Custody in Asia's newly integrated markets

BENCHMARK THE Asset RESEARCH

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I. Executive summary

QDII. MRF. ARFP. The list of acronyms that condense the multitude of market developments in Asia's asset and investment management industry is ever growing. In collaboration with China Merchants Bank (CMB), Asset Benchmark Research surveyed 149 asset managers, institutional investors and other market participants in the summer of 2016 about their plans to seize opportunities that arise from the integration of Asia's capital markets. This report presents the findings of this pan-Asian research and outlines the implications for service providers in the region, particularly custodian banks.

Asset and fund managers make up the largest group of respondents (66%), followed by securities firms and market makers as well as trust companies and long term institutional investors. Nearly two-thirds of respondents are located in mainland China, while the remainder constitutes international market participants with a presence in Asia.

We observe a healthy interest in most cross-border market integration schemes that are already or will shortly become available to investors, first and foremost the Shanghai-Hong Kong Stock Connect and the Qualified Domestic Institutional Investor (QDII) programmes. Already, more than a third of respondents use the Stock Connect, most of which also plan to use the link between Hong Kong and Shenzhen bourses launched in December 2016.

For service providers, both Chinese and international, the changing landscape bears both opportunity and challenge. Clients expect more value-added services from their custodian banks, including enhanced cash and liquidity management offerings and customized reporting. Yet, custodians will need to adapt their strategies to cater to regional differences, the findings also highlight.

66%

ASSET AND FUND MANAGERS MAKE UP THE LARGEST GROUP OF RESPONDENTS

FIGURE 1
Respondent distribution by region: China vs International

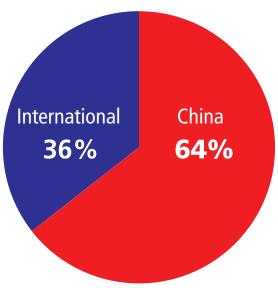
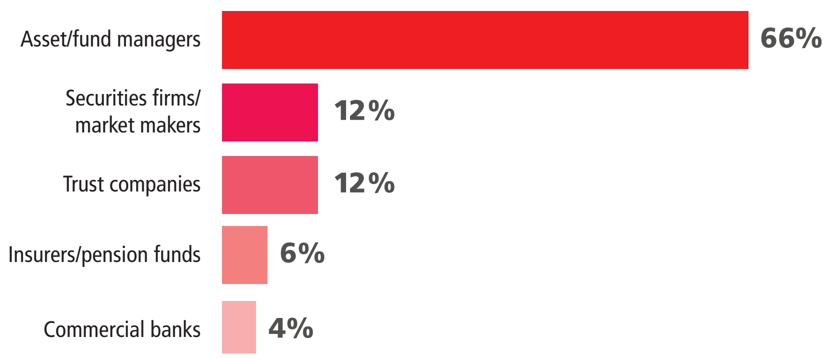


FIGURE 2
Respondent distribution by type



II. The opening of China's capital markets

80%

OF THE TOTAL SOUTHBOUND QUOTA HAD BEEN USED BY THE END OF AUGUST

Shanghai-Hong Kong Stock Connect

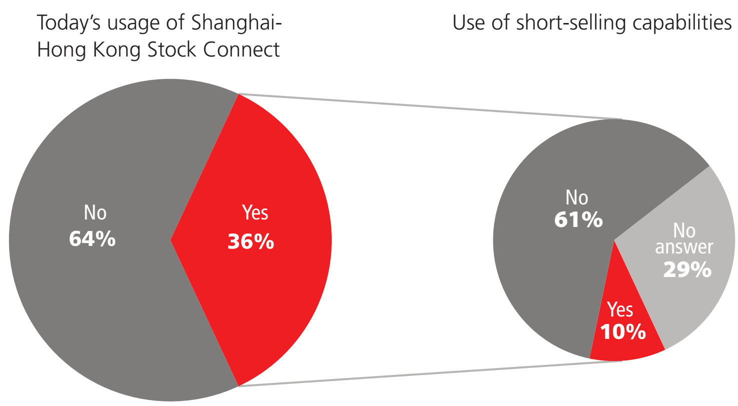
Both onshore Chinese institutional investors and their overseas counterparts have witnessed a multitude of reforms in the past 24 months that have allowed them to broaden their investment choices. The further opening of China's interbank bond as well as equities markets has stirred great interest among foreign investors, not least because yields in China remain elevated in comparison to other markets. As an illustration, among the five Special Drawing Rights (SDR) currencies, renminbi-denominated 10-year government debt yielded around 230 bps more at the end of July than the average yield on government debt in the four other SDR currencies.

Likewise, Chinese investors are keen to increase portfolio allocations to overseas assets. While, for instance, only half of the northbound quota of the Shanghai-Hong Kong Stock Connect scheme was utilized by the end of August, nearly 80% of the total southbound quota had been used.

Among our respondents, 36% state they already use the Stock Connect scheme between Hong Kong Exchange (HKEx) and Shanghai Stock Exchange (SSE). The percentage is slightly higher among onshore China investors (43%) versus international respondents (23%). Of those who do, 10% also use the short-selling capabilities of the scheme. So far, short-selling predominately occurs in the southbound rather than the northbound direction, although certain SSE stocks have also become eligible for short selling since March 2015.

