Looking ahead as China opens its capital account
HKSI Institute SFC Executive Director Series

Alexa Lam
Deputy Chief Executive Officer

10 February 2015

As many of you may know, I will be retiring from the Securities and Futures Commission (SFC) at the end of this month.

I joined the SFC 16 years ago and if someone had asked me then whether I could have imagined staying this long, I would have been quite circumspect. If I was also asked then where I thought Hong Kong would be in 15 years' time, I probably would have woefully underestimated the important role that Hong Kong currently plays in the global financial arena today.

As I approach the end of my tenure at the SFC, I thought it would be interesting to draw on my experiences and learnings over the past 15 years to paint in broad strokes a picture of how I view Hong Kong in the next 15 years, in 2030. This could be a thought-provoking exercise, as how Hong Kong shapes up in 2030 is very much grounded on the direction Hong Kong takes today. This will be the main thrust of my speech this morning. Before I end, I will also say a few words about issues that are closer to home, including our latest regulatory thinking in the public fund management space.

The Mainland economy and reforms

First, let's do a stock take of where Hong Kong is right now and try to be very clear about the broader context in which we operate.

Hong Kong has successfully positioned itself as the testing ground for the Mainland's financial reforms, and the bridge that connects the Mainland with the rest of the world. I believe the stronger this bond is, the better it will be for Hong Kong for the near to medium term. Given its importance, I will focus this first part of my speech on where I think the Mainland's domestic economic and financial reforms are headed, as well as its outward looking economic relationship.

Let's start on the domestic front. When I joined the SFC in 1998, the Mainland had already experienced a decade of heady growth. Yet it was not quite the economic powerhouse that it is today. In 2000, China's GDP was USD1.2 trillion, ranking 6th in the world, in roughly the same league of economies such as France (USD1.3 trillion) and Italy (USD1.1 trillion). By 2010, in slightly over a decade, China had climbed to second place. The Chinese economy grew from being just 10% of the U.S. economy to 40% over the same period. Many predict that the Mainland economy will surpass that of the U.S. within the next couple of decades. As the Mainland economy continues to expand, one notable development which we expect by 2030 is that the Mainland would have amassed the world's largest pool of savings.

Yet rising incomes and larger bank balances by themselves will not necessarily make the average Mainlander feel richer in 2030. One reason for this is demographics. Right now, about three-quarters of the Chinese population are aged between 15 and 64, whereas less than 10% are above 65. By 2030, that demographic advantage would have disappeared. The U.N. estimates that in 2030 the number of Mainlanders aged above 65 would almost double, to 16% of the total population, reaching about 25% by 2050. Such a high dependency ratio would translate into a very heavy financial burden on the country's healthcare and welfare framework.

It is clear that the trajectory of the Mainland's development is changing. The headline GDP growth figure has come down, from the stratospheric 9% to a more reasonable but still respectable 7% in 2014, and that figure will likely consolidate further. Simple mathematics would tell us that between now and 2030, an economy that is growing at 7% would be a quarter smaller than that with an average growth rate of 9%. The pie may expand more slowly, and the challenge is to maintain consistency and sustainability.

The Mainland financial sector clearly needs to do a better job at directing hard-earned savings to more productive uses. The Mainland's leadership recognises this, they have set a rapid pace in terms of financial reforms over the past couple of years. We have witnessed an extraordinary range of initiatives being rolled out including the gradual internationalization of the RMB, the expansion in access to the Mainland markets, relaxation of the Mainland's interest rate control, the streamlining of its IPO regime to ease the allocation of capital to deserving enterprises, the establishment of multiple experimental zones for financial reforms, the emergence of new investment products and distribution channels, etc. Between now and 2030, such reform efforts will likely accelerate.

The Mainland and the rest of the world

The second important factor that affects Hong Kong is the way the Mainland interacts with the rest of the world.

In this respect, many of us working in finance have been focusing on two broad Mainland strategies. First, promotion of the international use of RMB. Second, relaxation of capital controls. By and large, these strategies have been successful. Just last month, SWIFT reported that RMB is now the world's fifth most used payment currency.

