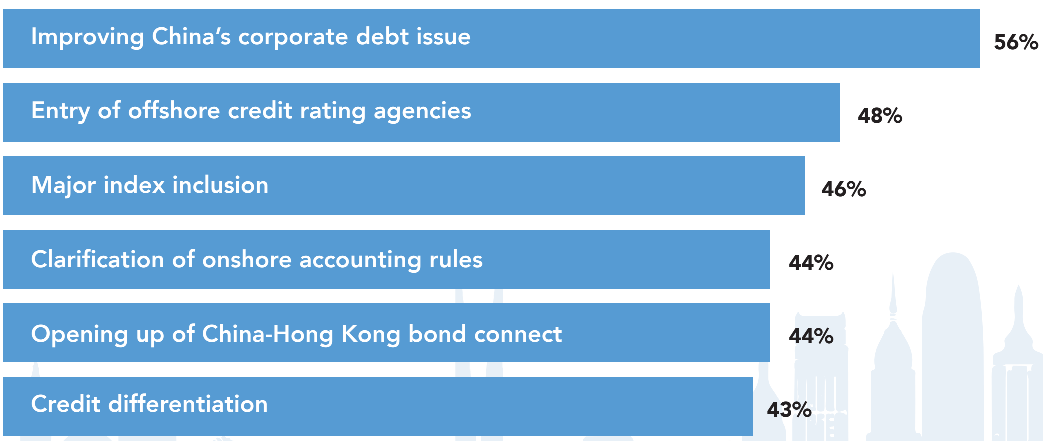
In July, offshore financial institutions have increased their onshore renminbi bond holdings by 39.9 billion yuan, including 37.8 billion yuan in treasury bonds. The incremental investment in onshore renminbi bonds from overseas investors was the largest since the beginning of the year.

ABR also reached out to more than 250 sellside individuals in the summer of 2017 to assess the factors that matter in developing the onshore China bond market. Responses cited most frequently revolve around credit quality of issuers, while bond index inclusion and onshore accounting rules also feature high (see Chart 12).

Among China-based investors, interest in overseas assets is more subdued when measured by their allocations. Though a third of China-based respondents say they are QDII license holders, their average allocation to overseas assets is just 2.2% of their entire portfolio. Three investors say they seek to actively utilize the new Bond Connect scheme. All of them are existing QDII holders.

One respondent of a large insurance company in China is keen to use the new scheme but is awaiting regulatory clarity. "It depends on the China Insurance Regulatory Commission," he states. "[Once we know their approach] we can determine if we can go ahead or not. Without that, I cannot make the decision."

Chart 12. Factors that matter most in developing China's onshore bond market - Views from sellside individuals active in Asian local currency bonds




% indicates the weighted importance from overall respondents

## d. Plans for the next 12 months

THE survey asked both overseas and China-based investors about their plans for the coming year and what type of service providers they prefer to help them achieve their goals. 60% of respondents plan to launch new products, including new funds. Both overseas and China-based investors agree on this point but then diverge in their rankings. For China-based investors, increasing repo transactions (38% of respondents), third-party clearing (18%) and collateral management (12%) follow in the list of priorities. For overseas investors, securities lending (29%), electronic trading (26%) and FX hedging (21%) are the other important goals for the coming 12 months.

All of these factors are auxiliary services offered by large custodian banks in the region. These service providers can count on existing clients approaching them first, based on the survey results. 40% of respondents state they have used the same primary custodian for more than 10 years and 60% of respondents have been with the same provider for at least six years.

Survey results also indicate that China-based

Table 2: Respondents' plans for the coming 12 months - overall respondents

| | Increase | No change | Decrease | Not active |
|---|---|---|---|---|
| New products launch | 60% | 19% | 4% | 6% |
| Repo transactions | 26% | 22% | 1% | 26% |
| Electronic trading | 17% | 19% | 0% | 19% |
| Securities lending | 18% | 19% | 1% | 40% |
| Third party clearing | 14% | 18% | 1% | 36% |
| FX hedging | 14% | 18% | 0% | 42% |
| Third party collateral management | 13% | 17% | 3% | 44% |
| Cash equitization | 7% | 24% | 0% | 24% |
| Transition management | 4% | 18% | 0% | 29% |

% indicates respondents' plans on these activities investors prefer to keep working with Chinese custodian banks when investing in overseas markets and vice versa. 50% of China-based respondents prefer a Chinese custodian bank, 11% look to work with both international and Chinese custodians and only 6% prefer international banks when investing overseas.

One China-based respondent explains: "It is convenient to communicate with Chinese custodians. If any dispute arises, I can contact them easily. Chinese banks use the same legal system we do while the overseas banks do not."

