A New Frontier for RMB Investment Products and Asset Management Business

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Introduction

Good afternoon, ladies and gentlemen.

I would like to first thank the Hong Kong Securities and Investment Institute (HKSI) for inviting me here today. I would particularly like to commend the HKSI's effort in facilitating dialogues between regulators and market participants. This is crucial to market development and effective regulation.

Over the past few years, when regulators speak to the industry, the subject matter has tended to revolve around regulation, risk management and what the industry needs to do more. They are no doubt important. More than four years into the financial crisis, I suspect that you would like some lightening up, i.e., a "tell me what I can look forward to" story, rather than a "where I went wrong" lecture.

With that in mind, I would like to talk about something other than regulation today. As you all know, Hong Kong has been positioning itself as an international asset management centre and the preeminent offshore RMB centre. Last week, you were all excited about the expansion of our RQFII. The RQFII is a brilliant creation; we all take pride in that. It puts us ahead of our competitors. But what we need to do next is to seek, and break, new frontiers. Today I would like to talk about my vision for the next breakthrough in our asset management and offshore RMB business.

The current state of Hong Kong's asset management industry

First, let us take a look at where we are in our asset management industry.

Industry estimates have it that gross retail fund sales for 2012 could reach a record high of US$55 billion. This will surpass the pre-crisis record in 2007. 2012 was not an easy year, yet Hong Kong's asset management industry succeeded to maintain a strong showing. This is a testament to the agility of our industry; in particular their ability to innovate and understand investor needs.

RQFII and asset management

Among the many milestones in Hong Kong's asset management industry, one stands out in particular. It is the RQFII funds. It is my belief that the success we enjoy in this endeavour lays the groundwork for our next breakthrough. To explain what I have in mind, I must first share with you the story behind how we got the RQFII, as this gives us good pointers.

History of RQFII

RQFII funds started coming to the market at the end of December 2011. But in fact, preparation began as far back as in 2009.

The RQFII was conceived partly by design and partly as a reaction to circumstances. We first came up with the RQFII idea, or rather, the precursor to that idea in 2009, in the middle of the financial crisis. Lehman Brothers had just collapsed. The survival of many major financial institutions was in serious doubt.

At the time, some of the biggest and most actively traded ETFs in Hong Kong were synthetic ETFs linked to the Mainland markets through derivatives. These derivatives are known as China A-Share Access Products (CAAPs). They are issued by QFII quota holders, typically the major international investment banks. Although these synthetic ETFs were popular, the use of CAAPs exposed ETF investors to the credit risk of the CAAP issuers. When the financial crisis hit, counterparty risk was very much in the consciousness of many regulators. Needless to say, we were one of them.

And so were our Mainland counterparts. They were aware of our synthetic A-share ETFs. These are Hong Kong products, but they are linked to the Chinese A shares. Naturally, the Mainland regulator wanted to know how we looked at the situation. It was early 2009 when I had this conversation with them. After explaining the measures that we were putting in place to deal with the risks, I asked, for the first time, for SFC licensed asset managers to be given a QFII, so that we could have real physical A-share ETFs. These would not expose our investors to counterparty risks, I argued. At the time, my rationale was simple. Our A-share ETFs were hugely popular. Yet our asset managers did not have QFIIs. That put them and our investors at a disadvantage. We should ask for a QFII for Hong Kong. It was as simple as that.

Later that year, the Mainland Government announced a pilot program for RMB cross-border trade settlement in five cities. It became obvious to us that the Central Government was taking its first major step in the liberalization of the RMB, i.e., allowing a wider usage of the currency outside the Mainland. It was also clear to us that for the RMB to gain wider acceptance, there must be RMB assets and investments available to those holding the currency outside the Mainland. Trade settlement alone would not be sufficient; outsiders would not wish to hold the currency unless it could be invested for a return. At the time Hong Kong already had a very limited range of RMB financial products – RMB deposits by individuals, and a small pool of RMB dim sum bonds. We were well positioned to become the offshore RMB centre. What we needed to do was to quickly build a RMB investment product pool in Hong Kong. With that cognition, it became only too obvious that we should ask the Mainland authorities for a special RMB QFII for Hong Kong. Later that year, we revised our request and asked for a RMB QFII, instead of a HKD QFII.