Unlike in Hong Kong, where finance is considered a pillar of the economy in its own right, Mainland leaders have always stressed that finance must serve the real economy. As the Mainland rolls out policies to structurally reform its capital market and open its capital account, it is also considering, in parallel, broad strategies for sustainable, longer term economic development, particularly in the context of carving out a meaningful role for itself in Asia. What do I mean when I say having a "meaningful role"?

One of the Mainland's most important strategic initiatives is the so called "*One Belt One Road*". For those of you who are less familiar with the concept, it refers to the Mainland government's plan to, on one hand, reactivate economic and trade links with the central Asian countries along the ancient Silk Road, and on the other hand, extend economic links through maritime routes with countries in south and southeast Asia, potentially reaching as far as Africa and even Europe. I know many of us remain unconvinced about such ambitious schemes. But let us put aside for a moment the grand rhetoric and focus on the thinking behind it.

What this initiative embodies is a vast, sweeping vision - an economic bloc within which goods and services flow freely across borders. The objective is to enable firms to strategically configure their distribution chains and enjoy ready access to raw materials and markets at lower costs and without burdensome bureaucracy. Capital will flow to the most deserving institutions and provide sustainable growth for the entire region. Consumers will also benefit from being able to pick and choose from a wide range of offerings by a host of suppliers. And investors will have access to a huge range of suitable investment opportunities from all corners of the bloc.

Does all this sound too good to be true? If we look at what the Mainland has achieved in a short space of 30 years, and we have all heard the saying that time and tide wait for no man (or country for that matter), then maybe it doesn't seem so farfetched after all.

On the whole, I am quietly confident and even a little excited that this vision will come to fruition. My reasoning for this is partly because the allure of the Mainland market is so strong. Partly it is because of the strong political support coming from the very top. President Xi Jinping and Premier Li Keqiang have repeatedly championed this idea in public and the Mainland government is putting money where its mouth is. For instance, in November last year, it announced the setting up of the Silk Road Fund to improve infrastructure links across the region.

Last but not least, technology will play a key role. The wide universe of information and opportunities that are accessible by all investors and markets in the economic bloc through the internet should help transition this concept into reality. Closer economic ties should enhance diplomatic and cultural exchanges, bind countries closer together, and promote regional peace and prosperity.

My prediction is that by 2030, some form of regional economic bloc would have come into existence, with bustling trade and economic activities crossing borders. One can easily see how the current ongoing initiatives of RMB internationalisation and capital account opening fit into this picture. The Central Government probably aspires to have RMB become the reserve currency through which governments, firms and individuals within this block transact and invest, and the Mainland capital market will become the central hub of the regional capital market. The new economic bloc will also supply ample investment opportunities for the Mainland's massive reserves.

The implications for Hong Kong

So far, Hong Kong has been given a front-row seat in the Mainland's domestic financial reform and external relationship-building efforts. We have very capably performed the twin roles of a super connector linking the Mainland with the global markets, and a laboratory for capital market reform experiments. But the paradigm is shifting.

First, the Mainland's border is becoming increasingly porous by design. Previously, international investors who wanted to take part in the Mainland growth story had few options other than going through Hong Kong. But as the Mainland continues its reforms and relaxes its capital control, the number of entry points into the Mainland will continue to increase. They are not just physical crossings such as the free trade zone in Shanghai which, we have been told, will be replicated in other parts of the country. They also include institutional arrangements that allow capital to flow in and out of the Mainland, such as RQFII and Stock Connect. Qualitatively too, there are changes in the Mainland's approach towards the opening of its financial market. For instance, we are seeing an overall loosening of

bureaucratic control, witness the adoption of “negative lists” in the Shanghai Free Trade Zone, and the Stock Connect’s use of market-wide quotas rather than the traditional firm-by-firm quotas. As the Mainland continues to open up, Hong Kong will face stiff competition from within the Mainland and the rest of the world.

When we talk about competition from Mainland financial centres such as Shanghai and Beijing, we tend to focus on their growing sophistication and kind of mutter under our breath about the fact that previously exclusive privileges for Hong Kong are now available also to Mainland cities, thus narrowing Hong Kong’s lead. We mustn’t forget that when it comes to testing reform initiatives, there is another consideration. From the Central Government’s perspective, once a policy initiative has been tested and proven, it would usually be rolled out nationwide, to maximise its impact and benefits. Unfortunately, the factors that make Hong Kong such a successful testing ground also limits the Mainland’s ability to immediately replicate a policy that originates from Hong Kong across the country, simply because we have a different system. A good reminder of this limitation is that one of the criteria for designing the legal, institutional and policy arrangements of the Shanghai Free Trade Zone is that they must be readily and immediately replicable across the country. This could be challenging for Hong Kong, being a different system.

