

The Great Era of Financial Transformation Financial Times Investment Management Summit

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18 June 2015

Introduction

I would like to first thank the organisers for inviting me here today. It is an honour to have the chance to speak to so many of the leading lights in our industry.

Since Easter, the local financial gossip columns have been talking almost nonstop about Great Era¹. For those of you less familiar with the Hong Kong television drama scene back in the early 90s, Great Era was a hugely popular series about the rise, and eventual demise, of a man who dabbled in Hang Seng Index futures. The series first aired in 1992 and was rerun in 2003 and 2007, gaining notoriety because each time it was shown it coincided with great turmoil in our local stock market.

As much I would like to, I won't be talking about local television drama today. But I do want to borrow the term Great Era. Not because our stock market turnover has doubled or the Hang Seng Index has risen a lot since Easter. Rather, because we are witnessing an epochal time – a time when the financial transformation of our giant neighbour is turbo-charging changes in Hong Kong's financial landscape.

I would like to take the opportunity today to share some thoughts on how this transformation affects us, and how we can best prepare for the challenges and opportunities that it brings.

Integration of Mainland capital markets into the global economy

Let me start by briefly taking you through some of the most relevant recent events, and how they fit into the big picture.

The Mainland's rise into the economic powerhouse it is today has been driven by a long series of opening and liberalisation reform that began in 1979. I believe most of you would agree that Stock Connect and the Mutual Recognition of Funds scheme, which were launched within months of each other, have been the two most significant financial market opening and liberalisation measures in recent years. These two initiatives ushered in a Great Era of Financial Transformation. They will bring Mainland and Hong Kong markets closer together, and speed up the Mainland's integration into the global capital market.

You probably know that these two initiatives have a long history. As early as 2007, there was the "Through Train" proposal, which would have allowed Mainland investors to access the Hong Kong stock market. And Mutual Recognition of Funds is a concept that the SFC has been championing since 2012.

¹ 大時代



The question is, why now?

One school of thought claims that this is all about the Mainland stock market. As we all know, up until the announcement of Stock Connect the Mainland market had lagged other major markets for several years. But since the beginning of this year, the CSI 300 has risen by about 40%. So clearly the Central Government used Stock Connect to attract more foreign capital to boost the stock market. Then what about Mutual Recognition of Funds, which was announced just as the rapid rise in stock market valuations started to raise eyebrows. Well, the claim goes, what else could it be except a way to give the Mainland market an outlet to let off some steam?

The problem with these arguments is that they miss the bigger picture. The reform and opening up of the Mainland financial market has been going on for more than a quarter of a century. The 2008 financial crisis slowed progress, but only briefly. In the most recent year, reform and opening up has resumed, the pace has accelerated and the clear aim is capital account convertibility.

As I mentioned already, two recent groundbreaking initiatives helped speed up the pace. The first was Shanghai-Hong Kong Stock Connect, launched last November, which allows individuals from the Mainland and Hong Kong to place orders on their home stock exchange to deal in the other stock exchange. Six months on, about half of the RMB300 billion Northbound quota and about 40% of the RMB250 billion Southbound quota have been utilised. In the future, the programme is expected to be broadened to stocks listed on the Shenzhen Stock Exchange and exchange traded funds (ETFs).

The second groundbreaking initiative was announced on 22 May 2015. The Mainland-Hong Kong Mutual Recognition of Funds scheme throws open the Mainland public fund market to offshore funds for the first time. Starting 1 July, the SFC and the China Securities Regulatory Commission (CSRC) will accept applications from plain vanilla funds that are domiciled and managed in one market and are seeking approval to enter the other market under a streamlined process. To be eligible, funds need to have a track record of at least one year and a minimum size of RMB200 million or its equivalent. The scheme's initial investment quota will be RMB300 billion on a net basis each way. Not only is the overall quota sufficiently large to meet investment needs in the initial period, it will also be liberally administered. That is, the State Administration of Foreign Exchange will not be applying a quota limit at the individual fund product level or the institutional level.