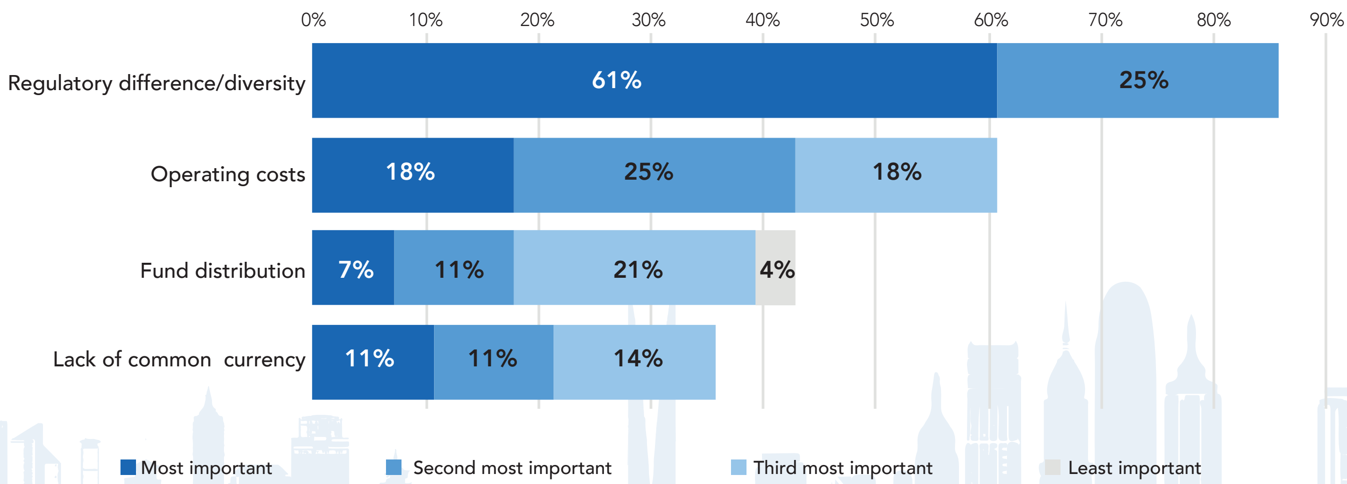
Another adds: "International custodians do not know how to stretch the rules. There is no flexibility. They also need a long time for meetings. I worked in international custodian banks before, they need one or two weeks to have a meeting. Bocom needs two days."

Given the relatively low allocation to overseas assets of this group of clients at the moment, Chinese custodian banks like Bocom stand to benefit from the potential that growing southbound flows hold.

Although custodians benefit from customer loyalty, respondents' plans for the coming 12 months highlight the need to clearly differentiate the services they offer to clients. While overseas investors are keen to increase securities lending and electronic trading, China-based investors are more interested to explore niche services such as repo transactions and third party collateral management.

Chinese custodian banks are actively building overseas capabilities by setting up offshore custody centres. Currently in Hong Kong, 95% of the market has been unevenly shared by international banks.

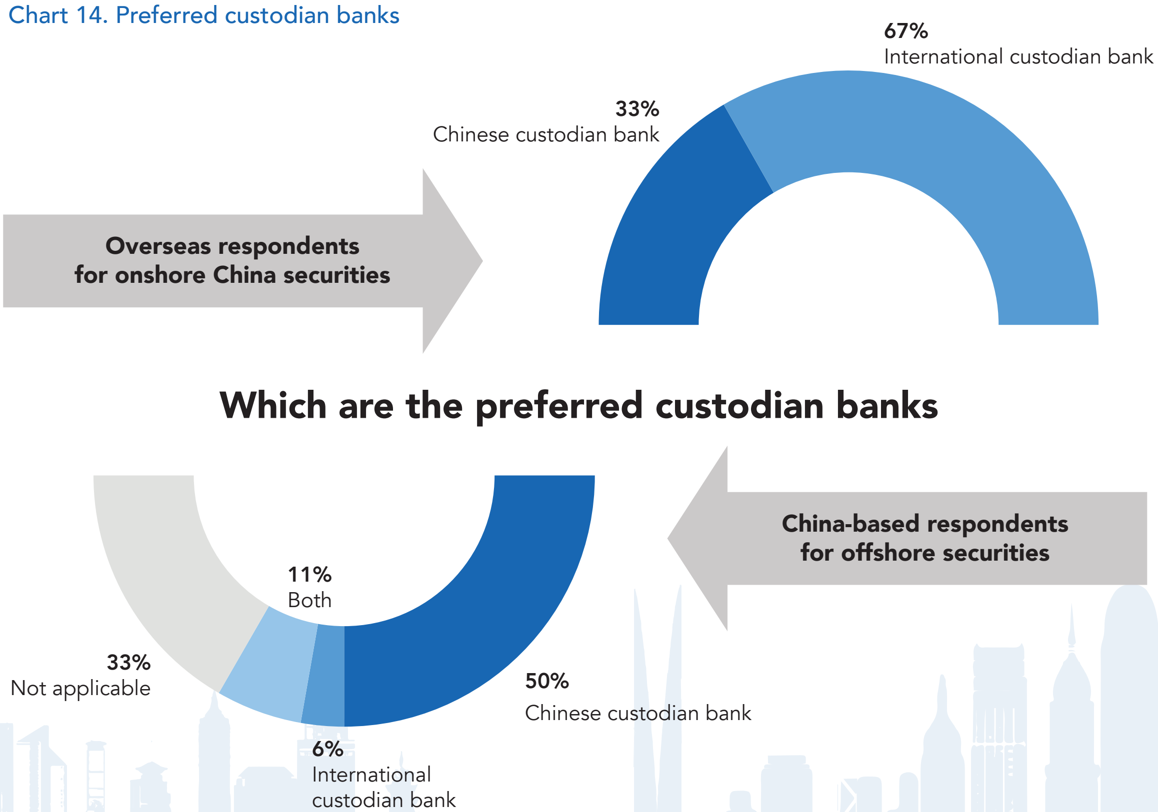
Chart 13. Top challenges of operating across different Asian countries - overseas respondents



