New schemes herald next era for custody

BENCHMARK THE Asset RESEARCH

交通銀行
BANK OF COMMUNICATIONS

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.

Co-published by Asset Publishing and Research Limited and Bank of Communications Limited

Asset Publishing and Research Limited
Suite 1203-05, 12th Floor
Chinachem Exchange Square
1 Hoi Wan Street, Quarry Bay
Hong Kong SAR, PR China
Tel: +852 2573 6078

Bank of Communications Limited Head Office
188 Yinchengzhong Road
Shanghai 200120
PR China
Tel: +86 21 95559

Disclaimer
This report has been prepared on the basis of information obtained by Asset Publishing and Research Limited in our research. Although Asset Publishing and Research Limited has made every effort to ensure that the contents are representative and accurate, neither the authors nor the directors of Asset Publishing and Research Limited shall be under any liability whatsoever for any inaccurate or misleading information in the material provided. Any material in this research remains the intellectual property of Asset Publishing and Research Limited. The contents do not and will not constitute an advice, nor be a consumer's guide on the subject matters of this and future reports. This and future reports are made without malice. Any praise or criticism or any negative or positive comments in the report are intended to represent useful feedback.

© Asset Publishing and Research Limited, 2018

Contents

I. Executive Summary **2**
Key findings of the report

II. Cross-border Schemes **3**
a. Stock Connect
b. Bond Connect, QFII/RQFII and CIBM

III. Pension Fund **7**

IV. Conclusion **8**
About Bank of Communications

Executive summary

The report incorporates both quantitative and qualitative approaches in analyzing cross-border custodian activities. The quantitative research is based on Asset Benchmark Research's annual asset servicing survey which attracted 64 respondents in 12 countries in Asia-Pacific and MENA. The respondents, 81% of which are outside of mainland China, cover asset managers, private investment funds, insurance companies and pension funds. The qualitative research is conducted through secondary research and interviews with custodian banks and institutional investors.

Key findings of the report

55%
of respondents have already or may consider appointing local/regional custodians as opposed to relying on global custodians.

66%
of respondents use Shanghai-Hong Kong Stock Connect. 63% also use Shenzhen-Hong Kong Stock Connect.Pre-delivery risk was noted as the largest obstacle.

0%
of our respondents short sell stocks on the Stock Connect schemes.

41%
of respondents say they do not have a back-up custodian. Among pension funds and sovereign wealth funds, this percentage is as high as 80%, according to secondary evidence.

66%
of pension fund managers see passive investments as a mature part of their portfolio.

The number of investors who are planning to use Bond Connect are **1.6** times that of CIBM Direct.

78%
of the respondents plan to launch new products in 2018-19.

Cross-border schemes

Stock Connect

As MSCI officially included China's A-shares into its emerging market index, overseas asset managers especially passive funds have been increasing their allocation to China's domestic shares. The elimination of the total quota and the expansion of the daily quota paves the way for more institutional investors to increase exposure to the second largest stock market.

Overall, 66% of respondents say they use the Shanghai-Hong Kong Stock Connect. This percentage is up from 45% of last year's respondents. Further, 63% of respondents use Shenzhen-Hong Kong Stock Connect.

The survey reveals that the scheme is more popular among overseas-based respondents, of which 57% use it to trade mainland listed stocks. In the survey conducted last year, more mainland investors used the scheme as opposed to overseas investors. None of our respondents short sell stocks on the Stock Connect schemes.

Pre-delivery risk was noted as the largest obstacle that hindered use of the Shanghai Hong Kong Stock Connect, followed by liquidity and settlement cycle.

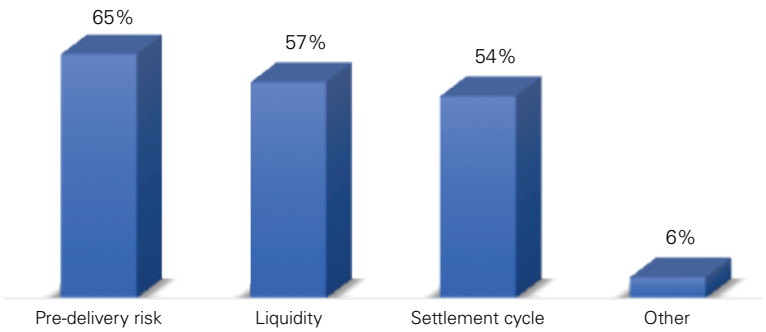
Among the 34% of respondents that do not use the Connect, most simply do not see a business case. This view is especially prevalent across overseas-based investors. Other major reasons include the requirement for pre-notification of trades and existing QFII access that already covers their needs.

