The promise of more to come

China is now a big market but there is still more growth to come, and much work still to do.

The mutual fund market in China was born just before the turn of the millennium. Since then the Chinese economy has grown well in excess of 10% p.a. compound, effectively increasing in size by a factor of nearly five times. So should the mutual fund business be deemed a success or not? In mid-2014, the Asset Management Association of China reported that there were almost 100 domestic Chinese mutual fund companies. Between them they had a little over $900 billion of assets under management (AuM). This means that the entire industry is slightly smaller than Fidelity, Vanguard and American Funds in the United States. The top 10 mutual fund managers in China oversee around $420 billion of assets or about 50% of the total. The top 10 U.S. funds manage around ten times as many assets, comfortably in excess of $4 trillion overall. The European mutual fund market is well in excess of $6 trillion of AuM. So while the China numbers are interesting, they are not yet, even after 16 years of trying, in the really 'big league'. Of course future growth is also a potential attraction. In the last twelve months, AuM among China's domestic mutual funds was nearly 50%, with the assets of the top 10 growing by more than 40%. At first glance that looks very attractive. However, during the same period net fund sales in Europe were more than €200 billion, which means it will be a few years yet before China's mutual fund business has the same global impact as its wider economy.

Like many businesses in China, the development of the mutual fund industry specifically, and asset management more generally, has been tightly controlled through a combination of regulation and procedural requirements. China fully recognises the importance of developing over time a range of long term savings products, whether through insurance, pension or mutual fund provision. It has also been channelling investment into modernisation and infrastructure developments. That has meant that it has been relatively happy to see financial services grow and learn in a relatively controlled way. The important question for the future is the extent to which there is a desire to speed up the process and move forward more rapidly. Based on the development of Tianhong Asset Management following its product launch in conjunction with Alibaba in 2013, it is clear that the supply of assets is there, albeit in that specific case money market funds rather than equity or bond funds.

There are a number of reasons to believe that the pace of growth and the development of greater competition may be taking off in China. Since the end of 2012, the authorities have issued a series of new rules and regulations, designed to increase the scope of investments and reduce investment thresholds to encourage greater participation. The new regulations have tended to break down previous demarcation between banking, mutual fund, stocks, trust and insurance funds. As a result the market is already becoming much more competitive. To date this competition has flourished most in the area of innovations in the distribution process, specifically around mobile applications. So, as well as the Tianhong link up that allowed investors to access their account from the e-commerce firm's website, China Asset Management Company (China AMC) launched its first on-line product in January 2013. ICBC Credit Suisse, the venture between ICBC and Credit Suisse, provides clients with a range of products available through smartphone apps. Its assets reportedly grew by some 70% in the last year, and it now ranks fifth among all mutual fund managers in China. The savings being tapped by these new investment vehicles appear to be coming from money previously held in banks. So it would appear that in terms of product innovation, the strategy of opening up the business has been a success from a consumer perspective, with the losers being banks; a repeat of what happened elsewhere, especially in North America.

As well as looking towards more effective distribution in China, there is the growing opportunity to create new funds based on the market in Hong Kong, following implementation of Stock Connect late in 2014. From an overseas perspective, the attraction of Stock Connect is intended to be the fact that non-Chinese investors will have the ability to trade Shanghai A-share stocks, of which there are more than 500 listed.

However, for domestic Chinese investors the appeal is that firms can create and offer products whose returns are tied to the Hang Seng index. The possibility exists that eventually there will be mutual recognition of funds based in Hong Kong and mainland China, with the potential to boost sales in both. Demographic considerations continue to be positive. Despite the recent reduction in the rate of growth in the economy, it remains high, relative to population growth and Western countries. The result is that personal wealth is increasing. Given a natural propensity to save among many Chinese it will likely result in further growth in mutual funds and other savings related vehicles.

As far as custody services are required, as ICBC point out in their provider questionnaire, the domestic custody market was further expanded through new regulations and amendments to existing regulations completed in 2014. "The regulations on the operation of public-raised securities investment fund" issued by the China Securities Regulatory Commission (CSRC) was designed to offer further protection for investors' rights, particularly those of smaller investors. Meanwhile, the CIRC issued a series of regulations aimed at broadening the investment scope of insurance funds, and to implement a custody policy for all insurance assets. Finally, in December 2014, the China Futures Association issued "Tentative regulations on asset management business of futures companies". This proposal looks to ensure that client assets are held by custodian institutions. As the various rules become more formalised, it is clear that scope for business expansion among domestic custodians will be considerable. Leaders, including Agricultural Bank of China, Industrial and Commercial Bank of China (ICBC) and China Construction Bank, appear well placed to take maximum advantage.

