Powering the flow of global capital
Capital markets issuer insights
Investor engagement in emerging markets

By Zafar Aziz, head of DR Investor Relations

The survey responses make it clear that, together with the economic outlook and political stability, capital markets infrastructure plays a vital role in determining global investor appetite for opportunities in emerging markets.

As the survey shows, of the BRIC and MINT countries, China, Indonesia and Russia rank highest for their capital market infrastructures, while India and China are rated as having made the greatest infrastructure improvements during the past five years.

At the same time, there are still plenty of local regulatory requirements that prevent foreign investors from directly accessing emerging markets. Freeing up the movement of capital can definitely improve liquidity, raise valuations and heighten investor confidence. Opening up the barriers to entry is also key to making overall markets more efficient.

With this in mind, China’s Shanghai-Hong Kong Stock Connect programme is justifiably attracting a lot of interest from financial market participants. Chinese authorities are also looking at whether some of the Chinese A-share issuers will be able to list in London or other locations in order to gain access to a wider pool of foreign investors.

If that does happen, I think it would really help to ease access to the market and there is likely to be significant demand from a wide range of international institutional investors.

The survey responses also show that the majority of institutional investors are planning to deepen their corporate governance role in emerging markets through increased participation in investor meetings and conferences. Before, investors would wait for emerging market issuers to visit popular locations like London and New York. What we’re finding now is that investor conferences are on the increase in Asia and investors are willing to meet companies there.

In the past, corporate governance departments within investment institutions may have been quite small. Now, they’re becoming much more influential and we’re seeing increased interest in governance, especially in dealing with regulatory change. This theme clearly emerges in the survey responses.

And, instead of issuers travelling to see an investor, they’re quite happy to use a virtual platform or another method to engage with them. Physical meetings will never be substituted but we’re seeing much more of this type of interaction as a supplement to their regular investor relations activities.
The market welcomes the right regulations

Most beneficial regulations

- Basel III 62%
- Solvency II 48%

Least beneficial regulation

- FATCA 53% (Alleged as the most burdensome)

Greatest concerns regarding the changing regulatory environment

- 43% Increased cost
- 31% Reduction in liquidity
- 26% Increased counterparty credit risk charges

1. The market welcomes the right regulations

2. Blockchain is coming sooner than you think

- Blockchain and distributed ledger technology will have an impact on the market for securities services. 87%
- This technology will be actively used within the next six years. 78%
- Blockchain could reduce the cost of providing securities services by more than 20%. 38%
- Systems failure (and subsequent market disruption) is the most important risk that blockchain technologies could reduce. 48%

3. Emerging markets are due a revival

- Emerging markets will deliver growth rates last seen during the 2001-2011 boom within the next four years. 54%
- Regulatory hurdles are among the greatest challenges when carrying out securities transactions in emerging markets. 62%
- A lack of capital markets infrastructure deters them from operating or investing in otherwise attractive emerging markets. 76%
- India and South Asia is the most attractive region for long-term growth prospects. 88%

Respondents were asked to select top two options.

Key findings

Trends

Biggest improvements in capital market infrastructure over the past five years.

- 28% China
- 40% India
- 13% Indonesia

43%

13%

26%

31%

48%*
The market welcomes the right regulations

Regulations may be part of life for both issuers and investors these days but that doesn’t mean they’re always seen as a burden.

The volatile macroeconomic climate and low returns are both preoccupying financial sponsors, broker-dealers and banks (Figure 1). This shouldn’t come as a surprise, given the unpredictable nature of global markets at the moment.

As the head of structured finance at a Swiss financial institution points out: “Negative interest rates are causing huge deficits in our interest earnings. Issuing new securities will only put us into more trouble as we are unable to gain sufficient returns from the proceeds of our borrowing.”

What is surprising is the relative consensus on regulatory change. For example, from a list of current or impending financial sector regulations (Figure 2), survey respondents rank Basel III the most likely to bring the most benefits (62%) followed by Solvency II (48%) and Europe’s Alternative Investment Fund Managers Directive (AIFMD) (34%).