In early summer 2010, we started discussion with Mainland authorities on how the RMB QFII could be structured, and what the rules should look like. We were all excited about this initiative. We called this, fondly, the “Mini QFII” (“小 QFII”). I am sure many of you remember this name.

The RMB QFII touched on a large number of complex issues, including foreign access to the Mainland capital markets, cross-border RMB flow and the use of RMB outside the Mainland. It involved multiple Mainland authorities. It took the Mainland authorities a good year's time to settle the policy. Their final decision was to start the program on a small scale. Only Hong Kong licensed asset management subsidiaries of Mainland brokers and fund managers would be given a quota, initially.

In August 2011, during his visit to Hong Kong, Vice Premier Li Keqiang publicly announced his support of the RQFII scheme (giving official blessing and a formal name to our "Mini QFII"). Then finally, in mid December 2011, the three responsible Mainland authorities, the CSRC, PBoC and SAFE jointly released the RQFII rules.

By February 2012, we authorized a total of 19 unlisted RQFII public funds. You will recall that there were some queries in the market why it took us so little time to authorize 19 RQFII funds. As we had explained at the time, we had been vetting many of these applications for compliance with our requirements well before the final rules were published by the Mainland. But the point to make here is, not willing to waste a moment, the managers who qualified for the RQFII quota worked zealously to meet all our public fund requirements immediately after Vice Premier Li's visit. As Hong Kong continues to compete for RMB business, this is the attitude we must all adopt.

When the RQFII funds were first launched, there were some unfavourable comments – that these funds did not sell well, because they were all the same (they had to conform to rather structured investment and strategy restrictions), many of the managers were unknown to the Hong Kong market, and Hong Kong investors were not familiar with the Mainland interbank bond market (in which these funds invested). These comments might have been a little too harsh. On average, the funds were about 50% subscribed during initial launch. For a matured market like Hong Kong that offers a broad depth of products, this is not a bad result. In my mind these funds carried the very special mission of bringing about a new breakthrough for our RMB investment product market. For the first time in our history, SFC-authorized funds could invest directly in the Mainland equity and interbank bond market in RMB. In that, these funds were successful. They demonstrated to the Mainland that as an arrangement that links the offshore RMB market and the Mainland capital market using the Hong Kong asset management platform, the RQFII works.

Further opening of the RQFII quota came very quickly two months later, when Mainland authorities announced in April 2012 an expansion of the RQFII quota by RMB50 billion for A-share ETFs to be authorized by us and listed in Hong Kong. Four RQFII ETFs have since been launched. At the end of December, these ETFs were managing about RMB44 billion assets. In a short span of three months from launch, one of these ETFs became the second most actively traded ETF in Hong Kong.

In November 2012, the State Council approved an additional RMB200 billion RQFII investment quota. We are holding high-level discussion with various Mainland authorities on expanding the scope of eligible RQFII applicants and relaxing the RQFII investment restrictions.

Significance of the RQFII

In less than a year, the industry and regulators in the Mainland and Hong Kong have together developed a new product class worth RMB56 billion (RMB44 billion of RQFII ETFs and RMB12 billion of RQFII unlisted public funds).

The RQFII may be a watershed in the history of the development of many Mainland asset managers. Prior to the RQFII, these firms had little or no access to international liquidity, and no brand recognition outside the Mainland. RQFII products changed this forever. The RQFII ETF managers tell me that since the launch of their products in Hong Kong, the world's largest pension funds and institutional investors have been coming to Hong Kong in droves to meet them, asking them to manage a portion of their money. RQFII products give these firms an opportunity to prove themselves and claim a place in the asset management world. As the RQFII is set to expand and more firms here would become eligible, it is not difficult to envisage that Hong Kong will see an explosion of new players and liquidity from around the world.