FIGURE 3

Today's usage of Shanghai-Hong Kong Stock Connect and whether or not they use the short-selling capabilities

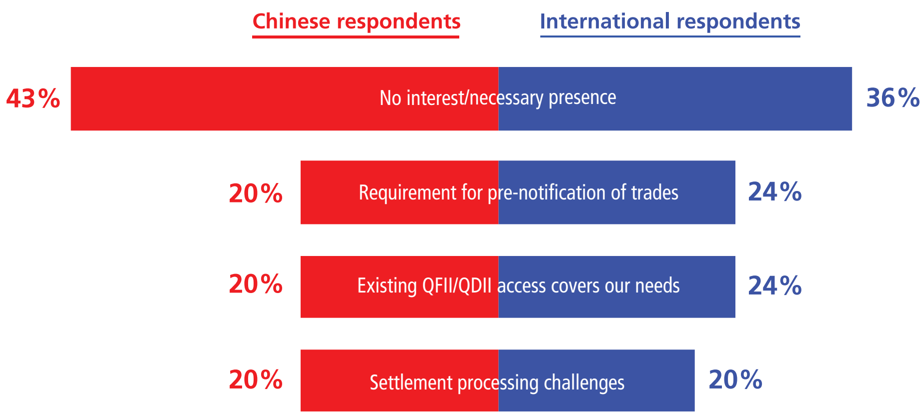


The most common reason stated for not using the Shanghai-Hong Kong Stock Connect, for both onshore Chinese and international investors, is simply a lack of relevant business in either of the jurisdictions. International investors are able to access Shanghai A-Shares easily: a brokerage account with a local broker in Hong Kong suffices. However, access to the market by itself has little value to investors that have no expertise on the shares that are eligible for purchase. For many of them, the vast Chinese market is still a black box and without access to equity research, preferably through proprietary on-the-ground access, use of the Stock Connect is not considered a viable option.

Meanwhile, those institutional investors with existing expertise in the China market have found the other well-established access schemes to the equities market to be sufficient, including the Qualified Foreign Institutional Investors (QFII) and Renminbi QFII schemes. As a result, nearly one in four international respondents who currently do not use the Stock Connect say it is because their existing QFII quota covers their needs. Likewise, one in five Chinese non-users feel that QDII or equivalent programmes meet their needs. The requirement for pre-notification of trades (which applies to securities lending and short-selling) as well as settlement processing challenges are also named as challenges.

FIGURE 4

Reasons for not using Shanghai-Hong Kong Stock Connect



Ranked in the order of importance by overall respondents

> *"Taxation expertise and management are the most important qualities in a QDII custodian bank. Overall, most of our custodian banks are not specialized in this. As the operation department, we particularly emphasize the qualities of settlement and evaluation. We also emphasize effectiveness, competence, and timeliness in operations. For example, most of our custodian banks are not familiar with W-8BEN forms which is needed when we are investing in US stock markets"*
>
> – Fund manager, China

We also asked respondents whether they will be using the new Shenzhen-Hong Kong Stock Connect scheme, launched in December. The response was overwhelmingly positive, with 76% of Chinese respondents saying they will, even though they already have access to Hong Kong shares through the existing Shanghai link. Indeed, among Chinese respondents currently using the Shanghai-Hong Kong Stock Connect, only one institution says they are not interested in the Shenzhen iteration. All others express interest in also trading Hong Kong shares through a broker in Shenzhen.

76%

OF CHINESE RESPONDENTS SAID THEY WILL USE THE NEW SHENZHEN-HONG KONG STOCK CONNECT SCHEME

QDII Scheme

The QDII scheme celebrates its 10-year anniversary in 2016, offering domestic investors access to overseas capital markets. With yields in the mainland generally trending downwards, following six benchmark rate cuts since November 2014, interest in overseas assets has picked up among Chinese institutional investors. Among our Chinese respondents, 22% state they are licensed QDIIs with allocated quotas and funds for distribution. A total of three investors state they have a QDII license and quota but do not (yet) offer funds for distribution. Meanwhile 26% of Chinese respondents invest in QDII funds, leaving less than half of respondents without any exposure to the scheme at all.

FIGURE 5
Intention to use Shenzhen-Hong Kong Stock Connect from Chinese respondents

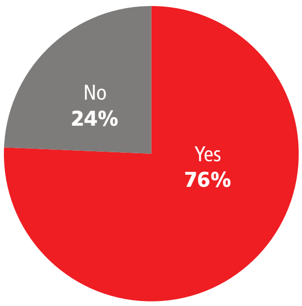
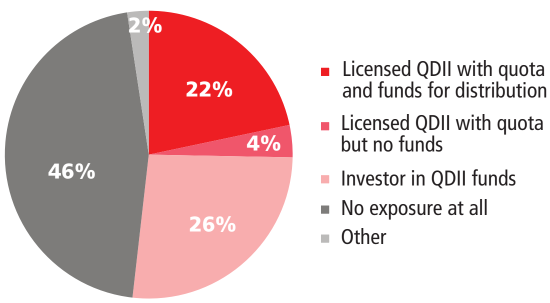