“Investors see the benefits of regulations that improve their protection in terms of understanding what they are buying,” says Jose Sicilia, head of Issuer Services at Deutsche Bank. “Things like MiFID and Basel III help to increase transparency. They force businesses to ask questions of themselves and clients, and to reflect on relationships, structures and deals early on.”

This consensus is also present when asked about regulations least likely to bring benefits (Figure 3): 53% highlight the Foreign Account Tax Compliance Act (FATCA), followed by 48% citing the European Union’s Capital Requirement Directive IV (CRD IV) and 29% citing the European Market Infrastructure Regulation (EMIR).

Survey interviewees confirm that securities issuers are in broad agreement with these findings.

For example, as the director at one Asian financial institution points out, “The Basel III regulations are helping the financial sector improve liquidity, which will ultimately bring faster development.”

For most buy-side and sell-side respondents, the greatest concern regarding the outcome of regulatory changes is the likelihood of increased costs of execution, followed by the prospect of a reduction in market liquidity (Figure 4).

“Changing capital requirements have impacted our business model significantly,” says the head of structured finance for a Swiss bank. “Our risk-weighted assets are likely to be impacted severely and a surge in operational and implementation costs will act negatively on our revenues.”

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A number of sell-side survey respondents also mention the potential drawbacks of the FATCA regime. As Deutsche Bank’s Sicilia points out, FATCA represents an operational challenge: “In the past, when investors sought access to the US market – particularly for the debt capital market space – they would probably have considered a 70/30 split, with 30% to the US and 70% to the rest of the world. Now many might have to consider the cost of the FATCA regime in their decisions.”

The senior executive at a US mortgage lender agrees: “FATCA has changed the way financial institution issuers manage underwriting procedures. Surging compliance has increased the costs of operations and the prices offered to customers are being raised, which has a negative impact on the demand for new issuances.”

“The biggest drawback of these regulations is their impact on costs,” adds the head of debt capital markets at an Indian bank. “Investors will not only have to pay more to execute their existing strategies but higher costs will also affect returns.”

The head of operations at a US custodian bank adds that changing regulations mean liquidity has now become difficult even in high liquidity markets like the UK, Germany and France.

Survey respondents are also overwhelmingly negative about any potential financial transaction tax – 87% of banks and 80% of financial sponsors regard such a tax as likely to cause them to exit certain business lines or strategies.

Enhanced asset safety worth the cost
Under Europe’s AIFMD, fund depositaries have to indemnify investors in the region’s hedge funds against possible losses caused by fraud or negligence at the level of the custodian or sub-custodian.

Europe’s UCITS V Directive, which covers traditional mutual funds (UCITS), contains an equivalent level of protection and extends the indemnification to the central securities depositaries (CSDs) where funds’ assets are held.

For those in the custody business, an important question is whether large institutions are likely to request the same levels of asset protection in segregated accounts. The survey shows that 80% of banks and 70% of broker-dealers think the additional protections embedded in AIFMD and UCITS V are worth the extra cost.

Asset safety regimes differ around the world, ranging from “direct” holding structures (where individual ownership is recorded at the level of the CSD) to indirect or omnibus structures (where investors’ ownership rights are recognised only at the level of the custodian or sub-custodian, which may pool client assets in so-called omnibus accounts). Under Europe’s CSD Regulation, CSDs have to offer both individual and omnibus client segregation.

Bank and broker-dealer respondents express some or significant appetite for individually segregated accounts both at the CSD level (Figure 5) and the sub-custodian level (Figure 6), mirroring the level of appetite for segregation among buy-side survey respondents.
Backing up demands for greater asset safety, 92% of banks, 85% of financial sponsors and 80% of broker-dealers say they think sub-custodian risk should be partly or fully indemnified by global custodians (Figure 7).

Taken together, these survey answers suggest that a significant reallocation of responsibilities and costs among those involved in the custody chain may lie ahead.