As rules become more homogenous across different types of investment, opportunities grow for economies of scale to be achieved and for consolidation to take place across the industry. If that occurs, the custody industry in China will parallel the experience in Europe and North America. The key to that process will be the most effective use of technology among the Chinese custodian banks. Whether they develop the systems themselves or acquire products tried and tested elsewhere is not certain for now. However, whoever gets that decision correct will likely emerge as the dominant providers to a fast growing industry.

Overall, these remain exciting times for the asset management industry in China, and the custodian banks that support it. While much has been achieved, there clearly remains much work still to be done. Even as custodians begin to achieve some real scale in assets under custody, it is clear just how many opportunities the future will hold. Interesting times indeed. ■

SURVEY OVERVIEW

Is everyone really that happy?

Scores in response to the Survey are excellent, even from the very largest clients. That is positive but all may not be exactly as it seems.

The most important component of any survey is the quality and credibility of its respondents. We are therefore delighted with the nature of clients who have responded to this, our very first survey of domestic custody business in China. Of the 10 largest mutual fund managers, nine responded to the China domestic survey. The exception was a manager specialising in money market funds, which though large in asset terms, carry less complexity in operational, reporting and valuation services. Fully three-quarters of the largest 20 managers answered our questionnaire and we thank them for their contribution to our efforts to inform. To these were added a number of smaller managers as well as some of the largest insurance companies and pension funds. The survey therefore represents a comprehensive picture of the current state of the custody industry in China.

The results are, based on a superficial reading at least, exceptional. The average overall score is better than 6.50 i.e. between Very Good and Excellent. Figure 1 shows the actual scores received in each of the ten core areas of service evaluated within the questionnaire. The results are indeed strikingly good. However, just as in every survey run by *Global Custodian*, attention has to be paid to the nature of the respondents and their approach to answering to the kinds of questions posed. In the major long-standing surveys, patterns in scoring between respondents of different sizes, different businesses and different locations are now well entrenched. Indeed, the normalisation algorithm applied in these surveys is to some extent predicated on different approaches to scoring among different groups. While fixed patterns can only emerge over time, it is perhaps not surprising that in the first such survey of this kind, across Chinese domestic clients, scores are very high. Recognising this, it is important that any review of the scores concerns itself with relative, as well as absolute outcomes.

The lowest score was given for Cost and Value Delivered, including the level of fees charged and value for money assessed by respondents. This is in-line with almost all surveys conducted by *Global Custodian*. While clients' comments on fees were limited, they are clearly as keen to maintain a competitive environment, as their counterparts do in North America and Europe. It is also worth noting that Cost and Value Delivered was the second most important priority as assessed by clients and illustrated in Figure 2. This is a higher ranking than would be normal in *Global Custodian* surveys, where clients are typically less willing to accept the importance of monetary considerations in their overall view of providers. Either these respondents are more open about their motivations, or their level of concern is higher than the scores might suggest.

Looking at scores for functional capabilities, Technology achieved the second lowest score. Interestingly, given the emphasis on technology in the distribution side of the business, the level of priority attached is low. Once again, however, this in fact parallels the situation for many Western