The RQFII also has less visible but perhaps more significant implications. For regulatory authorities in the Mainland and Hong Kong, the rolling out of RQFII products, which involved not just rule-writing but also end-to-end testing of financial infrastructures, systems and firms in both markets and regulatory wit to manage the complexities, took our cooperative relationship to a newer and higher level. We were able to demonstrate to our Mainland peers that the SFC understands complicated Mainland policy imperatives, and can resolve technical, operational, system and logistical difficulties. The positive partnership experience and the successful rollout of the RQFII give Mainland authorities confidence to pursue bolder capital market-opening initiatives with us. They could see that Hong Kong funds are a good instrument that they can use as they continue to connect their capital markets with the rest of the world. And this is where my vision for our next frontier begins.

The next frontier: Mainland-Hong Kong mutual recognition of funds

My vision, ladies and gentlemen, is for the Mainland and Hong Kong to build a mutual recognition platform for our public funds. The RQFII's success underscores the strong appeal of the RMB, and the attraction of the Mainland market. The next step, therefore, is for us to experiment boldly on the back of this experience.

Again, the story started in 2009. I recall that when I first raised the mutual recognition idea with my Mainland counterpart in one of our informal meetings that year, in archetypal Chinese modesty, he smiled and asked me if I was ready to approve and accept Mainland-authorized funds. You could probably guess my response. That conversation marked the start of a multi-year effort that I believe holds even greater promise for the financial industry and the broader economy in the Mainland and Hong Kong.

As you know, since April 2006, we were able to get some of our SFC-authorized funds indirectly sold in the Mainland, through the QDII program. We were the first regulator to sign MOUs with all the Mainland financial regulators, CSRC, CBRC and CIRC. Under these MOUs, Mainland financial institutions could create foreign exchange investment products for Mainland investors wrapping SFC-authorized funds. That gave me the inspiration – if our funds could be sold directly on the Mainland, and theirs in Hong Kong, we could combine our strengths and establish a very sizeable platform. By 2009, I felt that it was the right time to introduce this concept.

Mutual recognition of funds

Before I tell you where we are with this project, let me clarify for you what we envisage, how will it work and what we hope to achieve.

Typically, in the absence of mutual recognition, if a foreign fund wants to be sold to the local market, it has to obtain the local regulator's authorization. With mutual recognition between the home regulator that authorized that fund and the host regulator of the jurisdiction where the manager wants to sell the fund, when the local regulator processes the application, it will deem the fund to be generally in compliance with local regulations. Granted, the fund will still have to seek local authorization, but the process will be streamlined.

Currently we already have mutual recognition with Taiwan (for ETFs) and Australia. Mutual recognition arrangements make the process of creating funds, seeking authorization and selling them in these jurisdictions easier, thus saving costs and time. But the situation is different in the case of cross-border selling between the Mainland and Hong Kong. Because of capital account restrictions in the Mainland, cross-selling of funds between the Mainland and Hong Kong is effectively off limits. There is simply no channel for Hong Kong authorized funds to directly sell to investors in the Mainland; and investors outside the Mainland cannot invest in Mainland authorized funds. The Mainland-Hong Kong mutual recognition initiative will open the gate to this mutual traffic flow, for the first time. This will be a very substantial breakthrough.

Under this arrangement, we envisage that qualified SFC-authorized funds domiciled in and operating from Hong Kong would enjoy the status of "recognised Hong Kong funds", and qualified Mainland funds would enjoy the status of "recognised Mainland funds". These recognised funds could then obtain authorization and be sold directly in the other's market.

In recent months there has been reporting in the media about a fund passport between Hong Kong and the Mainland. Let me be clear about this, we are not aiming for a fund passport in the near term. A passport implies that once the home country regulator has authorized a fund, the fund will have a passport with which it can automatically enter any host country that recognises the passport. The UCITs would be an example of the fund passport. We cannot be overly ambitious. At a time when the Mainland still maintains capital account restrictions, and when the RMB is not fully convertible, we must first start with a mutual recognition program. Recognised funds will have the privilege of getting on the highway that leads to other market, but they need to go through checkpoint at the border.