Consolidation versus concentration risk
The TARGET2 Securities (T2S) project, which went live in 2015, is designed to rationalise and harmonise Europe’s system of securities settlement. T2S introduces a single set of rules for securities settlement and is meant to make the functioning of capital markets more seamless by lowering operating costs, improving liquidity and allowing for the easier movement of collateral.

Just over half (51%) of survey respondents say their experience of the system has been somewhat or very positive, with 27% saying it has been somewhat or very negative and 22% saying they hadn’t used T2S or that it was too early to say.

Individual comments by respondents are, however, almost exclusively positive about T2S. The following quote is typical: “It has simplified the way we carry out settlements. It is a unified system, cross-border fees are less and it has reduced the risks we face,” says the COO of a UK asset manager.

Over three-quarters (77%) of survey respondents expect either some or a dramatic increase in consolidation among sub-custodians in Europe as a result of T2S.

Figure 7: To what extent do you think sub-custodian risk should be indemnified by global custodians?

Consolidation among network providers in Europe

However, any push towards a consolidation of network providers is likely to be counterbalanced by pressure to rotate market counterparties in the face of potential concentration and other risks: 71% of survey respondents say they foresee moderately more or significantly more pressure to address such risks during the next five years.

Third-party collateral management
Although survey respondents rank EMIR as one of the least beneficial reforms for the global financial system, nearly four-fifths of institutional investors expect to make greater use of third-party collateral management services as a result of its introduction (Figure 8). Sovereign institutions in the survey express a lower level of interest.

Sell-side survey participants say EMIR’s collateral requirements represent an operational burden on their clients: “EMIR is likely to have a huge impact,” says the director of debt capital markets at an investment bank in the US. “Clients now need to keep aside collateral and monitor it daily – the whole process has become more time-consuming.”

On balance, a majority of the sell-side survey participants feel that regulators have a good grasp of their industry’s major risks, relative to all respondents: 52% of banks, for example, agree or strongly agree that regulators fully understand the risks present in their business, with 33% neutral and only 15% disagreeing (Figure 9).

Figure 8: Would your organisation consider using third-party collateral management for dealing with the increased collateral requirements imposed by EMIR?

Figure 9: “Our regulators fully understand the risks present in our business” (all respondents)
Blockchain is coming sooner than you think

Sell-side firms are optimistic about blockchain and the pace of its implementation but not everyone agrees on what it will look like when done.

According to a recent study by Oliver Wyman, banks’ IT and operations expenditure in capital markets totals $100–150 billion a year, with a further $100 billion spent on post-trade and securities servicing fees. Market participants also incur substantial capital and liquidity costs as a result of inefficient post-trade infrastructures, according to the consultant.

Distributed ledger technologies like blockchain promise to replace the current model of a single central ledger and record-keeping based on labour-intensive reconciliations by a post-trade process involving shared datasets. In theory, the blockchain model may be able to streamline many current support operations or make them redundant.

Survey participants on both the sell- and buy-side are optimistic about the future prospects of blockchain-type distributed ledgers: 87% of respondents expect such technologies either to completely disrupt or have a moderate impact on the market for securities services.

“We use technology far more than our competitors,” says the director of investor relations at a tyre manufacturer in India. “New technology to trade shares internationally is in the planning stage and the necessary licences and approvals are being analysed in order to achieve greater compliance in our issuing activity.”

The fact that 75% of survey respondents see distributed technologies being widely used within the next three to six years (Figure 10) suggests a surprising degree of certainty in an industry that can take its time when it comes to implementing technological change. Many remain pessimistic about how quickly it can be brought on board due to the technical challenges involved.

“To adopt and implement blockchain technologies will be quite tough,” says the director of treasury at a South American broker-dealer. “A lot of changes will be required and systems will need to be upgraded. This will create disruptions and affect company performance in the short term.”