One respondent of a large institutional investor based in Philippines says that their remaining QFII quota has not yet been exhausted, hence a need to use the new link has not arisen. Another respondent which does use the link responds that they "still don't have a policy for investing in that market", implying that a wait-and-see attitude is still

66%

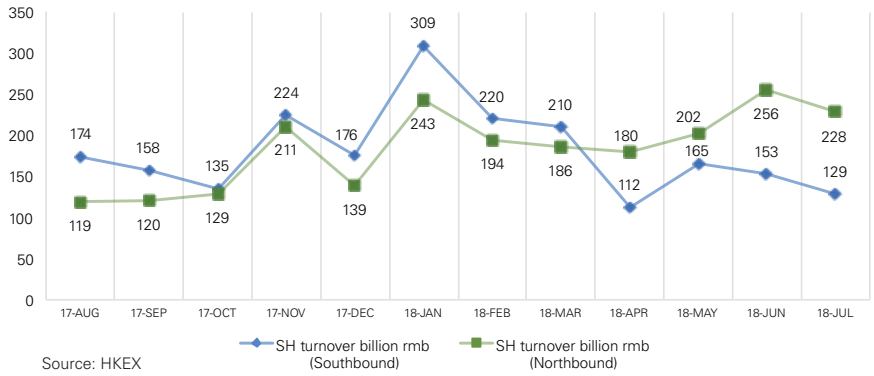
OF RESPONDENTS SAY THEY USE THE SHANGHAI-HONG KONG STOCK CONNECT

Chart 1: **What are the obstacles that, in your opinion, hinder the growth of Shanghai-Hong Kong Stock Connect?**



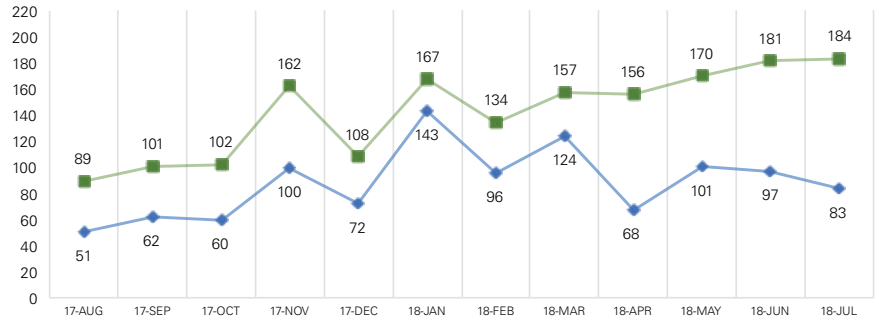
Source: Asset Benchmark Research
Asset Servicing Survey 2018

Chart 2: **Monthly trading volumes of Shanghai-Hong Kong Stock Connect**



Source: HKEX

Chart 3: **Monthly trading volumes of Shenzhen-Hong Kong Stock Connect**



Source: HKEX

34%

OF RESPONDENTS THAT DO NOT USE THE CONNECT, MOST SIMPLY DO NOT SEE A BUSINESS CASE

common among overseas investors.

Market infrastructure builders such as global custodian banks are also eyeing the opportunities from the MSCI inclusion. BNY Mellon is the first triparty agent to provide collateral services for securities settled through Hong Kong (HK) Stock Connect, supporting growing cross-border trade volumes into and out of mainland China. The bespoke solution expands the range of eligible collateral available to investors, just as international interest in Stock Connect gathers steam.

Hong Kong Exchanges and Clearing Limited (HKEX) on August 24 announced the launch details of the investor identification model for Northbound trading through its mutual stock market access programme with the exchanges in Shanghai and Shenzhen. The model was launched on 26 September 2018.

Bond Connect and QFII/RQFII, CIBM

Since Bond Connect was launched in 2017, the new cross border fixed income investment channel has attracted a number of overseas institutional investors. According to Bond Connect Company, a joint venture created by the Hong Kong Stock Exchange and the China Foreign Exchange Trading System, the number of international investors using Bond Connect reached 400 as of August 15. 61% of accounts are opened by global asset management companies and fund managers.

