The View From Hong Kong

By Charles Gubert

Following on from its successes in Warsaw and New York, The Network Forum (TNF) rounded off its global event series for 2017 in Hong Kong at TNF Asia Meeting. More than 100 representatives from the securities services industry gathered at the Excelsior Hotel in Causeway Bay, a venue made famous by its close proximity to the Noonday Gun, which as the name would imply is ceremoniously fired at mid-day throughout the year.

For those TNF delegates unfamiliar with the tradition, the sound of a loud artillery shell going off at close proximity was certainly a shock to the system, but it was also a perfect metaphor for what is unfolding in the custody business today. Nowhere is this more obvious than in the emergence of disruptive technology, the consequences of which have not fully been digested or accepted by everyone in the industry.

In the 1980s, the labour-intensive, unproductive Linotype method of printing newspapers made way for digitalisation leading to drastic workforce cuts, cost savings and efficiencies. A similar process is currently underway in securities services as Blockchain and AI migrate away from secluded regulatory sandboxes and isolated incubation laboratories into real, meaningful operational processes.

"For years, securities services has made a living by providing incremental efficiencies to inefficient, disintermediated markets. Distributed ledger technology's (DLT) immutability and real-time transactional processing is potentially going to remove the need for counterparties sitting in the middle between issuer and investor," said one Blockchain provider at TNF Asia Meeting.

However, a market infrastructure expert conceded securities services faced a number of inefficiencies, but added providers were being holistic as to which solutions they could work with to achieve automation and STP. Despite this, 46% of TNF delegates in Hong Kong said Blockchain would have the most significant impact on securities services, with AI coming in second (30%).

The Blockchain provider also pointed out that regulators' attitudes to nascent technology had matured dramatically, and they were now ahead of the game, having for a long period adopted a fairly retrospective approach to managing change and risk. 42% of TNF attendees agreed, stating regulators were being active in helping Blockchain develop, although 49% acknowledged the authorities were being "noticeably passive."

Nonetheless, some believe that Blockchain's impact will be constrained, not least because legacy technology will have to undergo some serious realignments but also because of the potential new risks it introduces. Just as Einstein's ground-breaking Theory of Special Relativity paved the way for a huge number of positive innovations, it also introduced new risks, namely the introduction of nuclear weapons.

Blockchain, for example, may bring about instantaneous trade settlement and negate duplication, but the industry is starting to ask questions about how it will confront an encryption busting quantum computer operated by a cyber-criminal. Just as it did in Warsaw, cyber-crime is certainly giving TNF attendees lots of sleepless nights, not least because of the premium, best in class software being used to attack businesses, as shown by the mind-blowing theft at the Central Bank of Bangladesh last year.

Before the electrification of share certificates, misappropriation of assets would typically have been the result of an opportunist breaking into a defenceless or vulnerable bank vault. This old-fashioned approach to theft is arguably extinct as cyber-criminals have found cheaper, more effective ways of extracting far greater sums from banks simply by hacking their computer systems.

Network managers need to diversify their due diligence processes, and factor in cyber-security into their visits, a point made by one technology expert. The passing of UCITS V and AIFMD (Alternative Investment Fund Managers Directive) and their prescriptive rules around strict liability for loss of assets held in custody means that network managers need to be fully aware of these new cyber risks. Having assets parked with an institution that gets hacked will definitely not be covered by AIFMD's indemnification clauses.

A poll at the Asia Meeting, however, found just 5% of network managers prioritised cyber-security in their due diligence visits on their sub-custodians, compared to 55% who focused on operational flows; 17% on regulatory changes and 14% on compliance issues. Less reassuring was that only 2% of network manager due diligence visits prioritised disaster recovery and business continuity. The findings were, however, disputed by one network manager who said cyber-security was a pivotal assessment during due diligence visits.

It is true that the Association for Financial Markets in Europe (AFME) DDQ contains a section on cyber-security, but one expert said it would be complacent to take sub-custodians' responses on the issue at face value. He highlighted the only way to guarantee providers' cyber controls were robust was by testing them. Nonetheless, some sub-custodians may find such actions to be intrusive.

But not all of the talking points at the Asia Meeting were focused on the rampaging speed of technological innovation. No conference held in Hong Kong could ignore the remarkable developments and progress being made in China's capital markets, not least the country's inclusion onto the MSCI Emerging Market Index and several major bond indices, the liquidity benefits of which will be seen in 2018.

Liberalisation efforts are also on-going. Connectivity between China's equity markets in Shanghai and Shenzhen and those of Hong Kong were formalised with Stock Connect. Now connectivity is being extended to China's fixed income market with the launch of Bond Connect in July 2017.

Loosening restrictions for foreign investors accessing the China Interbank Bond Market (CIBM) has been happening for a while. "Bond Connect allows investors to access the CIBM without having an onshore presence in China," said one expert. Other Bond Connect selling points include a lack of quota obligations, a T+2 settlement cycle and the availability of onshore hedging.

Marginal changes do need to be enacted if Bond Connect is to truly flourish. TNF speakers said regulated mutual funds in the US and EU wanted CDDC to migrate to real DVP to mitigate counterparty risk while Chinese authorities were implored to spell out their position on beneficial ownership. Nearly all attendees, however, are confident that both of these areas of concern will be addressed soon, at least before the next TNF Asia Meeting in Singapore in 2018.

The Network Forum Meetings in 2018

Global events will continue into 2018, with The Network Forum Africa Meeting taking place in Cape Town between March 12 and 13, while The Network Forum Annual Meeting will return between June 25 to 27 in Vienna.