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Digital application processes,
TRACE and the young competition:

**Why custodians should start digitalizing
the withholding tax process now**



OUTLINE

Trade Republic is Germany's most valuable startup and, after a new round of financing, is worth more than five billion dollars. It's a bang for the buck that should shake up even the last traditionalist in the industry.

Finance is in the midst of a global crisis. More than any other sector, the major financial service providers are fighting for their supremacy in a new world. A world driven by young FinTechs and the wealth of knowledge of a new generation of digital natives. At the same time, digital application processes and the introduction of TRACE in Finland are making custodian banks struggle.

If financial institutions want to survive in this climate of rapid digital competence development, they need to think and walk new paths. And these paths are driven by cutting-edge digital technologies. Externally as well as internally. Because introducing a banking app alone is not enough. It is the internal processes that offer enormous potential for greater efficiency, productivity and value creation in securities management and beyond. Avoiding withholding taxes through relief at source and reclaim is no exception.

In our whitepaper, you will learn why custodians need to harness the mechanisms of the young guns if they want to win the customer hunt in the long term and uncover unimagined opportunities.



Digital application processes,
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The pressure of digital transformation on European custodian banks is increasing. Externally and internally, new technologies need to be adopted and implemented to keep up with the pace of a digitizing industry. This also applies to the process of withholding tax recovery; a prime example of the gap that custodian banks find themselves in when it comes to digitization. While countries such as Switzerland, Austria, Denmark and the Netherlands have long relied on digital processes for the transmission of withholding tax applications, the manual execution of withholding tax applications is still the status quo in many European securities and tax departments. There is a lack of the right technologies, resources and know-how to drive the digitization of the withholding tax process. Consequently, not only the departments, but ultimately the entire organization loses tremendously in efficiency and productivity. With the introduction of TRACE in Finland, the tension of the digital divide will now become even more noticeable.

At the same time, neo and smartphone banks are giving traditional banks a hard time. For most major banking houses, the race to catch up around impending customer losses has long since begun. Because if there's one thing the innovative FinTechs have understood, it's how to satisfy the needs of their target group. For digital user experience as well as for profitable services. It may not be long before online trading platforms embrace the issue of withholding tax. After all, hardly any need is greater than that for profit growth. And the profits that remain abroad thanks to unclaimed withholding taxes are worth billions.

If custodian banks want to remain attractive for their small and large investors and not lose out in the power imbalance, they will have to find new ways in the long term to catch up with the efficiency lead of the digital pioneers. At the same time, it is up to custodians to embrace the opportunities of digital transformation with smart automation of processes. Either way, one thing is certain: there is no way around digitizing the withholding tax process. →



However, the pandemic is reshaping the industry on a number of dimensions: ushering in a new competitive landscape, stifling growth in some traditional product areas, prompting a new wave of innovation, recasting the role of branches, and of course, accelerating digitization in almost every sphere of the B&CM space.

– Deloitte Banking and Capital Markets Outlook 2021

The status quo in the financial sector: Where do banks stand in digitization?

The financial sector has always been a pioneer in digital transformation. Since 2017, digitization efforts in the financial sector have even tripled according to Gartner. But even the banking world has been hit hard by the Corona pandemic. In a Deloitte study published at the end of 2020, four out of five respondents said that the crisis exposed digital deficits in their organization. Gartner also makes it clear that despite their above-average level of digitization, banks should not rest on their laurels and that the midfield in particular must continue to actively drive digitization in order to hold their own against the competition in the long term.¹ So the fact is: In many banks, digital potential lies fallow. As a result, numerous advantages that could arise from the automation of internal processes, for example, are simply not being exploited. In the process, traditional banks are squandering valuable opportunities to set themselves apart from their mostly younger competitors.