FIGURE 6
Exposure to QDII scheme



The setting up of a QDII fund is relatively straightforward and highlights the important role the domestic custodian plays:

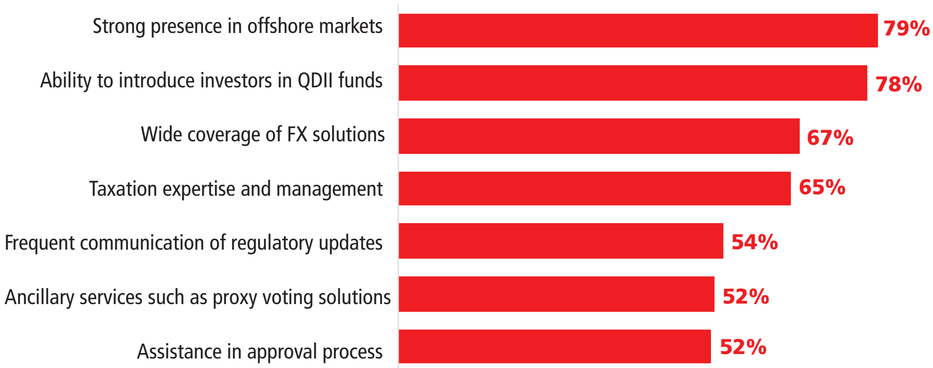
1. Domestic main custodian bank signs a statement (trust fund contract) with domestic QDIIs
2. Domestic main custodian bank opens a domestic custody account in which the fund's assets are deposited and completes securities delivery and clearing for overseas investments on behalf of QDIIs
3. Funds are delivered directly from the domestic custody account to the overseas custody account and the overseas sub-custodian bank completes delivery and settlement of securities and fund clearing overseas
4. The local Chinese custodian bank conducts accounting (recording QDII investment activities in the account books) and asset valuation (valuate QDII investment assets according to international accounting standards)
5. At the final stage of the QDII investment process, funds withdrawn directly transfer from the overseas custodian account to the domestic custodian account, and are distributed into specified accounts

79%

(ON A WEIGHTED BASIS) CITED "STRONG PRESENCE IN OFFSHORE MARKETS" IS THE MOST IMPORTANT QUALITY IN A QDII CUSTODIAN

Clearly, the domestic custodian bank is in many ways the most important service provider that QDIIs choose to work with. As the bridge between the investor and the overseas sub-custodian, it fulfils critical tasks including fund accounting and asset valuation. When asked what the most important qualities in a QDII custodian are, respondents cite "strong presence in offshore markets" (79% on a weighted basis), "ability to introduce investors in QDII funds" (78%) and "wide coverage of FX solutions" (67%) as the three most important features. For onshore custodian banks, this means gaining a competitive advantage in this niche market requires more than just excelling at standard features required by custodian banks. Indeed, a preferred QDII custodian is even able to help fund managers introduce investors into their funds – not usually considered a function performed by custodian banks.

FIGURE 7
Important qualities in a QDII custodian



Mutual Recognition of Funds

Yet another reform project further integrating China's capital market with the rest of the world is the Mutual Recognition of Funds (MRF) scheme, which allows Chinese mutual funds to be registered and distributed in Hong Kong and vice versa. A total of 15 fund managers (21% of respondents to the question) already distribute their funds across the border through the MRF scheme, while an additional 15 say they plan to either distribute or invest in MRF funds in the coming 12 months.

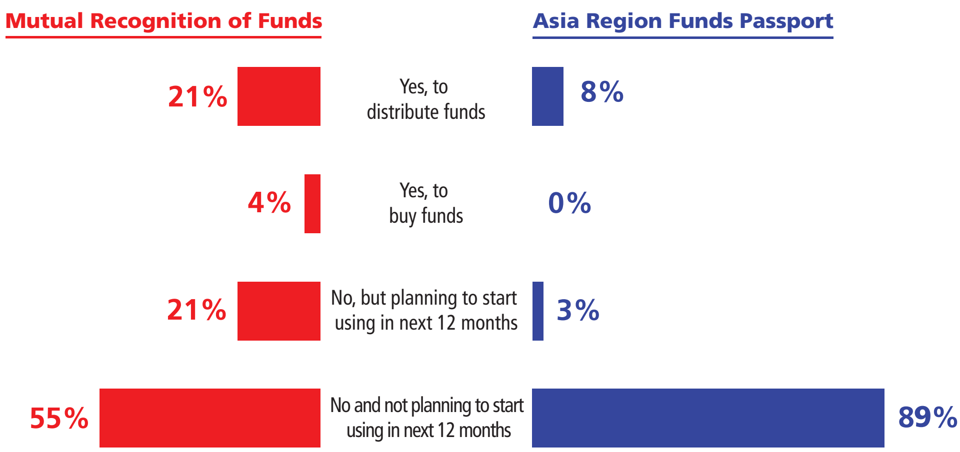
55%

OF FUND MANAGERS HAVE NO INTENTION TO GET INVOLVED IN THE CROSS-BORDER DISTRIBUTION OF FUNDS

A majority (55%) have no intention to get involved in the cross-border distribution of funds. Yet, that compares to 89% of respondents (mostly international), which are not and will not distribute their funds through the Asia Region Funds Passport (ARFP) scheme. Respondents note the scheme is either not interesting to their business or that their home jurisdictions have not issued specific regulations regarding the scheme. Some are wholly unaware of the programme.