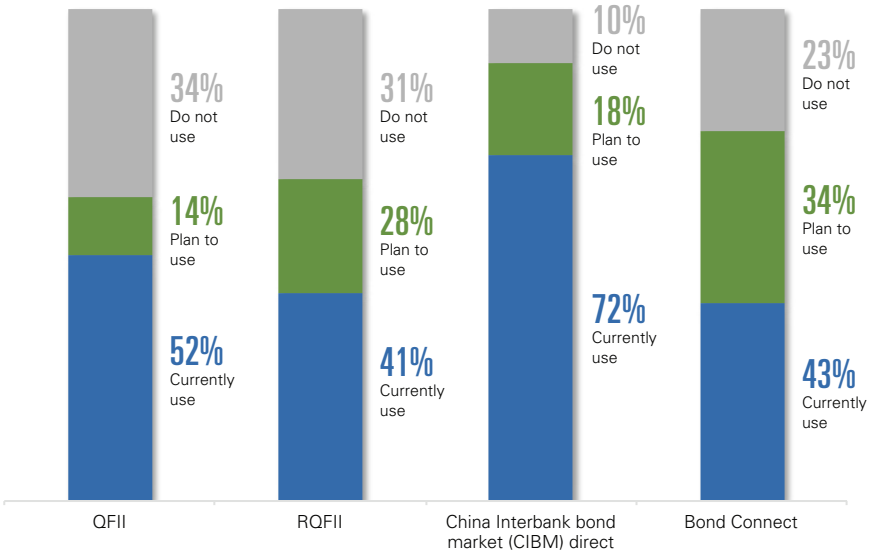
According to the latest Asian Local Currency Bond survey conducted by Asset Benchmark Research (ABR), the number of investors who are planning to use Bond Connect are 1.6 times that of CIBM Direct. Yet the total number of international investors subscribing to CIBM Direct is 1.2 times that of Bond Connect.

One key issue which was recently solved in Bond Connect is the delivery-versus-payment (DVP) settlement, which has been in place in domestic China market for a few years. However, for cross-border transactions, it took more than one year for DVP to be available. "For Bond Connect, we are not looking into it yet because the process is not yet DVP. A lot of UCITS funds or CSSF funds have not approved Bond Connect yet," said one large foreign asset manager prior to the launch of DVP.

Delivery-versus-payment (DVP) settlement has been fully implemented in Bond Connect starting from 24 August. All trades under the Bond Connect are now settled on a DVP basis.

In addition, Bond Connect launched block trade allocations in late August, which allows asset managers to allocate block trades to multiple client accounts prior to the trades. With the pre-trade allocations function, traders can execute a single block trade and allocate specific percentages or amounts of the trade to up to 30 individual accounts.

Chart 4: **Which access channels do you use to invest in China's onshore bond market**



Source: Asset Benchmark Research
Asian Local Currency Bond Survey 2018

61%

OF ACCOUNTS ARE OPENED BY GLOBAL ASSET MANAGEMENT COMPANIES AND FUND MANAGERS

The launch of block trade allocations marks an important step forward for Bond Connect to enhance the scheme in terms of trading workflows and operational efficiencies. Buy-side investors are able to implement their trading strategy without spending additional time to manage the blocks. The adoption of block trade allocations is the second of the three conditions from Bloomberg Barclays index inclusion that have been met within a week after the recent full implementation of DVP. These developments are expected to accelerate the participation in Bond Connect by global asset managers and investors.

In August, the State Council announced interest income by overseas institutions from investments in the onshore bond market will be exempt from income and value-added taxes. The tax exemption period is tentatively set for three years.

As the implementation of DVP, launch of block trade allocation and tax exemptions remove obstacles for overseas investors, it is expected that foreign investors will increasingly shift to Bond Connect as a more efficient channel once the DVP is completed.

"If some of the hurdles are removed, we will move to Bond Connect. The ease of processing, the turnaround time are a lot easier under Bond Connect. The Bond Connect is an easy route for foreign investors," comments another portfolio manager at a European asset management.

Another issue with Bond Connect is the funding of CNY for global custodians. "There's the issue with the access with CNY. The global custodians haven't figured out how to manage the trade flow for the funding for CNY," said a Singapore institutional investor.

Meanwhile, CIBM remains attractive for several reasons. First, it allows investors to trade a wider range of hedging tools such as interest rate swaps and forward rate agreements. "We choose CIBM because of the availability of instruments," said one institutional investor based in Singapore.

A more substantial benefit of using CIBM Direct is the exposure of onshore bond market information. "The problem with Tradeweb (the trading platform for bond connect) is that you seldom get information about the onshore bond market as you are not communicating with traders and sales in person over the counter. I believe CIBM Direct offers us more exposure to the onshore bond market. And in fact, we trade more often via CIBM than Bond Connect. 80% of our trade in onshore bond market are made through CIBM Direct," a Taiwan based investor explained.