Survey data and diagrams:
Almost two-thirds (62%) of survey respondents expect the introduction of distributed ledger technologies in the securities services market to produce savings ranging from 11–25% (Figure 11), with survey respondents saying that the most likely benefit of blockchain will be a reduced risk of system failure and market disruption (Figure 12).

Dealing with increasing regulatory requirements, overcoming legacy IT architecture, avoiding inadvertent data disclosure and preventing cybercrime are seen as other potential benefits. “Blockchain technologies will be very efficient,” says the director of operations at a US custodian bank. “They are very difficult to breach and are a very secure form of transaction. These technologies will help improve our security and reduce costs.”

Securities issuers in the survey have broadly positive views on the prospects of blockchain and the technology’s “smart contract” capabilities. “Blockchain can unlock hidden opportunities for banks and financial institutions,” says a senior executive at a US mortgage lender. “The dependency on digital currencies is growing and support from governments is helping mitigate the fiduciary requirements of issuing securities. Blockchain technologies have the ability to maintain a higher security and accuracy level.”

Despite this optimism, there remain a number of questions that need to be answered before it is accepted across the board. “Distributed ledgers are fine within a big firm,” says Deutsche Bank’s Sicilia. “But when you try to operate with someone else, how is that linkage going to deal with data secrecy, cross-border regulations, the legality of the distributor ledger, beneficial ownership issues and regulatory aspects – and most important, how do you manage the cash? These are some of the questions...
that we’re trying to answer and our clients seem to be asking them as well."

**Spending more for cybersecurity**

Spending on cybersecurity continues to increase in real terms among sell-side firms, with banks expecting the largest growth in spending in the near term. On average, banks anticipate a 12% increase in cybersecurity spending over the next three years, compared with a 9.9% increase over the past three years. Broker-dealers expect spending on cybersecurity to decelerate to a 9.9% increase over the next three years, down from 11.7% over the past three years (Figure 13).

All the broker-dealer survey respondents say that cybersecurity consumes between 11-20% of their overall IT budget (Figure 14), while 80% of banks say it ranges from 11% to over 20%.

More sell-side firms than buy-side respondents say they are prepared to take a collaborative approach to dealing with cybersecurity threats and responses: 90% of broker-dealers and 60% of banks say they are sharing (or considering sharing) intelligence on cybersecurity threats and responses with external partners, compared with half or less of institutional investors and sovereign institutions (Figure 15).

Firms on both the buy-side and sell-side cite the lack of a common framework as the main barrier to a more collaborative approach, followed by incompatible data formats and privacy or regulatory concerns.

“We are considering sharing information on the threats and problems we face, but it is difficult to share data as we have our own systems in place. Making our systems compatible with those of external partners will be a lengthy and expensive process,” says the vice president of debt capital markets at an Italian bank.

As well as using advanced data analytics and real-time monitoring to combat cybersecurity threats, almost all survey respondents expect to make use of cloud services within the next three years (Figure 16). Machine learning and artificial intelligence techniques, however, are being considered by only a third of respondents.

“We do use cloud services to help us manage cybersecurity and we use real-time monitoring to keep an eye out for risks and cyber threats. We have employed advance analytics to help us identify hackers and any risk that we could be exposed to,” says the director of debt capital markets at a German bank.

On the insurance side, 40% of banks say they have purchased coverage for any losses caused by cybersecurity breaches, while a further 47% are considering doing so. All of the broker-dealers in the survey say they have either purchased such insurance or are considering doing so.

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**Figure 15: Do you currently swap intelligence on cybersecurity threats and responses with external partners?**

**Figure 16: Which of the following technologies do you currently use for cybersecurity? Which are you likely to introduce in the next three years?**

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**Advanced data analytics**

- **Currently use:** 17%
- **Likely to introduce in the next three years:** 28%
- **Not using or likely to use in next three years and not considering:** 48%

**Cloud services**

- **Currently use:** 74%
- **Likely to introduce in the next three years:** 12%
- **Not using or likely to use in next three years and not considering:** 15%

**Real-time monitoring**

- **Currently use:** 16%
- **Likely to introduce in the next three years:** 62%
- **Not using or likely to use in next three years and not considering:** 23%

**Machine learning/artificial intelligence**

- **Currently use:** 4%
- **Likely to introduce in the next three years:** 31%
- **Not using or likely to use in next three years and not considering:** 50%
Of the BRIC and MINT countries, China, Indonesia, Russia and Turkey rank highest for their capital market infrastructures, while survey respondents say India and China have made the greatest infrastructure improvements during the past five years.