FIGURE 8

Comparison on the usage of MRF and ARFP



III. Value-added services in China and overseas

60%

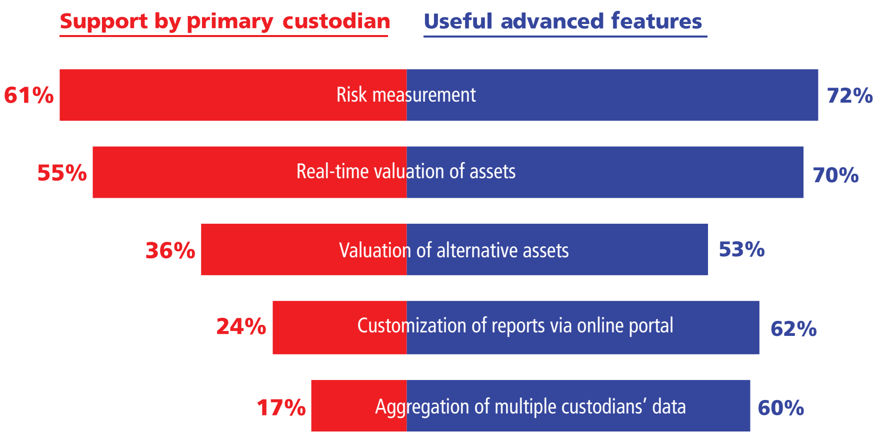
OF RESPONDENTS WOULD FIND BANK-AGNOSTIC AGGREGATION OF MULTIPLE CUSTODIANS' DATA A HELPFUL FEATURE

The field of custody services is fast evolving in China as well as overseas markets. Settlement and reporting services have become commoditized as clients expect a much wider portfolio of services from their custodian banks. Some providers are going the extra mile to raise their appeal to clients, offering services not usually considered as the core competency of custodians. CMB, for instance, offers a fund comparison platform that allows subscribers to compare performance and fees of various mutual and money market funds. Based on the experience of our respondents, CMB is the only bank with such a platform – while some other banks (such as Standard Chartered) have a fund database that is fed by third party vendors (such as Morningstar).

But there are still gaps in the service offering of custodian banks in Asia, according to respondents. Sixty percent of respondents would find bank-agnostic aggregation of multiple custodians' data a helpful feature, yet only 17% state that their primary custodian bank offers multi-bank reporting at the moment. Customization of reports through the custodian's online portal is another feature more clients would like to see their primary custodian offer. Meanwhile, the most useful value-adding feature offered by custodian banks is already widely supported. Sixty-one percent of respondents say their primary custodian provides risk measurement tools to understand what proportion of assets under custody are at risk, as a result of concentration for instance – a feature that 72% of respondents find useful.

FIGURE 9

Supporting of advanced features in valuation from primary custodian and whether they are useful



37%

OF CHINESE RESPONDENTS PLAN TO DECREASE BUNDLING OF OUTSOURCING SOLUTIONS

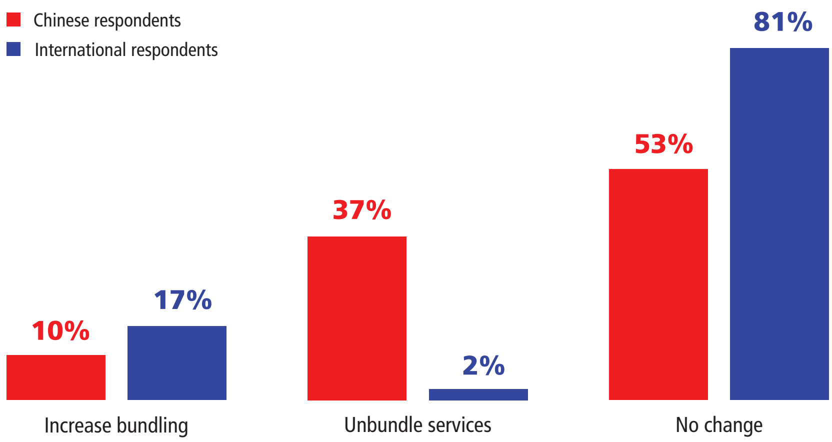
Outsourcing trends diverge regionally

An important distinction between Chinese and international respondents can be drawn with respect to their attitude on outsourcing various parts of the value chain and the consolidation of service providers. While only a negligible 2% of international respondents plan to decrease bundling of outsourcing solutions, 37% of their Chinese peers plan to do so. Seventeen percent and 10% of international and Chinese respondents plan to increase the bundling of outsourcing solutions among fewer service providers, respectively. A majority within both groups will not change their current setup.

Both approaches merit advantages. Those seeking to rationalize the number of service providers can benefit from discounts and reduced operational costs that arise from managing a multitude of service providers across back and middle office functions. Asset managers (or owners) bundling more services with one provider can also raise their status in the eyes of the provider and thus are better placed to exert influence on their product strategy.