Fig 1: Average scores by category

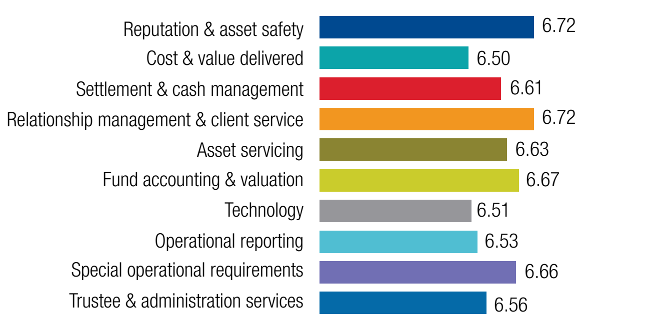

Fig 2: Respondent priorities ranking

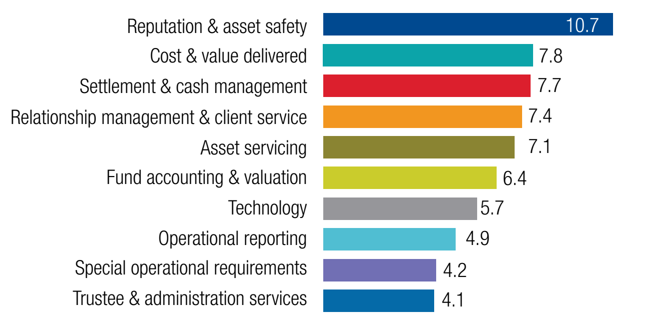

Fig 3: Type of respondent

Fig 4: Size of respondent

asset management companies. They too are very keen to maximise the use of technology in all its forms when it comes to gathering new assets to manage. However, when looking at middle and back office services, they are all too often unwilling to acknowledge the key role that technology must play if business is to be genuinely scalable. The relatively low scores are corroborated when asked to identify areas where they would like to see improvement. Of all the items mentioned by respondents, more than one-third highlighted technology as an area of relative weakness. So, while an average score of 6.51 looks superficially excellent it may not tell the whole story, and clients raised a number of specific areas of technology where they saw room for improvement.

The area of single most importance to clients is Reputation and Asset Safety. Recent trends in global custody have also caused a focus on these aspects of service. The financial crisis resulted in a clear move away from less systemically important sub-custodians in local markets around the world, which benefitted the global banks. It is hardly surprising that in the rapidly evolving but inherently conservative Chinese market, these issues should be seen as key. This will play to the strengths of those institutions like ICBC, Agricultural Bank of China (ABC) and China Construction Bank (CCB) that already enjoy a strong business and are rapidly earning a reputation for having a serious commitment to it. That will also make it hard for less well established local banks and also foreign banks, to compete for business in the future. It is worth noting that Reputation was also the area where the highest scores were achieved across the survey, suggesting that clients strongly believe they have made the right choice.

The other area to receive very high relative scores was Relationship Management and Client Service. This again is similar to other custody related surveys. Although only ranking fourth in terms of major priorities for clients, this area is one where providers do have the opportunity to differentiate their offering. This may be through the quality and effectiveness of personnel and/or superior processes and support. While the range of scoring between providers was not necessarily large, variations have to be seen in the context of the overall results. Small differences in scores may in fact belie quite large differences in perception of performance. It is worth noting that this area received the most mentions as being a key strength of service provision, accounting for more than 40% of all mentions. It is also worth noting that some providers received many more mentions around this aspect of service than others.

Figure 3 shows the different type of clients who responded to the survey. The largest group was Mutual Fund managers, who were even more dominant in terms of the weight of responses due to their relatively large size. They in fact gave the second lowest overall scores. Pension funds, which are included in the Other category, were lower but both separate account investment managers as well as insurance companies gave generally higher scores than mutual fund managers. Figure 4 illustrates the fact that the vast majority of respondents were quite large in terms of assets under management. Average scores were dominated by institutions with more than CNY 5 billion AuM. They too were the clients who, on average, gave the lowest scores. This is also in-line with experience in other surveys organised by the magazine.

The overall conclusion from the survey is that basic scores cannot be ignored. They paint a picture of broad satisfaction with services across all providers. However, there are certainly nuances in the scoring between different providers and different aspects of service, as well as between different types of client. These suggest there remains scope for some measure of competitive differentiation, as well as scope to further enhance services in a number of areas. ■

Methodology

Global Custodian domestic surveys are intended to assess the extent to which local service providers are meeting the expressed needs of their domestic clients. Such needs are often different from those of cross-border investors covered in the Agent Bank surveys published by the magazine. Many service providers also focus mainly or exclusively on domestic clients.

To obtain the relevant information, clients are invited to complete a short questionnaire. This typically involves around 20 questions. The questions are grouped into between eight and twelve service categories for presentation purposes. Respondents evaluate each question for each service provider that they use. Scores range from 1 = Unacceptable to 7 = Excellent. Where clients have insufficient experience of a service or do not use it at all, they can enter N/A. Clients are also asked to indicate which categories are most important to them in assessing the overall service being received and are given the opportunity to provide explanatory comments and identify specific strengths and weaknesses of their service provider(s).

