The Role of Custodian Banks in the Development of Capital Markets

Citi as a custodian bank is assisting with the evolution of Vietnam’s capital markets

For any market with an evolving financial infrastructure, the successful development of a modern capital market is a difficult task. Despite eliminating much of the risk associated with investments in any particular country, a solid and effective infrastructure makes a capital market less susceptible to external shocks and instantly attractive.

As economic integration intensifies, the financial infrastructure must evolve to enhance its effectiveness as a conduit for flow of capital, which is fundamental for development of an efficient capital market. But the development of a robust financial framework does not appear overnight. It is a laborious process whose payoff is often experienced only decades later.

Thus strong leadership and commitment from local governments and financial intermediaries such as global custodian banks, are required to strengthen the local financial infrastructure. International custodian banks can bring a more efficient process of capital allocation and mitigate risks to markets as the global economic and financial activities continue to increase and integrate.

Aside from bringing in the investor base, liaising on clarifying the tax and regulatory regime for clients, improving liquidity and playing a pivotal part in the trading cycle, custodian banks have been serving many roles in emerging capital market development. Increasingly, custodian banks are spearheading efforts to build the proper financial infrastructure and have been the strongest non-governmental organization globally in driving and advising international models of clearing and settlement.

The role of the custodian bank in emerging market infrastructure does not end there either. In many cases, even with the establishment of a central securities depository (CSD), custodian banks continue to bridge the structural differences between local and global markets, which exist due to different regulatory frameworks, market practices, risks, technology, currency and language, amongst many other variables that may impact capital flow and risk dynamic.

VIETNAM’S DYNAMIC ECONOMY

In 2007, Vietnam has become Asia’s most relevant example of how custodian banks can play an important role in the development of emerging capital markets. For example, Citi, as a custodian bank, has been heavily involved in the capital market development of Vietnam. Citi, has been active in discussions with regulators focusing on providing more flexible account structures for foreign investors and financial intermediaries, recommendations on streamlining foreign investment processes and clarifications on tax regulations in the country.

With GDP growing at an average of 7.8% annually since 2001, significant increases in per capita GDP, inwards foreign direct investment and market-orientated reforms and accelerated global integration resulting from WTO membership, Vietnam is now a market no serious emerging markets investor can ignore. Within this country of close to 84 million, investment is booming, exports are multiplying, and domestic demand is soaring, and advice is required.

Although the existing infrastructure can handle the current volume, it is still developing and evolving, albeit quickly, and requires assistance from international custodian banks to help streamline and attract more cross border investment flow by conforming to global standards. Custodian banks are also required to mitigate many of the risks felt by investors when entering an emerging market. Upgrades are imminent and investors will also require the expertise from custodian banks to guide them through the current processes and future capital market developments.

Considering this environment, Citi is extremely excited at being one of a select group of custodian banks with a presence in Vietnam, and sees plenty of opportunities to assist in its evolution, while continuing to serve investor and financial intermediaries.

POSITIVE SIGNS IN THE STRUCTURE OF VIETNAM’S SECURITIES MARKETS

Presently, the Vietnam capital market remains in an early stage of development, but the speed of this development has been very encouraging for market participants. The launch of Vietnam’s first global sovereign bond in late 2005 and a 10-year Vietnamese Dong (VND)-denominated corporate bond in late 2006 both received strong receptions from international investors.

Additionally, a strengthening of the regulatory environment and plans by the Vietnam government to make the VND fully convertible by 2010 have also contributed to a positive opinion of the current and future prospects of the country’s capital market. The anticipation that
Vietnam is ready to take its next big step towards a more solid and secure capital market is also illustrated by the ongoing development of a CSD for the country, which custodians have been actively advising on.

Aside from the more conspicuous elements of the capital market agenda, Vietnam has also made significant progress in adhering to recommendations by the International Securities Services Association (ISSA) that enables efficient and fair settlement and clearing in a market.

Prior to the CSD launch, financial institutions interfaced with depository members through the two Securities Trading Centers (STCs), located in Hanoi and Ho Chi Minh City. Interfacing with depository members is done manually through facsimile or physical collection of settlement vouchers and other documents, as automation is non-existent. Risks do exist with this process, but are mitigated by custodians. Through good controls, rigorous reconciliation and safekeeping procedure and professional risk management, custodians can ensure efficient and effective settlement of investments whilst minimizing certain administration costs to reduce cost of investing in Vietnam.

Vietnam launched the CSD to further improve efficiently by decoupling the depository function from the STCs and consolidated them into under its roof. The settlements of securities that are listed or registered on the STCs operate in a scripless settlement and clearing in a market. The aforementioned CSD will coordinate the exchange of cash and securities in a multilateral settlement process that nets members’ settlement obligations. In other words, the settlement process moves cash and securities through a series of suspense accounts that belong to the participants and the STC, with obligations reconciled at each step. In the final stage, cash is moved at the BIDV immediately prior to the movement of securities at the STC, which accords with ISSA recommendations.

Aside from identifying and mitigating settlement risks prior to the CSD launch, custodian banks have been proactively working with regulators on international settlement standards, sharing infrastructure models from other markets and advising on standard messaging protocols.

Responding to the upcoming capital markets reforms and the unfolding economic growth story, Citi launched its custody offering in February 2006, making Vietnam the 15th market in Asia Pacific where it provides securities services. In Vietnam, Citi provides clients with direct custody and clearing and securities services solutions locally including settlement, corporate actions and proxy voting, foreign exchange services and securities and cash reporting, and messaging. Citi is committed to actively working with regulators to ensure that the financial infrastructure will complement the vast potential of the country’s capital market.

By leveraging international experience, Citi’s direct custody and clearing and securities services solutions can add value to Vietnam’s future development.

While many elements of the country’s financial infrastructure already exist and comply with the ISSA criterion, impediments to a more efficient capital market still exist. For example, the 100% pre-funded requirement, cumbersome registration process, lack of common standard for settlement of unlisted securities and currency convertibility continue to concern foreign investors. In addition, Vietnam’s government will usher in a slew of changes by 2010, which custodian banks will need to assist on and navigate for customers. Under its new CSD, the introduction of new features including enhanced bond-trading systems, derivative exchanges, clearing houses and enhanced interbank payment systems are likely to emerge.

LEVERAGING EXPERIENCE FOR VIETNAM’S FUTURE DEVELOPMENT

It is here where the real impact of an international custodian bank with a presence in Vietnam will be truly beneficial to the further development of this capital market and position Vietnam for a seamless integration with the global capital market. The aforementioned CSD will require international expertise and custodian banks have been working closely with Vietnamese regulators to assist in many aspects of the process.

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