Overall, to foreign investors, global custodian banks are still the preferred banks when it comes to access to China onshore bond market. "Optionality is key. Currently, I would say the landscape is dominated by foreign banks because the connectivity of global custodian is key," says a global asset manager based in Hong Kong.

Yet, their attitudes are changing. In the ABR study, 55% of respondents have already or may consider appointing local/regional custodians as opposed to relying on global custodians.

55%

OF RESPONDENTS HAVE ALREADY OR MAY CONSIDER APPOINTING LOCAL/REGIONAL CUSTODIANS AS OPPOSED TO RELYING ON GLOBAL CUSTODIANS

Pension fund

The pension fund industry in Asia Pacific has seen significant developments in the past two years. Many overseas pension funds have unveiled ambitious programs with intentions to step out of the comfort zone of their home markets. The desire to diversify and to boost returns are pushing pension funds to think creatively and globally.

Australia and New Zealand are increasingly looking outside for new investments, even though a great proportion of the superannuation fund's assets are still invested at home. The exploration of new investment opportunities gives rise to demand of mid and back office outsourcing.

"We would like to see custodians at a point where we can outsource the preparation of the ancillary clerical tasks. So bringing in the market data, bringing a group of data and validating it and passing it to us. It is an area that custodian are increasingly looking at but even though they increasingly look at this area, none of them are progressing except for one or two," says a general manager of operations at a large superannuation fund.

The shift has also been spreading to other places in Asia, such as Japan, home to the world's largest pension fund, where the holding of domestic bonds has been slashed by almost half in the past few years in favour of overseas assets. The region's emerging markets, such as Thailand and Malaysia, are also following suit.

"Custodians can do middle office outsourcing because they do have a platform. What we have not seen is around the data, what we call the T-ball, I-ball, A-ball: the treasury book of records, the trading book of records, the accounting book of records. If our Custodian can broaden that up and bring in the pieces of data that we need into a single place, manage the relationship, manage the validation, and come to us and say this is your clean copy of data, then that would be interesting. And I think no single custodian can do it now, they claim they can but I have not seen anyone using," says a Pension fund representative.

In the ABR study, 41% of respondents say they do not have a back-up custodian. Among pension funds and sovereign wealth funds, this percentage is as high as 80%, according to secondary evidence.

Asia Pacific accounts for the fastest aging population and a rapidly declining old-age support ratio. This leads to another significant development: retirement funds are accumulating fast in some of the largest markets which demand a much more comprehensive and efficient pension system. China is expected to attract net new inflows of 15% annually through 2025, double the rate at which assets for the largest 22 pension funds globally have been growing in the last two decades.

41%

OF RESPONDENTS
SAY THEY DO NOT HAVE A
BACK-UP CUSTODIAN

Conclusion

With a majority of investment professionals (78%) surveyed planning to launch new products in 2018 and 2019, 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 successful equity and promising bond connect scheme, 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.

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

78%

SURVEYED PLANNING TO LAUNCH NEW PRODUCTS, THEIR CUSTODY SERVICE PROVIDERS SHOULD BENEFIT FROM HIGHER BUSINESS ACTIVITY

交通銀行
BANK OF COMMUNICATIONS

About Bank of Communications Limited

As one of the first batch commercial banks that have custody licenses in China, Bank of Communications ("Bocom") started its custody business in 1998. Having carried out the business for more than 20 years, Bocom has developed into one of the custodian banks who has the most complete custody qualifications and varieties, the most different types of custody assets, and one of the most complete custody services with a well-known market reputation. As a state-controlled commercial bank, Bocom values the importance of the Fund that related to people's livelihood and financial stability, and has accumulated rich experience in custody. At present, Bank of Communications is the only commercial bank with all the National Social Security Fund, Insurance Protection Fund and Pension Fund custody qualification. Bocom is the main custodian bank of the National Social Security Fund and the custodian bank of the Insurance Protection Fund.

In March 2013, Bocom established its Asset Custody Business Centre in Hong Kong. It was the first professional offshore custody platform set up by Chinese banks 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 investors' policies 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 fund custody, Bond Connect custody, mandatory provident fund custody, insurance and offshore asset custody, QFII, RQFII, QDII securities investment asset custody, Bond Trustee, Hong Kong third-party Stored Value Facility (SVF) asset custody, Share Award Scheme and third-party escrow accounts services. Bocom also provides custody services for foreign institutions to directly invest in the China inter-bank bond market.

ASSET ASIAN AWARDS 2018

THE Asset

TRIPLE A

交通銀行

BANK OF COMMUNICATIONS

Best in Asset Servicing, China

Best Custodian, Pension

The Asset Triple A Asset Servicing, Fund Management and Investors Awards 2018