On the other hand, Chinese respondents in particular appear to prefer a wider portfolio of service providers. Rather than bundling services, they either do not believe any provider is suited to deliver a "one-stop-shop" service in their main market or they prefer to leverage on perceived strengths of the various service providers. For some it may also be a risk management strategy as maintaining a wider network of providers reduces counterparty risk and makes switching easier.

FIGURE 10
Intentions on bundling of outsourcing solutions in the next two years



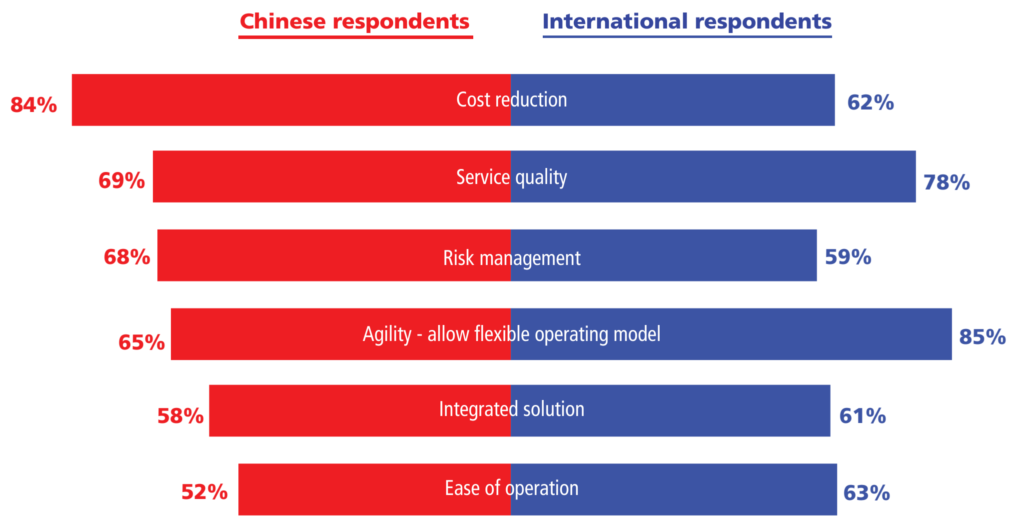
The different elements of the value chain in the investment process that can be outsourced to custodian banks and specialty service providers span back office – including pricing, NAV calculation, fund administration, tax compliance and statutory accounting – as well as the middle office – including trade matching and confirmations.

Again, geographical differences become apparent when asking respondents about the underlying drivers for outsourcing any of these services. While cost reduction is the primary motivator for Chinese respondents (84%), a more flexible operating model is the benefit that most international respondents desire (85%). For service providers that cater to both groups this means operating and marketing strategies that work in one jurisdiction may not resonate in the other. Specifically, Chinese custodian banks expanding overseas will be less likely to win business based purely on pricing, while their global peers entering the Chinese market will equally have to adjust their approach to winning bundled business.

84%

OF CHINESE RESPONDENTS SAID "COST REDUCTION" IS THE PRIMARY MOTIVATOR IN OUTSOURCING DECISIONS

FIGURE 11
Priorities in outsourcing decisions



Ranked in the order of highest priority by overall respondents

75%

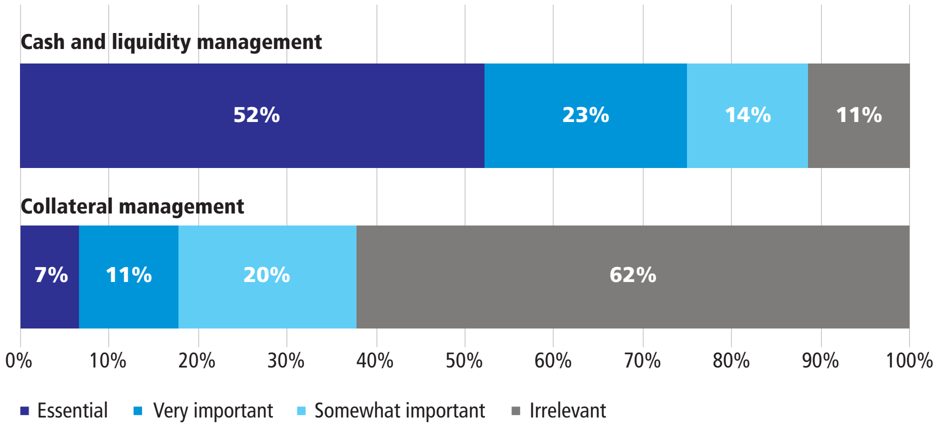
OF INTERNATIONAL RESPONDENTS RATE CASH AND LIQUIDITY MANAGEMENT SERVICES AS EITHER ESSENTIAL OR VERY IMPORTANT

Cash, liquidity and collateral management among international investors

We also wanted to shine light on the differences in the services that clients demand in China compared to overseas markets. First, we asked international respondents to comment on the importance of cash and liquidity as well as collateral management services provided by their custodian banks. While the former is rated of essential importance, the latter remains a niche service.