Boom times are expected to return, as investors shift their focus from China to South Asia in their search for better returns.

“‘It’s not surprising that investors are searching for higher yield in emerging markets, given the persistently low interest rates we’re seeing in so many markets,’” says Zafar Aziz, head of DR Investor Relations at Deutsche Bank.

Nearly two-thirds of survey respondents are optimistic that emerging markets will return to the growth rates seen during the boom of the past decade.

“It’s worth noting that survey respondents are equivocal regarding China’s economy: more than half say they expect the country to experience a prolonged period of slower growth. “India and China are witnessing massive demand, mainly in the manufacturing and industrial sectors. Their mid-term growth prospects are significant,” says the director of treasury at a Brazilian broker-dealer.

“We’re seeing significant appetite from investors,” agrees the director of investor relations at an Indian manufacturer. “The Indian economy is growing and new trading tools are now making it possible for foreign investors to tap the best performing shares in the Indian equity market. As we are one of the top businesses in this region and in our sector, the demand for our shares and investments have been significantly higher than any other businesses in our operating market.”

The survey respondents say that the economic outlook, political stability and capital market infrastructure, in that order, are the factors influencing decisions to allocate funds to emerging markets (Figure 17).

“Political stability does have an impact on the markets and how well they will perform,” explains the director of operations at a US custodian bank. “But primarily we look for markets where there is growth, as this assures us of the returns we need. The capital market infrastructure needs to be good to avoid business risks or regulatory problems.”

Focus on India and China

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“We have seen quite a few changes in the capital market infrastructure in India. It has been opening its market and has made many changes to its rules and regulations in a very short time, making it more attractive for investors,” says the head of global operations at a Philippines bank.

Survey respondents rank the economic outlook more highly in Indonesia, India and Nigeria than the capital market infrastructure in those countries. In Turkey, Mexico, Russia and Brazil, the reverse is the case.

Emerging market challenges and reforms

These findings suggest that there is an opportunity to be had in some emerging markets, but some investors may be hesitating.

“Regulations in emerging markets are not very stringent and are sometimes detrimental to growth. They may make it difficult to invest in the country. Tax structures are also different and may not follow international norms, making it difficult to obtain returns,” says the senior managing director of operations at an Indian investment bank.

This view is backed up by the survey results: 62% of survey respondents rank regulatory hurdles as their greatest or second greatest challenge when carrying out securities transactions in emerging markets (Figure 18), while 53% name political interference/instability as a challenge, and 40% point to the unreliable capital markets infrastructure.

Bold regulatory reform is the single most important step that emerging market governments can undertake to deliver growth, according to survey respondents, followed by a simplification of tax regimes and stronger governance structures (Figure 19). Infrastructure improvements and changes to securities market laws rank as less important among those surveyed.

“Emerging market players must achieve a high degree of sophistication and financial transparency to enable them to tap the international capital markets effectively. It’s a necessary evolution and it is critical,” says Deutsche Bank’s Sicilia.

Survey respondents are unequivocal about their intention to deepen their corporate governance role in emerging markets through increased participation in investor meetings and conferences: 93% of respondents foresee a substantial or moderate increase in their attendance at such meetings.

Issuers are already seeing that increase in participation: “This is catching pace now,” says the head of the investor relations division with an Indonesian energy group. “Competition laws are now a barrier to emerging market growth.

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Contact

If you have any questions or would like to speak with someone at Deutsche Bank about these findings, please email gtb.marketing@db.com

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