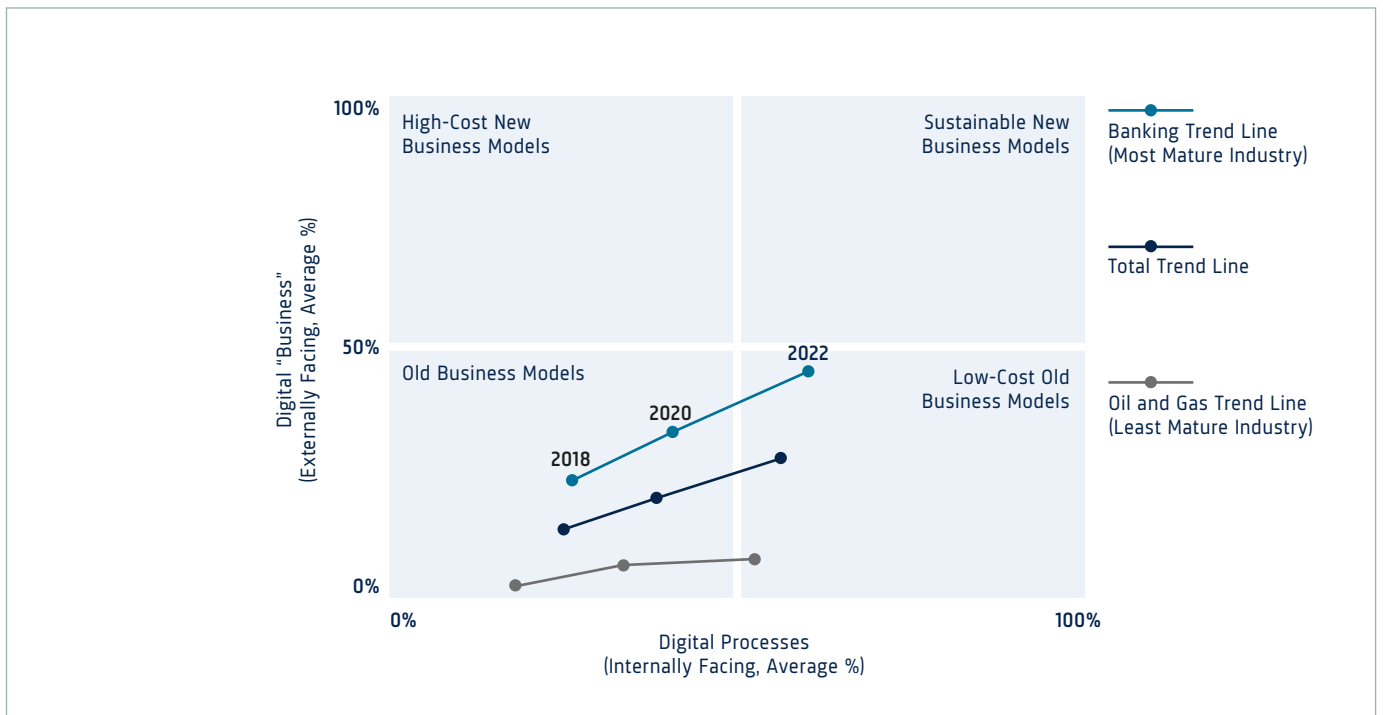
Digitizing the Withholding Tax Process: Seizing Unprecedented Opportunities

The process of reclaim and relief at source from foreign withholding tax is a prime example of the digitalization gap banks find themselves in. Because the fact is: In most departments, the application process is still manual. And because of the complexity of the process, it requires a great deal of resources, with little result. This is because withholding taxes are usually only reclaimed as a service for a selection of highly invested customers. The percentage of investors for whom the effort is worthwhile is thus dwindling. The withholding tax process therefore offers financial service providers enormous potential for optimization. →

¹Gartner 2021 CIO Agenda Banking



This is because modern process management methods have long since made it possible to automate the entire withholding tax process to the greatest possible extent. The decisive factor here is a consistent end-to-end view of the reclaim process and the digital networking of the individual steps. From data collection, analysis and evaluation, to application and write-off, digitization of the withholding tax process allows centralized information control and thus shifts almost every process from manual execution to digital.



Average percentage of revenue from digital sales vs. average percentage of digitized processes

Source: 2021 Gartner CIO Survey

Another advantage is that only profitable applications are generated through profitability calculations and plausibility checks. This ensures the uniqueness of application data 100% and thus completely curbs the error rate of manual processes.