What do these two reform initiatives have in common? In a mutual, balanced and orderly manner, they allow individual investors to access each other's capital market. Through buying into recognised Hong Kong funds, Mainland investors invest not only in Hong Kong's fixed income and equity markets, but also the rest of the world's. This is a step closer toward capital account convertibility and a major milestone in the integration of Mainland's capital market with global markets. Leveraging this, the Mainland is driving ahead with domestic reforms which aim to achieve a degree of openness and to deepen its domestic capital market.

Transformation of Hong Kong's financial landscape

So far, the Mainland has been able to integrate its markets in an orderly manner in large part because Hong Kong serves as the superconductor of international capital flows. Under Stock Connect, non-Hong Kong foreign institutional investors make up an estimated 40% of northbound flows, with Hong Kong institutional accounting for another 20%. The flow from



overseas will continue to grow as the underlying investible assets expand and investors become more confident about them. Meanwhile, Hong Kong will transform itself into a truly global, full-service asset management centre, complete with a broad spectrum of value-added services.

With roughly 70% of the managed fund business here sourced from outside Hong Kong, we are already the largest sales and distribution centre in Asia. In recent years, an increasing portion of the total assets is managed in Hong Kong, a trend that is reinforced by the new investment channels to Mainland markets. Renminbi assets made available through these channels can be packaged in Hong Kong into public, private and wealth management products for sale in Asia, Europe and elsewhere. Take renminbi investment products. With RMB270 billion in fully utilised quotas, Hong Kong is the first and by far the largest manufacturing centre for Renminbi Qualified Foreign Institutional Investor (RQFII) products.

Already, direct access to Mainland stocks via Stock Connect has changed the investment management landscape in Hong Kong. Existing RQFII funds including ETFs could now utilise Stock Connect as a cheaper conduit to gain direct access to A shares. New and innovative products could be structured with underlying renminbi assets. In fact the number of products is on the rise. As of May 2015, the SFC authorized a total of 91 RQFII/Renminbi Stock Connect funds and ETFs. This is about two-thirds more than a year earlier, and meanwhile these funds' aggregate assets under management have increased about 30% to RMB69 billion. Not only that, but RQFII/ Renminbi Stock Connect ETFs typically account for about 30% of the average daily turnover for all ETFs, despite the fact that such ETFs account for only about 15% of the total by market capitalisation.

At the same time, the newly unveiled Mutual Recognition of Funds scheme will encourage both global and local fund houses to establish and domicile in Hong Kong. Plain vanilla offshore funds which are already managed in Hong Kong and have been authorized for more than a year can redomicile in Hong Kong and be immediately eligible for the mutual recognition scheme. Global fund houses which have not brought their fund platform to Hong Kong can weigh the cost of doing so against the opportunity of marketing funds on the Mainland under their own proprietary label.

You may ask this question – is this an exclusive arrangement, and for how long? Will similar arrangement be struck with other markets, in the same way RQFII quotas are allocated to other markets? These are the wrong questions to ask. In front of you is a pathway through Hong Kong to sell funds to the Mainland. The question is, should you walk through this door, or should you wait for another door to open somewhere else?

An asset management strategy for the future

As you ponder this question — and I do hope you have come up with the answer already — you should keep in mind something that CSRC Chairman Mr Xiao Gang said in his speech at the Asian Financial Forum in Hong Kong earlier this year. Chairman Xiao articulated a vision of a more integrated Asian financial market where Asian savings can be more effectively channeled to fund Asian investments.

When the SFC and CSRC agreed that Mutual Recognition of Funds “will lay the foundation for the two regulators to jointly develop a fund regulatory standard”, we moved one more step down this road. Given the size and development potential of the Mainland market, the Mainland-Hong Kong mutually recognised market for funds will be the largest in Asia.



Our goal now is to work together with the Mainland to implement the scheme in a manner which will serve as a foundation for promoting the development and integration of the Asian asset management industry. In short, the door does not just lead you to the Mainland.

