German custodians on the New Silk Road

Guiding investors into faster growing markets

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The German custody and depositary bank industry has seen transformational change, with the market massively consolidating and service providers focusing on regulatory change, improving cost efficiencies, and streamlining their organization. Service providers with a long-term strategy must now focus on innovation and become providers of knowledge and solutions. The key macroeconomic trend will be the increasing importance of Asia generally and China specifically: custodians have to set out for the New Silk Road.

The German custody and depositary banking market is seeing transformational change. More than 70 percent of the market's €1.72 trillion in assets under custody[1] is now consolidated with the five largest providers: BNP Paribas, J.P. Morgan, State Street, BNY Mellon, and HSBC. A considerable number of local providers have exited the market over the past 24 months. This development towards consolidation is largely the result of three key factors:

The regulatory paradigm change

Not only have the laws changed, but the world in which the custody market operates has also seen a fundamental shift. The regulatory tsunami that the market has seen and continues to see is merely the result of a new financial world order, which has been triggered by the global financial crisis. Regulatory change comes at a massive cost, and this cost imposes a significant burden on service providers. EMIR, AIFMD, UCITS V, MiFID II, and FATCA, to name but a few, may serve as examples that affect essentially all providers. Where providers lack critical scale, the cost of regulatory change is forcing many to exit the business.

Margin compression

There is continued margin compression both in core custody and ancillary revenue, putting a significant strain on custodians.

Core custody revenue in itself has come under pressure as institutional investors and their asset managers are passing on their own margin pressure to their service providers. The expectation is frequently that market initiatives around infrastructure harmonization (such as Target-2-Securities) or moves to self-clearing and self-custody via proprietary agents should be reflected in improved rate cards.
Margin compression also extends to ancillary revenue. Years of an almost unprecedented low interest—and even negative interest—environment put an additional burden on market participants. FX revenue, traditionally a significant source of ancillary revenue for global custodians, has also been under pressure for years. Where providers lack sufficient revenue, they opt to leave the market.

Rationalization

A significant number of banks have pursued exercises to improve efficiency, increase profitability, and streamline their organization. This tends to come with a focus on core competencies and in some instances with a disposal of business activities which may, for one reason or another, be considered as non-core. Such considerations are likely to have led smaller providers to exit the custody business, particularly in cases where they lack scale, where they work on an outdated IT infrastructure and where they would have to approve substantial IT investment to merely retain their market position in the medium term.

These three factors have considerably changed the shape of the German custody market and continue to truly represent what one commentator has recently referred to as *"a crackling market environment"*[2].

In such a challenging market environment largely dominated by regulatory and cost challenges, custodians that do play in the big leagues and have a long-term growth agenda need to be able to demonstrate that they have a relentless focus on future growth and innovation. They need to be able to differentiate themselves and determine which overarching trends are most fundamental to their clients and their business, and invest to provide comprehensive solutions.

Typically, industry discussions focus on the following key issues:

Firstly, there is the issue that could be summarized as the digital agenda. This discussion is about automation, connectivity and data provision. This type of innovation is largely related to systems and processes with the objective of achieving greater efficiency, helping clients and service providers to bring down costs. In essence, this is innovation to achieve optimization.

1 *BVI Verwahrstellenstatistik (investment statistics of the German Federal Association for Investment and Asset Management), as per 30/06/2015*

2 *Clemens Schuerhoff, "Ein knisterndes Spannungsfeld", dpn Dossier / Special Report "Custody / Administration", August/September 2015, p. 7*

Secondly, there is the issue of demographic change and an ageing society, largely discussed in-country although it applies to most of the Western world more generally. The assumption is typically that this inevitably leads to substantial growth in both the life insurance business as well as in fully-funded pension schemes, whether they are corporate, occupational or private. Innovation within this area of discussion aims at developing bespoke solutions for this particular industry, e.g., the servicing of new investment vehicles (in Germany for example the so-called Investment-KG), solutions for unit-linked life products, overlay management or master record-keeping solutions. This type of innovation is undoubtedly demand-oriented. The demand, however, stems from a delta in asset growth that is largely meant for future consumption. Hence, at least from a purely domestic perspective, this is innovation that helps to secure short and medium term strategic objectives but is unlikely to secure a long-term strategic position.

Thirdly, there is a significant discussion around innovation to support so-called new asset classes (depending on the perspective of the investor). There is indeed increased client demand for the launch of credit or loan funds, for volatility as an asset class, for investments in infrastructure (toll roads, airports, pipelines, etc.), real estate, and a variety of alternative investments (e.g., airplanes, ships, wine, forests, etc.). Largely, this growing demand is not the result of a voluntary change in risk appetite among investors. Rather, many investors, particularly insurance companies and pension funds—which in Germany constitute the two largest groups of institutional investors—are forced to increase risk. This is because they must meet obligations which typically result from contracts that were concluded at a time when an environment of near-nil or negative interest rates over a prolonged period of time were inconceivable. Again, while innovation in the area of new asset classes is clearly demand-oriented, it is essentially innovation addressing risk-driven behavior.

There is one overarching phenomenon, which from its macroeconomic importance outshines the three other issues by far. That dominant macro development is the transformation of the global economy.
HSBC research shows that by 2050, 19 of the world's 30 largest economies will be countries that we consider as emerging markets today[3]. The market is already observing a massive re-allocation of wealth and of investments—from West to East, and, to a lesser degree, from North to South.