Our advantage over overseas financial centres is also being chipped away. The inherent strength of our financial market and the tenacity and creativity of our people have always been important factors behind Hong Kong’s success. At the same time, there is no denying that favourable Central Government policies have played an important role.

The reason for the Central Government favouring Hong Kong over other overseas markets is obvious. After all, we are part of China. But as I mentioned earlier, the Mainland is becoming more outward looking. Finance and economics are becoming important and influential tools of Mainland diplomacy. Even RQFII, an initiative for which we had canvassed hard for two years, was offered to London and Singapore shortly after its launch in Hong Kong. I hope the trend is becoming clear to you.

Taking stock of Hong Kong’s strengths

Despite these challenges, I am nevertheless cautiously optimistic that in the years to come, Hong Kong will further consolidate its position as one of the world’s leading financial centres. To get there, however, we cannot simply continue to rely on the tried and tested models of being China’s super connector and reform testing ground. We need to blaze new trails. The time has come for us to change the way we look at Hong Kong and perhaps reinvent how we engage and integrate with China as a whole. Hong Kong’s role as the main thoroughfare between the Mainland and the rest of the world is fast becoming obsolete as the Mainland demolishes the old barriers that used to separate it from the rest of the world. At the same time, the Mainland is diligently extending its external reach and economic clout.

Rather than bemoaning the loss of privileges and benefits, I see these developments as a potential source of new opportunities for Hong Kong. So far, we work with the Mainland on a transaction basis. We are just an adviser, at best a project manager. We work outside the Mainland theatre. In the new paradigm that I have just outlined, we must work inside the Mainland theatre, and seek to play an integral role in the overall design and execution of the China story as it continues to unfold.

I believe the “One Belt One Road” project will give Hong Kong a brand new platform and an exciting opportunity to evolve into an integral player in the next phase of the China story. One

of the major practical challenges that the Mainland faces in connecting with markets in the One Belt One Road bloc is that there is great disparity and little commonality among these markets. In terms of language, legal system, regulation, education, professional qualifications, culture, etc, the Mainland is quite different and distinct from many economies in the region.

This scenario is almost tailor-made for Hong Kong strengths. Hong Kong speaks the language of both the developed and the emerging markets, literally and metaphorically. Our systems are universally accepted and respected and that is our greatest advantage. People from all over the world feel at ease doing business here. We are very successful at being a major financial hub. That's because our laisse faire system, freedom of capital control movement, low tax and the stability of our exchange rate regime is universally appealing and indispensable to all credible investors and global business.

What I'm trying to say is that we have the skills, expertise and market savvy to help the formation of the regional economic bloc and provide the vital glue to mould the different markets in the region together into a coherent single platform. The countries in this new bloc don't and shouldn't have to lose their national identities to achieve this. Our differing levels of development and national priorities preclude the use of the single rulebook approach of the European Union. Rather, we can transcend differences by facilitating, connecting, communicating, and most importantly, translating our common objectives into a coherent, transparent and mutually beneficial framework. The "One Belt One Road" project will not be built in a day but we should stay focused on the longer term objective. The sooner Hong Kong can start helping regional economies to eventually converge into a single platform, the faster the entire region can start reaping the benefits of increased connectivity.

Let me give you a concrete example of how Hong Kong could go about this. The market practices and the legal and regulatory systems of the Mainland and Hong Kong are clearly very different. Yet over the years, we have honed the art of establishing close cross-border cooperative arrangements without requiring either side to make disruptive changes to existing local rules or market norms and practices. No other market has the experience we have in dealing with the Mainland. The Shanghai-HK Stock Connect is testimony to the success of our efforts. The much anticipated mutual recognition of funds will be another. Once it goes live, the mutual recognition platform will give us a framework to bring in other jurisdictions in the region to create a common market for funds in Asia.