Bocom completed its overseas custodian service coverage in 2013 by setting up its Bocom Asset Custody Business Centre (Hong Kong), primarily serving institutional clients in both domestic and overseas market. Bocom's peers in China are also catching up -- China Merchants Bank, for example, set up its global custody centre in Hong Kong in 2016. On top of strengthening internal capabilities, Chinese custodian banks are also seeking collaboration with large international banks.

Although the Chinese market already plays a major role in the business growth of asset service providers in the region, it has come to play an even more dominant role over the past few years with new opportunities brought about by the Mutual Recognition of Funds (MRF) scheme, the Stock Connect scheme, the Bond Connect Programme and the opening up of the CIBM. In particular, the MRF scheme was reopened in May when Schroder Asian Asset Income Fund was approved by the CSRC. For the preceding 16 months, no new funds under MRF scheme had been approved. The recently opened Bond Connect also achieved good results since its official launch. Bocom completed the first cross-border transaction under Bond Connect.

Chart 14. Preferred custodian banks



On the investment front, Asian sovereign wealth funds, insurance companies, and other institutional investors seeking to improve the performance of their portfolios in a persistently low-yield environment continued to push their asset service providers into producing new solutions for servicing their portfolios. This client requirement has resulted in more creative mandates spanning custody, securities lending, fund administration and corporate trust, among others.

With increasingly demanding requirements from clients, service providers have been seeking ways and means to maximize the overall efficiency of their operations in order to improve service quality and cut costs with the overall objective of enhancing client engagement.

Global service providers such as HSBC and Standard Chartered have invested in a new platform that has simplified into a single layer its previously multi-layered global custody and direct custody platforms. This has resulted in enhanced efficiencies by providing a single point of contact for clients and greater client access to domestic markets, among others. With a wider global network, the three leading international banks, HSBC, Standard Chartered and Citi are stepping up in the new custody model, taking substantial market share from global custodian banks such as State Street, Northern Trust and BNY Mellon.

“In the past, the client either buys direct custody services market by market or otherwise goes into an aggregated model whereby they buy global custody services in the hub. But then they're really two steps from anything that is happening in the local market. We now have a single layer so the client buys with a single contract but then they have direct access into each local market,” says the head of securities services for one of the major international asset service providers.

Other service providers are also working on streamlining their client engagement models by building up the skills and knowledge of their front-line, client-facing professionals. In addition, a few international trustees have also cut their business in the region.

“Some clients still come straight to service delivery for certain requirements but increasingly we're getting clients coming into our central client service areas because of skills and knowledge that the team is building up,” says the head of securities services of another service provider.

# IV. Conclusion

WITH a majority of investment professionals surveyed planning to launch new products, their custody service providers should benefit from higher business activity. Sticky relationships that have often lasted for a decade or more may make it difficult for new entrants in the custody market to gain market and wallet share amid the buzzing market. The proliferation of cross-border investment, which is aided by the successful equity and promising bond connect schemes, may provide an impetus for some investors to extend their relationships. Chinese custodians stand to benefit from this trend in two ways: (1) their base of Chinese clients remains loyal to Chinese custodians even when exploring overseas markets while (2) foreign investors have limited choice of global custody partners in the mainland and may therefore opt to work with established local players.

By making use of the platform of Bocom Asset Custody Business Centre (Hong Kong), Bocom actively promotes the development of innovative businesses and explores new custody areas such as the Share Award Scheme for large multinational corporations and institutions, as well as SVF products in Hong Kong (for example prepaid credit cards, mobile wallet).

In 2016, Bocom took the lead in designing and launching trustee and custodian solutions for products in Hong Kong, and Bocom has also played a major leading role in the SVF custody market. Bocom's overseas service network has been expanding steadily focusing on building a global wealth management and financial services platform. These overseas branches are located in Asia, the Americas, Oceania and Europe.

Nowadays, developing the custody business has become an inevitable choice for commercial banks in order to maintain sustainable growth. Bocom is expected to allocate more resources to expand the asset custody business, and to usher in further development in the future.

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