FIGURE 12

Importance of cash and liquidity management vs collateral management



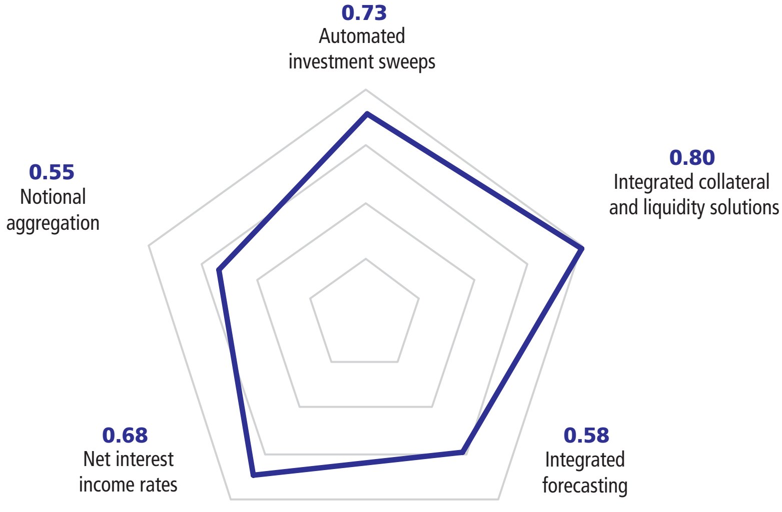
A service often underestimated in importance is the cash and liquidity management provided by custodian banks. This comprehensive group of services not only includes the debiting and crediting of fund subscriptions and redemptions, for instance, but should extend to extensive forecasting of the liquidity positions based on different what-if scenarios. How will the fund's assets under management change in certain circumstances? How about its net asset value? How will this affect the ability to borrow and lend securities?

Indeed, 75% of international respondents rate cash and liquidity management services as either essential or very important. The features most important to respondents include integrated collateral and liquidity solutions, automated investment sweeps and the interest income on idle funds.

The value respondents ascribe to cash and liquidity management services contrasts starkly to demand for collateral management services. Collateral management has become a sophisticated service area of custodian banks in Europe and the Americas. Collateral, typically in the form of cash or securities deemed risk-free, is required to be posted by asset managers active in securities lending, over-the-counter derivatives trading (both centrally cleared and not cleared) and repurchase agreements. As counterparty risk has risen since the financial crisis, collateral has grown in importance at an equal pace. Collateral management encompasses services such as eligibility screening of securities for collateral as well as the tracking and posting of margins coupled with reporting of these activities.

FIGURE 13

Important features in cash and liquidity management solution



Scale: 0- Not important; 0.5- Average; 1- Most important

Among our Asian respondents (outside mainland China), however, collateral management remains a niche service. Only 7% of respondents value this service as essential and 11% believe it is very important. For a majority (62%) of respondents, collateral management is irrelevant.

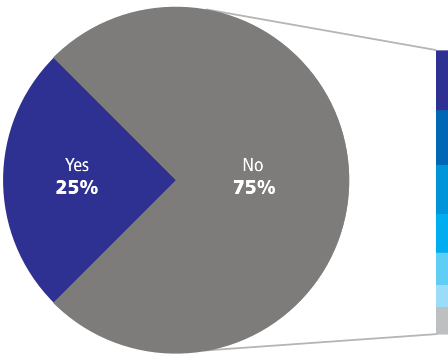
Part of the reason for the muted demand for collateral management services is the limited penetration of securities lending among our international respondents, which include asset managers, funds and insurers. One in four of them engage in securities lending, three-fourths do not. Interestingly, counterparty risk (16%) is the most frequently cited reason holding respondents back. Collateral management could address this issue. Asset managers also often face clients who prefer not to lend (or borrow) securities. Low returns on securities lent are not sufficient to make up for the operational risks and efforts necessary to set up a securities lending programme, some say.

16%

OF INTERNATIONAL RESPONDENTS CITED COUNTERPARTY RISK AS A FACTOR THAT HOLDS THEM BACK FROM BEING INVOLVED IN SECURITIES LENDING

FIGURE 14

Involvement in securities lending and reasons against



Counterparty risk	16%
Client's decision	14%
Returns don't warrant operational challenges	13%
Quality or access to indemnification coverage	10%
Cash re-investment risks	9%
Regulatory restrictions	6%
Other	7%