Each question is given an individual weighting depending on the importance attached to it by clients. Each respondent is given a weighting based on the scale and breadth of their business and the detail included in the responses they provide. Respondents are also described by their type of business and the level of their assets under management (AuM).

Global Custodian's Research department calculates weighted average scores for each provider, for each question, each category and an overall total. The Research department also calculates scores for different types and size of respondent allowing us to reflect as accurately as possible the relative position of each service provider, both overall and with specific client subgroups. Summary information is presented in each Provider Profile together with, where relevant, explanatory contextual commentary.

More detailed analysis of scores and comments received is available from the *Global Custodian* Research department. This group also administers the digital accreditation process by which suitably qualified providers can receive a formal accreditation of their achievements, in the form of one or more digital badges.

Agricultural Bank of China

Agricultural Bank of China (ABC) received more responses from mutual fund managers than any other provider. It also received, relative to the overall survey, a greater proportion of responses from larger clients. As such, the fact that ABC's overall scores were slightly behind those of ICBC and CCB is not unexpected nor a particular cause for concern. As in the survey as a whole, ABC saw its highest scores in the areas of Reputation and Asset Safety, and Relationship Management and Client Service. However, its strongest score relative to the survey was in Operational Reporting, while the area of greatest relative weakness was Fund Accounting and Valuation. It is not clear whether this position reflects its greater activity in this area, or suggests clients are less than fully satisfied. The overall score of 6.23 is still better than Very Good. However, in the context of other scores seen in the Survey, it is mildly disappointing.

Among the key strengths cited by clients were mentions of all key categories. Asset servicing and Reputation and Asset Safety were favourably commented on by more than one client. ABC also received praise for its Administration Services, the only bank to be recommended by any clients in this area. However, it should also be noted that no clients saw Fund Accounting and Valuation as a strength. Technology was mentioned by a number of respondents as a specific area with room for improvement. It would appear that some clients at least see a link between technology and effectiveness of valuations; something for ABC to consider moving forward. ■

Table 1: Client breakdown

Insurance company	11.1%
Investment manager (separate a/cs)	16.7%
Mutual fund manager	61.1%
Other	11.1%

Table 2: Service area scores

Service area	Agricultural Bank of China	China Average	Difference
Reputation and asset safety	6.52	6.72	-0.20
Settlement and cash management	6.41	6.61	-0.20
Relationship management & client service	6.57	6.72	-0.15
Cost and value delivered	6.26	6.50	-0.24
Operational reporting	6.42	6.53	-0.11
Technology	6.23	6.51	-0.28
Asset servicing	6.48	6.63	-0.15
Special operational requirements	6.41	6.66	-0.25
Trustee and administration services	6.27	6.56	-0.29
Fund accounting and valuation	6.23	6.67	-0.44

China Construction Bank

China Construction Bank (CCB) received around one-third of responses to the Survey based on the weight of the respondents. Slightly higher than its unweighted share. Its client base was somewhat narrower than either ABC or ICBC in that it had no pension funds or insurance companies among its respondents. It did, however, have quite a high proportion of larger clients. These effects probably offset each other to a considerable extent from a scoring perspective. As a result, the scores for CCB should be seen as exceptionally strong. To the extent users of multiple providers identified differences, these were in favour of CCB against other providers. Their scores in the two most important areas, Reputation and Asset Safety, and Relationship Management and Client Service were both perfect 7.0 (Excellent) level. Even allowing for the generally very generous scoring pattern among respondents, this should nonetheless be seen as a very good performance. Relatively speaking, Fund Accounting and Valuation, together with Technology, comprised the weakest scoring. Even here though, scores were very satisfactory.

Around 50% of all respondents for CCB praised their client service as a particular strength. This was far higher than that achieved by any other provider. One client in particular commented on "the good quality of work" they added that they found CCB to be "efficient, solution driven and down-to-earth." The only areas of relative weakness came from comments related to Asset Servicing and Technology. Given the scoring, however, these hardly represent a competitive vulnerability and CCB appears well positioned to grow its business further. ■

Table 1: Client breakdown

Insurance company	0.0%
Investment manager (separate a/cs)	43.8%
Mutual fund manager	37.5%
Other	18.8%