An appropriate eco-system

Having spent some time talking about the big picture, let's get down to business. I would like to fill you in on what the SFC has been and will be doing, so that you know what to expect and how to tailor your strategy accordingly. We are of course conscious that overseas sales opportunities are not the only factor when you decide where to locate your business. This is why our priority is to develop an eco-system in Hong Kong that is conducive to your business development.

In this spirit, we are taking a critical look at our authorization process. Product authorization is the bread-and-butter of my division. In my three months in this job, the most frequent comment I have heard is that we have to improve "time to market" to allow funds to meet changing customer demands.

Our efforts to streamline the process started in January 2014 when we reduced the time period for the lapse of applications from twelve months to six months. This had cut down authorization time by 40% to less than four and a half months on average. To improve further, we are proposing to the industry a "two-stream review process" whereby standard applications will be fast tracked. This will cover roughly half of all applications and we aim to complete them in less than a month and at most two months.

Additional measures will also be introduced to enhance the processing of non-standard applications. Clearly, getting a product authorized is a collaborative exercise. For instance, we will require applicants to provide proper, substantive and timely responses to our requisitions. We have formed a working group with the industry to work out the process with a view to roll it out in Q4 2015. Please stay tuned.

Another important part of our eco-system is the local distribution channel. The internet is revolutionising the way goods are bought and sold, particularly with the younger generation. Investment funds are no exception. Fund distribution in Hong Kong is highly concentrated in the bank channel and this limits investor choice and raises "trailer fees" and distribution costs. These are all negatives in terms of consumer outcomes. Together with the industry, we are exploring options for broadening fund distribution platforms, including online platforms investors can access directly.

We are also looking to improve our eco-system by introducing the open-ended fund company structure as an alternative legal form for public and private funds domiciled in Hong Kong. This is a long-running project. And it involves not just regulation but a whole host of legal and tax issues. The Financial Services and the Treasury Bureau is leading the discussion in this respect.

Enhancing investor protection and regulation of asset managers

I have spent a good part of my speech today talking about market development. But let us not forget the importance of a robust regulatory regime. It is fundamental to the development and growth of an international asset management centre.

The importance that we put on robust regulation is demonstrated in three key ways.



First, we make regulation a pre-condition for our market development initiatives. For example, before the launch of two of our most recent initiatives – Stock Connect and Mutual Recognition of Funds – we reached agreement with the CSRC on robust regulatory and supervisory cooperation arrangements. Protecting our investors and market integrity are non-negotiable.

Second, we constantly review our local regulations and markets to make sure that they serve the best interests of our investors. A good example is the guidance on product design we introduced in April 2014, which helped substantially improve Investment-Linked Assurance Scheme or ILAS products. All existing SFC-authorized ILAS were required to revamp their structures and disclosures to bring about better consumer outcomes and fairer product designs. Following the revamp, we have seen reductions in fee levels and the removal of overly complex product features.

Third, we benchmark ourselves against international best practices. The global financial crisis led to much soul-searching among regulators. A period of reforms ensued, with profound implications on the asset management industry, particularly around issues such as systemic risks, shadow banking, liquidity and risk management, enhanced custody requirements, securities lending and repos and product design. The SFC is looking at all of these, not to mention potential conflicts of interest when an intermediary receives commissions and other areas.

Conclusion

Remember the television series I mentioned earlier? Well guess what, it was rerun again this year. In fact, the final episode aired last Friday night. I am not superstitious, so I am not worried. In fact, I am pleased that the series came around again to remind us that this really is a Great Era.

We are truly at an historic juncture. Stock Connect and Mutual Recognition of Funds have set the stage for Hong Kong to develop as the preferred domicile and investment management centre for funds in Asia. I urge you all to grasp the significant opportunities this presents.

In conclusion, I will only say that there is no escaping the fact that markets have their ups and downs. We are fortunate that Hong Kong's markets are mature and highly sophisticated. As regulators we must remain vigilant to ensure fairness, effective enforcement and the highest standards of investor protection. We also need your support to ensure that our markets are of the highest quality, as that cannot happen without your active involvement.

Thank you.

Note: This is the text of the speech as drafted, which may differ from the delivered version.