The opportunities to the Mainland and Hong Kong

I think it is obvious to all of us that the initiative would bring exciting new opportunities. But what does it really mean for us?

As a start, you will be able to sell your recognised funds in the Mainland. With its high saving rate, low market penetration and rapid economic growth, we are all keenly aware of the Mainland market's enormous potential.

In addition, recognised funds from the Mainland would enrich the product offerings available in Hong Kong. The Mainland has a diverse pool of public funds. I believe these funds would have a strong appeal to Hong Kong and international investment community. This would mean more sales opportunities for product distributors here.

This arrangement will have equally compelling attraction to the Mainland. First, Mainland fund managers will have direct access to international investors eager to take part in the Mainland growth story. Indigenous Mainland fund managers have an edge when it comes to managing funds that invest in the Mainland market. Mutual recognition would allow them to leverage their comparative advantage and tap international money interested in investing in China.

Second, Hong Kong will offer a platform for Mainland fund managers to compete against other international players, learn international standards and practices, understand the requirements and preferences of international investors and build international branding. In the asset management value chain, Hong Kong is particularly strong in client service and sales. Mainland fund managers could learn and bring new strengths back to their Mainland operations. This would raise their overall service quality and risk management, benefiting their customers in the Mainland.

Mainland investors would gain too. They would enjoy a broader range of investment choices. SFC-authorized funds are diverse, covering practically all markets around the world. Recognised Hong Kong funds would bring fresh competition to the Mainland asset management market. Competition will drive down costs and offer better value and services.

Broader use of RMB outside the Mainland

Today, the race is on among the several offshore RMB centres to become the preeminent offshore centre. The one who is the first to build a market with critical mass of RMB investment and financial products supported by deep liquidity and good velocity wins the race; the others will then become its externalities.

As first mover we are ahead of other RMB centres. We have the largest pool of RMB deposit, and a fairly complete range of RMB investment products – RMB deposits, bonds, equity and bond funds and RQFII funds, listed RMB products like REIT, gold ETF, RQFII ETFs, and listed shares. Yet our pool is shallow as measured against the size of the Mainland economy, external trade and capital market, and the potential international demand for the currency. You all got terribly excited last week about the longer term aim to expand RQFII quota. The entire quota will not be given out in one rush, but the Mainland has confirmed that all SFC licensed asset managers who qualify under the new criteria would be eligible. I hope that it will give us the opportunity to create different and interesting products. But even when the new quota is fully allocated, RMB200 billion is a drop in the ocean of RMB assets that the world will demand as China's economic story continues and her capital market expands.

The fullest range of RMB investment products today are in the Mainland. At the end of 2012, there were more than 1,100 CSRC-authorized funds. Managed by professionals on the ground, these funds employ diverse strategies. If only we could get a fraction of these to Hong Kong, we would immediately add an exciting new depth and richness to our RMB product pool, boost the appeal of the currency outside the Mainland, and move closer to the goal of securing Hong Kong's position as the preeminent offshore RMB centre.

Financing the real economy

After 30 years of breakneck development, growth in the next decade will require targeted investments in modernizing agriculture, improving social safety nets, building infrastructures and homes for rapid urbanization, developing world-class industries with international brand names, upgrading the service industry and most importantly, encouraging innovation in science, technology and medicine.

The Mainland is not short of money. It has one of the world's highest saving rates. In fact, at US$4 trillion per year, it saves more money than any other country in the world. The bulk of this money is now sitting in banks, and bank lending represents by far the biggest source of financing in the Mainland economy. But banks are not necessarily the most efficient apparatus for pricing capital and risks. This is the function of efficient capital markets.

Efficient capital markets require a healthy proportion of institutional investors. The Mainland stock markets are still heavily retail (80%). The percentage has been improving. The CSRC has been working hard in this area. In 2012, the level of institutional investor participation increased to 17.4% (up from 15.7% a year earlier). But there is still a long way to go. Mutual recognition could give impetus to this shift. As recognised Mainland funds attract overseas investors through the Hong Kong market, these funds could play a larger role as the Mainland stock market's institutional investors.