In fact, banks have long recognized the opportunities of process digitization. In recent years, digitization initiatives have focused not only on opening up digital business areas, but also on digitizing internal processes. The reasons Gartner cites here are well known: Falling margins for traditional products and services, low interest rates and new competitors are the main drivers of digitization in the banking sector. And so the analyst firm forecasts: By 2022, more than 50 percent of internal processes will be digitized on average. Among the digital pioneers in the banking industry, the figure is significantly higher. →



For securities management, digitization means above all one thing: flexibility.

While the bureaucratic mill wheels turn slowly on the basis of manual processes, the digitization of individual process steps in the reclaim or relief at source of foreign withholding taxes also makes it possible to react agilely to new requirements. It is not just the different tax rates in the markets that complicate the reclaim process enormously. The requirements of tax authorities for the transmission of data also vary greatly – a development that has gained momentum worldwide in the course of digitization efforts as physical forms will be replaced by new digital processes in the medium term.

European countries with digital application procedures for the handling of foreign withholding taxes



- SWITZERLAND
- AUSTRIA
- DENMARK
- FINLAND
- NETHERLANDS



Take Switzerland, for example: the country recently digitized its reclaim process and, starting with the 2020 income year, requires only the digital transfer of all information and documents for applications from Germany. Austria, Denmark and the Netherlands also require the transfer of withholding tax data via a dedicated web interface, among other things. Added to this is the enormous amount of documents and forms required by the source countries. Depending on how many markets a financial service provider serves in the withholding tax service, the number of changing applications is around 15 per year. Flexibility is a must here. The pressure on financial institutions from all sides to respond promptly is thus constantly growing.

Digital interface: maximum security, minimum integration effort

This is because data transfer between the banking system and the claiming authority only works with the help of a suitable digital interface between the custodian bank and the tax authority. There are two options available to financial institutions. The first is a direct link with all the relevant tax authorities, which usually involves high integration costs. Another option is the use of a suitable digital interface. The advantages: The system forms a uniform interface internally with regard to technology and data format. This means that internal systems only need to be coupled once, drastically reducing integration costs compared to direct coupling with each individual





application center. The interface is usually integrated into the internal system and, in the best case, uses standard formats, making technical integration into any existing system possible. Another plus point is that data security is ensured. According to a Gartner study, cyber security is one of the most important aspects of digitization in the financial sector. Here, too, the digitization of the withholding tax process reveals its strengths: While manual applications seem downright rudimentary from a data protection point of view, digital solutions do justice to the security aspects that are so important for banks. Data and process security is thus not least a decisive driver in the introduction of digital interfaces for the transmission of tax information.

TRACE: Interfaces Bring Flexibility in a Rapidly Changing World

Once a custodian bank has implemented the appropriate interface, it can react promptly and flexibly to all future developments in the source countries and, in addition to direct competitive advantages, also secures a high degree of process efficiency. The latest developments in the TRACE procedure developed by the OECD show that the demand for flexibility on the part of financial service providers in the transmission of withholding tax data continues to grow.

As a pioneer among OECD countries, Finland officially introduced the **TRACE (Treaty Relief and Compliance Enhancement)** procedure on January 1, 2021 and implemented it in its legislation. Financial institutions thus have another option available in addition to the existing Finnish withholding tax refund procedures (the Standard Refund and the Finnish Tax at Source Card) if they wish to exempt their investors from withholding taxes on Finnish dividend payments.



↑ Helsinki, Finland



It is true that participation in the TRACE procedure is not an obligation for OECD countries. Nevertheless, it can be assumed that other countries will follow in the medium term as part of the EU's economic stimulus package adopted in 2020. If financial institutions want to apply for relief at source or quick refund from Finnish withholding tax, they will now have to follow two steps:

- 1 Registration as an authorized intermediary (AI):** custodian banks or depositories wishing to participate in the TRACE procedure must register once in advance with the Finnish tax authority as an AI.
- 2 Transmission of the annual report:** In a tax reporting to the country of the issuer (currently: Finland) the AI is obliged to disclose once a year all (Finnish) dividend income paid to its custody clients or to deliver a so-called Nil-reporting. In order to be allowed to transmit this information to the Finnish tax authority (Vero Skatt) the investor's consent is required.