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3 The World in 2050", HSBC Bank plc, 11 January 2012

Faster growing economies

Rather than merely constituting an additional, fourth discussion area, this transformational change of the global economy should be the key focus of all strategic discussions in the global custody arena: innovation that helps clients to invest in the world's faster growing economies is the only type of innovation that is purely based upon growth.

Figures from HSBC Germany may serve to illustrate that claim: while overall assets under custody have grown by 45 percent since 2011, emerging market assets held by clients have grown at a relative average of 78 percent (Asia Pacific 76 percent, Middle East 80 percent, Latin America 103 percent). It is the fastest growing business.

While Western markets require the highest possible degree of automation and a continuous improvement to STP rates, servicing investors in emerging markets first and foremost requires expertise, both in the target country as well as in the country where the investor is domiciled.

There are simple reasons why many of these economies require specialized expertise. Countries that are in the process of liberalization and market opening typically operate with stricter investor monitoring regimes. Commonly, individual investor licenses need to be obtained (and often require substantial documentation), frequently there are a variety of restrictions on foreign exchange, specific rules on account segregation, transaction reporting, pre-funding, shareholder limits, requirements on officially notarized translations, and highly complex tax rules, to name but a few.

There is of course no simple explanation for what generates economic growth in emerging markets and individual success stories tend to all have their own characteristics. However, improving productivity, better education, and strengthening of the rule of law are key factors that contribute to economic growth in the world's faster growing economies, apart from a demographic dividend that many emerging markets are enjoying.

India, the Philippines, and Malaysia will be among the world's fastest growing economies. However, the single most important market is China—and China is a market which requires highly complex and innovative custody solutions.

Why China?

China is by far the largest emerging economy. By 2050, China is likely to have overtaken the United States as the world's largest economy[4]. The role of the renminbi both as a trade and investment settlement currency is continuously increasing and is likely to expand until it matches China's economic power. China's resources and commitment to grow, and specifically to invest in large-scale infrastructure projects, are significant. Of the many major investments, the "One Belt – One Road" project is the most important one. This project, commonly referred to as the New Silk Road, will connect 29 percent of the world's GDP and is based on an estimated ongoing infrastructure investment of more than RMB1 trillion (approximately US$160 billion)[5].

4 ibid., p. 4. HSBC estimate based on UN, World Bank and proprietary HSBC estimates.

5 HSBC Global Research, Qu Hongbin, "Will China Hold Up?", The Hong Kong and Shanghai Banking Corporation Ltd., Q4 2015

China A Shares are increasingly likely to be included in some of the industry's leading emerging market indices. The China Interbank Bond Market has a total outstanding amount of RMB37.93 trillion[6] (approximately US$6 trillion) and continues to grow at double-digit rates. Moreover, the Chinese government has demonstrated that it is liberalizing its capital markets carefully, rigorously, and step by step, following Deng Xiaping's motto of "crossing the river by feeling the stones".

Traditionally, it used to be difficult for investors from outside of China to access its emerging capital market. Many market participants still have a perception that China involves a significant amount of bureaucracy and investments are potentially difficult to repatriate.

However, with the July 2014 extension of the Renminbi Qualified Foreign Institutional Investor (RQFII) program to asset managers from Germany, the situation has changed significantly.

Up until recently, German asset managers only had the QFII scheme (QFII as opposed to RQFII) available to invest in China, which required them to hold a minimum of 50 percent of their investments in equities. With German institutional money largely managed via so-called Spezialfonds, and these funds being formally represented by their management company (the KVG), the management company needs to apply for investor status and then have their underlying institutional clients inject money into the Spezialfonds. However, the 50 percent in equities criterion made investments in China somewhat unattractive for most of Germany's largest investors (particularly from the insurance industry), since their asset allocation is largely fixed income based.

With the 2014 introduction of RQFII to Germany, the 50 percent equities requirement was dropped. There are no longer any restrictions on asset allocation. Specific fixed income funds can now invest in the China Interbank Bond Market. Moreover, the former waiting period for additional quota applications and the six month injection period no longer apply under RQFII. Importantly, provided the fund is set up as an open-ended fund, daily liquidity is now permitted.

The RQFII scheme is open to institutional investors from a selected number of countries only. Currently, as the entire quota allocated to investors from Hong Kong is already utilized, Germany has more unallocated quota available than any other eligible jurisdiction, giving asset managers and institutional investors based in Germany an opportunity to seize the moment.

Where the German custody and depositary bank and the Chinese custodian work closely together, they are able to provide highly innovate solutions to their clients. The New Silk Road—literally and figuratively symbolizing and representing new markets and new opportunities in Asia—is a unique opportunity. As with all new roads, those who explore them first will know the road best. And those who are able to travel them with an experienced local partner can do so at a lower risk.

Future outlook

To be a provider of choice for the future, expertise, guidance, and knowledge will become an ever more important business feature. In the future, in addition to providing a highly automated technical infrastructure, global custodians must become providers of knowledge or vanish—in a digitized and commoditized business such as the securities services industry, they will differentiate themselves by the level of specialized expertise that they can provide to their clients. In particular, they must be able to show that they have expertise in Asia and specifically in China, as this will be the region with the strongest growth globally.

To do that, custodians will need to have three features:

1. an extensive proprietary network of local agents that help them to globally and rapidly channel local market developments
2. the ability to lead and guide investors into emerging markets rather than merely react to their technical needs
3. innovative product solutions that help clients implement their investment plans in this changing global environment.

The vision is that in the future, the custody industry will no longer speak of emerging markets. It will only speak of faster growing markets.