Financing an aging society

Research shows that the Mainland's elderly dependency ratio would quadruple between 2010 and 2050. By 2050, every 100 working age person in the Mainland will be supporting 42 elderly persons, up from 11 in 2010. This would pose a heavy burden on the future generation. The Mainland must put its people's savings into good use now, so that they earn a sufficient return to support the fast aging population.

Recognised Hong Kong funds would give Mainland investors easy access to some of the most attractive investment opportunities in the world. Markets around the world follow their own cycles. It is important that the long term investors have the ability to diversify.

Mutual recognition, investor protection and market stability

By now, some of you may be wondering, could it be that this is all good, and there are no risks.

The answer is, yes there are risks, and we will need to work through them. We already have certain tools – our cross-border cooperation in information sharing and enforcement is effective, we have been working closely with the CSRC on licensing and supervision issues relating to SFC-licensed firms whose parents are on the Mainland, and with the RQFII we have opened another theatre of cooperation.

Only SFC-authorized funds that are domiciled in and operated from Hong Kong would be qualified as "recognised Hong Kong funds". And these funds must first seek approval from Mainland authorities before they can be offered to Mainland investors. The SFC's regulatory platform for funds enjoys a solid reputation in Hong Kong and in the region. In any event the introduction of Hong Kong funds into the Mainland would be in a gradual, orderly and measured manner.

Of course, Mainland funds that are available to Hong Kong investors would be subject to a similarly robust gatekeeping and supervisory regime.

Progress so far

Now, onto the million-dollar question – when will this happen?

Our breakthrough came shortly after the successful roll out of the first batch of RQFIIs. In early summer 2012, we succeeded in persuading our Mainland counterpart to jointly study the idea. Towards the end of the year, a working group comprising members from both our two organizations was formed. The Mainland's regulatory framework does not cater for outside funds. Existing structures such as the QDII and QFII do not quite accommodate this new creature. As mutual recognition involves cross-border RMB flow between Hong Kong and the Mainland and fundamental questions on RMB capital account, the initiative will need detailed consideration by different Mainland authorities. This would take time. When exactly the initiative would be launched would also be influenced by the macroeconomic climate.

Conclusions and implications for market participants

I would urge that you start to consider the role you wish to play in this new initiative.

For those of you that are already operating in Hong Kong managing funds domiciled here and authorized by us, I encourage you to start thinking about which of your products would be suitable for the Mainland market, why they would be suitable, who your target investors would be, and how your products would help them.

Over the years, a number of you have complained that our market in Hong Kong is too small for you to enjoy economies of scale for building your fund domicile here. We are looking at what would be an appropriate regulatory framework for fund domicile. The Hong Kong-Mainland fund platform that we are building will likely be Asia's largest and deepest. I hope you will complain no more.

Some of you here today may be Mainland fund managers. The fact that you are here today means that your firm probably already has a presence in Hong Kong or is planning to expand into Hong Kong or other overseas markets. Mutual recognition of funds could give a new dimension to your existing strategy. I urge you to give it some thought.

I would also like to send a message to those of you that are visitors to Hong Kong. Hong Kong prides itself as an open international financial centre. We welcome overseas firms. I have always believed that the proposition that Hong Kong offers is enticing. If that has not been enough to bring you here, I hope this new mutual recognition initiative would give you reason to reconsider.

I recognise that developing the asset management industry may require complementary legal and policy support. The SFC is constantly thinking about how we could improve our regulatory framework for our market. If you believe that we have overlooked any particular issue that in your view is crucial, do let us know. Our door is always open.

I am conscious that I have covered a vast area today so let me wrap up here. I would like to conclude with a few words of encouragement.

At this time, I am reminded of the saying, "that which does not kill us makes us stronger". We have learnt from the crisis. We have survived the "apocalypse". Let us go forward now to build a responsible, solid and rewarding financial platform in Asia, in particular in Greater China.

To this end, I hope you will lend us your support, and I look forward to continuing our close working relationships.

Thank you!