For custodian banks, this requires more bureaucracy and an even higher level of data quality. This is because the responsible intermediary, usually the custodian bank, is responsible for the accuracy of the information. Automation of the withholding tax process ensures absolute process security, especially with new transmission procedures such as TRACE.

What customers want from banks: service

Do customers still need banks? The triumph of neobanks suggests: Not necessarily. But what they do need is service. And so the battle for the greatest competitive advantages will be decided not only in the field of digitization, but also in the area of services. After all, digital technologies create the best basis for banks to expand their services. Switzerland shows how it works.

Service first: What private banks in Switzerland are doing better

More and more financial service providers have recognized the importance of services. Good conditions may attract customers. But only exceptional service performance can win the long-term loyalty of investors. Swiss private banks have been following this credo for a long time and therefore offer their clients excellent customer service in addition to discretion. →



Taking the chance: The case of VZ Depotbank



FACTS

→ Headquarters in Switzerland

→ Specialized in securities trading

→ Core business: custody & account management for private customers

→ Central focus: comprehensive, customer-oriented service

→ Manages customer assets of about 25 billion euros



STARTING POINT

→ Time-consuming, manual and error-prone processing of withholding tax reclaims for selected customers



GOAL

→ Digital processing of withholding tax reclaims via software



RESULT

- Cost-covering withholding tax service
- Time and cost savings through automated processing
- Withholding tax as a customer service available to all customers



Swiss custodian banks set an example: If you put customer service first, you can survive even in the highly competitive investment business. And there is something else that distinguishes VZ Depotbank's approach: Even when it comes to digitization, the bank is not leaving its young competitors without a fight. Instead, it is setting an example of how excellent service works today: digitally.

The example of VZ Depotbank also shows that better service does not equal higher costs. Quite the opposite, in fact: thanks to low service fees for their customers, digitizing the withholding tax process can certainly pay off for financial service providers. The costs for software, licenses and processing are offset by immense savings in resources. For example, the use of automated withholding tax software results in time savings of up to 80 percent compared to manual handling of the process. However, in most cases only investors with a high investment volume benefit from the reclaim service. Manual handling of the bureaucratic and time-consuming process is simply not worth it for very small amounts. In the end, only a small percentage of investors actually get the withholding tax from investment income refunded. This means that custodian banks are addressing a small target group when it comes to withholding tax services – and are thus losing enormous potential in terms of the remaining investor mass. →



When will custodian banks seize the opportunities?

Falling interest income and disruptive competitors call for new approaches in the custodian bank business. In the case of custodian banks and the investment business, this means that digitization is the key to success and an enormous opportunity to benefit from more efficient processes and satisfied customers in the long term.

Online trading platforms and neobanks have long since recognized the ravages of time and are highly attractive, especially for a young customer segment eager to change – in other words, the major investors of the future. And thanks to far-reaching digital structures, they can respond flexibly to new requirements. A flexibility that custodian banks mostly lack. Also in the withholding tax reclaim process. With the digital application processes in Switzerland, Austria, Denmark and the Netherlands, the recent introduction of TRACE in Finland is also putting pressure on custodians to finally prioritize the withholding tax process in their digitization efforts. After all, the opportunities presented by digitizing withholding tax processing benefit both the tax departments and the entire organization. Not only can custodians respond more flexibly to withholding country requirements, but they also exponentially increase the efficiency of the application process compared to manual processing. Last but not least, withholding tax reclaim is a service that custodian banks can also take advantage of as such. Swiss banks such as VZ Depotbank are successfully demonstrating.

Only one question remains: how quickly will European competitors follow suit?

Sources:

→ [Gartner 2021 CIO Agenda Banking](#)

→ [2021 Banking and Capital Markets Outlook](#)