IV. Conclusion: Top challenges and plans

89%

OF CHINESE RESPONDENTS PLAN TO LAUNCH NEW PRODUCTS IN THE SECOND HALF OF 2016 OR FIRST HALF OF 2017

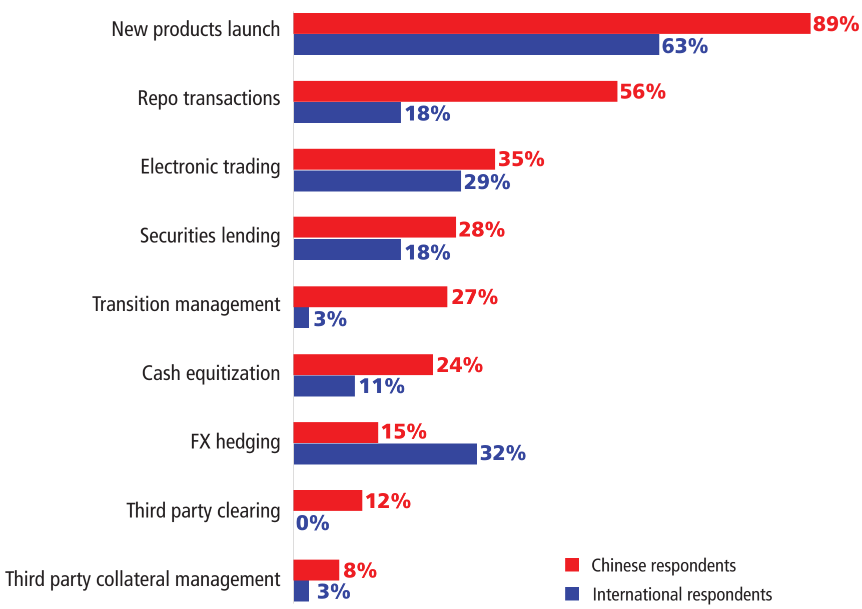
No other region in the world is currently witnessing as many sea changes in the public markets sphere as Asia Pacific. The opening of the vast Chinese fixed income and equities markets, coupled with the new-found appetite for overseas assets by Chinese investors, promise to have a lasting impact on global investment flows – as well as the operating models of custodian banks.

Clearly, asset managers see opportunity for growth in their activities and many of them plan to leverage on new and upcoming liberalizations, particularly those located in China. A majority of Chinese respondents in our survey plan to launch new products in the second half of 2016 or first half of 2017 (89%). Among international respondents 63% plan to do so. More than half of Chinese respondents (56%) also plan to either enter into or expand their use of repo transactions.

Niche services in the investment process are being discovered by more Chinese investors. Twenty-seven percent of them plan to make use of professional transition management solutions, for instance, while 24% seek higher returns on idle funds through cash equitization. International respondents appear more active only in their plans over the coming 12 months in respect to FX hedging.

FIGURE 15

Respondents' activity plan in 2016-17



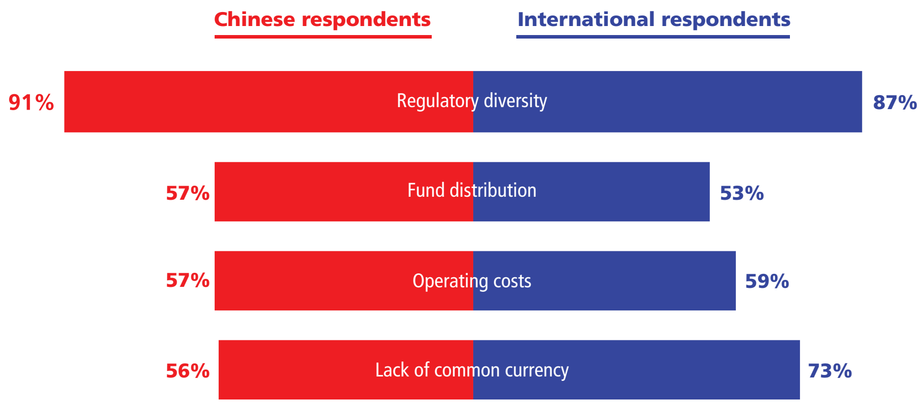
% showing respondents' increasing activity

While their plans for the coming months differ, the challenges that Chinese and international investors face in the region are broadly similar. The diversity of regulations is cited as the top challenge among respondents in both groups at 91% and 87%, respectively. Difficulties distributing funds, high operating costs and a lack of common currency also feature in their lists of challenges.

> *We still have some problems in connection with the valuation system and valuation policy because there is no uniform valuation method and policy in this business area, which increases the difficulty in communication*
>
> – Trust manager, China

FIGURE 16

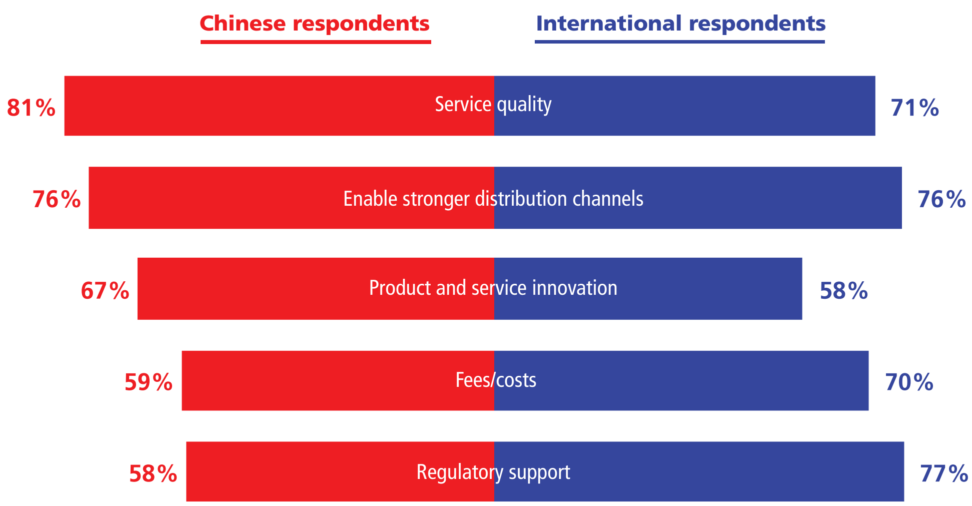
Top challenges of operating in Asia



Ranked in the order of importance by overall respondents

FIGURE 17

Areas to address for banks to improve services



Ranked in the order of importance by overall respondents

With the raft of opportunities presented to investors in Asia, custodian banks are also challenged to keep their business models agile. We summarize the most important lessons for custodian banks that respondents to our survey put forward:

1. Invest selectively	Not all liberalization efforts in the APAC region are appealing to investors. With resources scarce to invest in service offerings, custodian banks should eschew initiatives with little traction (such as the ARFP scheme) and instead focus on those endorsed by their clients (Shanghai and Shenzhen Stock Connects with Hong Kong, for instance).
2. Think outside the box	In order to cater to the diverse needs of Asia's emerging fund houses, particularly those in China, custodian banks will need to offer services not usually considered their competence, including help in introducing investors into funds and in navigating regulatory differences.
3. Recognize different regional agendas	While bundling of outsourced back and middle office functions remains a common theme among international investors, Chinese asset managers and asset owners prefer to use a wider network of providers for core and non-core services. Providers with presence in both markets must therefore be skilled at offering holistic and specialist services.
4. Fine-tune offerings for different clients	While cost is the biggest concern to Chinese clients, international investors are prepared to reward service providers if they can adapt as quickly as their own operating models.
5. Some niche services are more important than others	Collateral management receives a lot of trade press coverage but is not on top of agendas among Chinese or international investors. Rather, cash and liquidity management has advanced to grab more mindshare among clients as interest rates remain at all-time lows. This offers opportunities in related fields, including offering services such as cash equitization, particularly for yield-hungry Chinese investors.

V. Glossary

Terminology	Definition
QDII	A scheme to allow domestic institutional investors to invest in overseas capital markets
Cash and liquidity management	Maintain sustainable liquidity for daily operations of banking and financial institutions
Short-selling	The sale of a security that is not owned by the seller (naked short-selling) or that the seller has borrowed in order to profit from a fall in that security's price
QFII	A scheme to allow global institutional investors to invest in RMB-denominated onshore China capital markets
Securities lending	Refers to the lending of securities by one party to another, which requires that the borrower provides the lender with collateral
Local custodian	Specializing in home markets to serve domestic customers and manage inflows from foreign customers by working with global custodians
Mutual Recognition of Funds	A fund that has been authorized by or registered with the relevant authority in one jurisdiction (home jurisdiction) and is seeking or has received authorization or approval to be offered to the public in the other jurisdiction (host jurisdiction)
Asia Region Funds Passport	Provides a multilaterally agreed framework to facilitate the cross border marketing of managed funds across participating economies in the Asia region
Bundling	Refers to the offering of several products or services into one combined product unit when selling to customers. This allows customers to purchase several products or services from one single custodian bank, benefiting from cost savings and streamlined service for related products
Counterparty risk	The risk that the counterparty will fail to fulfil their obligations - usually either by failing to pay or by failing to deliver securities
Global custodian	This group of custodians offer a one-stop-shop service, usually covering about 100 markets, typically working with intermediaries in local markets. They are able to capture cross-border custody business without incurring substantial set-up costs and ongoing fixed costs
Notional aggregation	A type of interest optimization service that pools clients' different accounts in various currencies notionally (i.e. only on paper, not by physically sweeping cash from different accounts). Based on the level of aggregated amounts, the bank will provide better interest rates
Integrated forecasting	A service provided by some custodian banks that collates data from several custodian banks to provide fund managers a complete view of how trades across different asset classes and across securities held by different custodian banks will affect the fund's portfolio
Reinvestment risk	The risk that future coupons from a bond will not be reinvested at the prevailing interest rate when the bond was initially purchased
Repo transaction	A form of short-term borrowing for dealers in government securities. The dealer sells the government securities to investors, usually on an overnight basis, and buys them back the following day
Transition management	A service usually offered by sell side institutions to help buy side firms transition a portfolio of securities
Cash equitization	Describes the short-term investment of excess cash by a portfolio manager in equity linked products, including futures contracts and exchange-traded funds
FX hedging	A method used by companies to eliminate or hedge their foreign exchange risk resulting from transactions in foreign currencies
Contingency model	There is no best way to organize a corporation, to lead a company, or to make decisions. Instead, the optimal course of action is contingent (dependent) upon the internal and external situation
Corporate action	Any event that brings material change to a company and affects its shareholders (for example, a rights issue)
Distribution agent	Refers to a third party who is able to distribute funds and other services through its wide coverage in onshore and offshore markets
Integrated financing	From a financing point of view, it refers to the combination of various financial instruments in order to achieve an optimal capital structure
Transfer agent	Refers to a trust company, bank or similar financial institution assigned by a corporation to maintain records of investors and account balances and transactions, to cancel and issue certificates, to process investor mailings and to deal with any associated problems (such as lost or stolen certificates)

ASSET ASIAN AWARDS 2016

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