Table 2: Service area scores

Service area	China Cons. Bank	China Average	Difference
Reputation and asset safety	7.00	6.72	0.28
Settlement and cash management	6.88	6.61	0.27
Relationship management & client service	7.00	6.72	0.28
Cost and value delivered	6.86	6.50	0.36
Operational reporting	6.89	6.53	0.36
Technology	6.81	6.51	0.30
Asset servicing	6.92	6.63	0.29
Special operational requirements	6.92	6.66	0.26
Trustee and administration services	6.97	6.56	0.41
Fund accounting and valuation	6.81	6.67	0.14

Industrial and Commercial Bank of China

Industrial and Commercial Bank of China (ICBC) is the largest domestic custodian in China. It has significant market share in all key areas of the business. It received responses from a broader range of respondents than any other provider, including pension funds and insurance companies, as well as asset managers. It did, however, have fewer responses as a proportion of its total from mutual fund managers, and a higher proportion from relatively small clients. These served to help ICBC scores, but the effect was quite modest overall. Scores generally were very good, but suffered relatively, just like ABC, from excellent responses received by the smaller market participants. As a result its overall score was marginally below the Survey average. It scored highest, relative to the Survey, in Reputation and Asset Safety on the one hand and Special Operational Requirements on the other. These scores no doubt reflect the breadth of its business, and the range of the clients with whom it is dealing. Both of these factors remain considerable competitive strengths.

Clients also identified Technology and Relationship Management as particular strengths. ICBC was the only provider to have its technology regarded as a strong point of its service. Also, despite the high scores, ICBC was seen as having room for improvement in dealing with special requirements. Again, this no doubt results from the scale of its business relative to others. Overall, its leadership position is clearly based on excellent performance in all areas, and its pre-eminence will be hard to challenge. ■

Table 1: Client breakdown

Insurance company	11.1%
Investment manager (separate a/cs)	16.7%
Mutual fund manager	61.1%
Other	11.1%

Table 2: Service area scores

Service area	Ind. & Comm. Bank of China	China Average	Difference
Reputation and asset safety	6.68	6.72	-0.04
Settlement and cash management	6.56	6.61	-0.05
Relationship management & client service	6.50	6.72	-0.22
Cost and value delivered	6.29	6.50	-0.21
Operational reporting	6.22	6.53	-0.31
Technology	6.51	6.51	0.00
Asset servicing	6.43	6.63	-0.20
Special operational requirements	6.68	6.66	0.02
Trustee and administration services	6.38	6.56	-0.18
Fund accounting and valuation	6.51	6.67	-0.16

Other banks

Two other institutions received responses to the Survey, namely China Merchants Bank (CMB) and Bank of China (BoC). In neither case was the level of responses sufficient to merit an individual profile. Together the banks accounted for just below 10% of the total number of responses. However, based on weighted responses, the proportion was only a little over 5%. The responses received were from generally smaller clients who, throughout the Survey, offered more generous scores.

Bank of China received generally excellent scores. It did particularly well in Reputation and Asset Safety, as might be expected, given the scale of the bank's overall activity. There were no comments from respondents as to any areas of particular strength or weakness. The conclusion must be that where it provides service BoC is highly regarded, but that its base of business is not sufficiently well developed to be able to offer a complete assessment of capabilities. Indeed it only received responses alongside other providers (i.e. from clients offering multiple assessments). In each case, its scores, while good were not distinctive when considered in comparison with others.

CMB, by contrast scored well, but not at the very highest levels seen by BoC. Its scores fell short in a number of areas, perhaps most notably in Reputation and Asset Safety. While CMB of course scored well, there was nothing in the overall position to suggest that it will move significantly forward in the short term. ■

Table 1: Client breakdown

Insurance company	0.0%
Investment manager (separate a/cs)	80.0%
Mutual fund manager	0.0%
Other	20.0%

Table 2: Service area scores

Service area	Other banks	China Average	Difference
Reputation and asset safety	6.54	6.72	-0.18
Settlement and cash management	6.65	6.61	0.04
Relationship management & client service	6.85	6.72	0.13
Cost and value delivered	6.85	6.50	0.35
Operational reporting	6.54	6.53	0.01
Technology	6.71	6.51	0.20
Asset servicing	6.69	6.63	0.06
Special operational requirements	6.85	6.66	0.19
Trustee and administration services	6.64	6.56	0.08
Fund accounting and valuation	6.76	6.67	0.09