Asset management is just one aspect of finance. We should aim to become a similar focal point for firms and investors in the region to raise, manage and allocate capital. And we can offer trade financing, legal advisory and risk management services to support all manner of economic activities within the bloc. In short, we can become the financial hub for a new economic bloc, providing leadership in market infrastructure, system building and robust regulation.

Our latest regulatory thinking

I mentioned at the start that I would share with you our latest regulatory thinking in the public fund management space. This is what I will do now, before I conclude.

The first issue is about overseas fund managers wanting to publicly offer their overseas funds in RMB to investors in Hong Kong. Many overseas fund managers have approached us about this. Frankly, we have been reluctant to allow this for a number of good reasons. RMB funds are still a nascent product class and the currency is not fully convertible. Capital

going in and out of the Mainland is still subject to control. To ensure robust investor protection, we felt the need for stronger regulatory oversight. For these reasons, we have been urging overseas managers who would like to offer funds in RMB to Hong Kong investors to domicile and operate their funds in Hong Kong.

We are mindful that the RMB market has undergone a transformation over the past few years. The pool of RMB liquidity in Hong Kong, the selection of RMB investment and risk management tools have increased dramatically. Most significantly, the daily conversion limit of RMB 20,000 was lifted last year. We feel that the time is now ripe to start allowing overseas managers to offer their overseas funds in RMB in Hong Kong. For investor protection, we will require such offerings to satisfy two conditions. First, while these funds could continue to be managed overseas, their offering in RMB should be made in Hong Kong through a Hong Kong-domiciled fund structure with a Hong Kong manager. This is to provide the SFC with an appropriate regulatory handle. Second, to facilitate the development of Hong Kong's asset management and RMB expertise, the fund cannot simply use Hong Kong as a mail box. It must have substantive operations in Hong Kong, which could include activities such as actual portfolio management, foreign exchange management, currency hedging, etc. These substantive operations are important – they are the building blocks for the development of Hong Kong as an asset management hub. We have already started talking with different managers who are interested in this new program. For those of you that are interested in offering such products, you are welcome to come discuss with us.

The second issue that I would like to cover is about our authorisation process. Around the world, regulators have been seeking to reduce the time that they spend processing authorisation applications, to shorten the time to market and expand investor choices. The SFC has also been working on this as well. Last year, we put in place a six-month lapse period for new fund applications. Since then, the average processing time for new fund applications was reduced by about 38%, while the number of funds that we authorised in 2014 increased by more than a third.

The SFC is working diligently to keep up the improvement. At the same time, we also need input and support from your end. You must ensure that your submissions are of good quality, and that you respond to our requests and enquiries in a prompt and responsible manner. Our data shows that 15% of the applications that we received in 2014 were not taken up due to non-compliance issues. For those applications that were taken up, the processing time attributable to applicants consistently exceeds 60% of the total processing time. There is still significant room for improvement in the quality and timeliness of submissions. We would like you to work with us to make the process more efficient. Together, I believe we can bring more products to market, in a more timely manner and without compromising investor protection. To deter substandard or non-compliant submissions, some jurisdictions have built punitive measures in their authorisation application processes, such as imposing a moratorium on processing submissions from an applicant, or relegating its applications to the back of the queue. I hope that with a strong commitment on your part, we would not need to consider these avenues. At the same time, we are also reviewing how we could further improve our process. My staff will be in touch with some of you in due course to seek your input.

Conclusion

I have covered quite a bit of ground today. I would now like to conclude. When I joined the SFC in the wake of the Asian financial crisis, a cloud of gloom, uncertainty and trepidation

overshadowed the industry. Sixteen years on, and after a global financial crisis on a much larger scale (which was none of our doing I might add), Hong Kong is by any measure in a much stronger and better position.

Looking ahead, let us aim to be the place of choice for buyers, sellers, service providers and investors in the region and around the world. Let us be known for excellence in all that we do. To stay ahead of the curve, we must constantly strive to lift our game and be prepared to face challenges head on with courage and an enterprising spirit. Our framework must remain attractive and our people well-trained and adaptable. No one has a crystal ball big enough that can tell you with absolute certainty what will happen a decade or two down the road. But I sincerely hope, and envision, a prosperous future for Hong Kong and our financial industry, as the centre of a new and thriving economic bloc, and as the place where the world chooses to come together.