The SFC’s Investment Fund Strategy for Hong Kong

HKIFA Luncheon

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Thank you for inviting me to speak once again at a Hong Kong Investment Funds Association (HKIFA) event.

I will start by describing what we are doing locally so that Hong Kong can further develop as a very significant asset management centre. I will then touch on some important issues which affect your industry from a global perspective.

Starting with Hong Kong, we all know that its position as a centre for funds activity is already fairly strong, reflecting the fact that we are the largest sales and distribution centre for funds in Asia, with around 70% of the managed fund business having been sourced from outside Hong Kong.

Hong Kong is also by far the largest manufacturing centre for Renminbi Qualified Foreign Institutional Investor (RQFII), Qualified Foreign Institutional Investor and other renminbi products. These funds, including exchange-traded funds (ETFs), can now use Stock Connect as an alternative route to gain direct access to A shares. And on top of this, Hong Kong’s hedge fund industry has also been growing.

But we think that Hong Kong achieve even more.

Asset Management Strategy

For this reason the SFC is pursuing an ambitious asset management strategy. The goal is for Hong Kong to become a global, full-service asset management centre, complete with the full range of ancillary services.

The first part of this strategy is to develop Hong Kong as an onshore fund management hub and a domicile for investment funds.

Stock Connect and Mainland-Hong Kong Mutual Recognition of Funds (MRF) are a key driver for this. Trading volumes through these channels have not been large, and have varied over time. But this was expected; markets have been especially difficult and we know that it takes time to develop distribution capacity and new products. But in the longer term many believe there are significant opportunities arising from these new pathways between Hong Kong and the Mainland.

And we think that MRF will for now be the only real route for foreign-branded public funds to be sold on the Mainland.

For now the important thing is that Stock Connect and MRF have both operated smoothly, and have paved the way for more market integration and connectivity. This is clearly the
direction of travel and, as you may have gathered from media reports, we are now working on a further expansion of the Connect program to Shenzhen.

So I am fairly confident that Hong Kong will play an even more important role to enable Mainland savers to access the world and international investors to access China. I should also say that we are now in talks about mutual recognition with other markets, including some in Europe. These markets have recognised that the growing significance of the Hong Kong asset management industry should lead to a new era of reciprocal recognition arrangements. These may well supplant the type of unilateral recognition arrangements which have been the norm to support one-way fund sales into Hong Kong.

Other important aspects of our strategy relate to the way in which we authorize funds as well as market infrastructure. As you know, last year we streamlined our authorization process to speed up the time-to-market. We now aim to complete more straightforward applications in one to two months. And we are pleased that overall processing time did in fact shorten in line with this timeframe, and so we expect to adopt this process permanently after the six-month pilot period ends.

Incidentally, our experience here resembles a similar reform to the initial public offering process a couple of years ago. In both cases, the quality of offer documents improved significantly as the industry took on board the reality that a faster process depended on better preparation and response times. It seems that much the same has happened here, and those involved at the SFC appreciated the fact that the industry worked hard to achieve a successful outcome.

We are also working on diversifying fund distribution channels, which are now highly concentrated in the banking sector, limiting investor choice and raising “trail fee” and other distribution costs. One element of this might be an Exchange-sponsored platform for primary market subscription and redemption of funds. We are also looking at the development of online fund distribution platforms in Hong Kong and other markets which investors can access directly. Online platforms help broaden fund distribution channels and encourage competition. But this will require us to take a close look at how our existing conduct obligations can be met in a more automated environment, and here it seems clear that additional guidance from us will be needed.

So an internal working group has been set up within the SFC to look at clarifying our expectations of how the suitability requirement should be implemented across different business models, including exchange and online platforms. We are looking to issue formal guidance later this year.

Another market infrastructure development is the proposal to enable funds to be set up in corporate form under Hong Kong law, in addition to the traditional unit trust structure. The bill to allow open-ended fund companies is now in the Legislative Council, and when implemented, the SFC will be responsible for the regulation of open-ended fund companies (OFCs), whether they are used as public or private fund vehicles. This initiative involves not just regulation but also decisions about tax treatment. Clearly, tax neutrality will boost the appeal of private OFC vehicles and the attractiveness of Hong Kong as a private fund domicile.

More generally, it is always important that when new fund products are introduced the regulatory environment still ensures the right level of investor protection. A recent example
has been the introduction of leveraged and inverse products where we designed the regulations to contain systemic risk issues as well as to ensure that investors are aware that this is a day-trading product rather than a longer-term ETF tracker. Coming up, we expect to approve more futures-based ETFs, such as for crude oil. We also support the call for an increase in the RQFII quota to expand the use of renminbi products in the market.

Finally, we are working hard to enhance the existing regulation of the asset management industry, keeping a firm eye on evolving international standards. This entails a comprehensive review of expectations about conduct, taking in disclosure of commissions as well as independent advice.

We are also looking at the safe custody of fund assets, including the responsibilities of fund managers and custodians for these arrangements. And for liquidity risk management, we are considering the need to give guidance to implement IOSCO’s Principles in this area, including the requirement to conduct regular stress tests.

We plan to launch public consultations later this year on all of this, so stay tuned.

**NBNI G-SIFIs debate**

A couple of years ago, the Basel-based Financial Stability Board (FSB), which is made up largely of central bankers and finance ministries – turned its attention to financial stability risks in relation to funds. There was, and still is, a large measure of anxiety about the relationship between the search for yield, illiquid fund assets – especially bonds – interest rate normalisation and daily redemptions. All resulting in possible “run risks” and fire sales.

The question was whether to specially regulate some funds or asset managers which, because of their sheer size, are assumed to be potential sources of systemic risk. This would have been along the lines of the FSB’s work centred on ending “too big to fail” for large banks. Funds of a sufficient size would be designated as “non-bank non-insurer global systemically important financial institutions”, or NBNI G-SIFIs and subject to special measures. The joint work on this commenced by IOSCO and the FSB was to find a methodology to identify these larger funds or asset managers.

Our view was that this focus on size to deal with run risks was misconceived. And that any bank-like solutions to deal with a potential run – such as capital buffers – didn’t make much sense.

Central bankers have an understandable focus on bank balance sheets, bank capital and bank risks stemming from maturity transformation and unreliable short-term funding.

But capital markets, which are essentially mechanisms to achieve transparent risk-sensitive pricing of a range of financial assets, are very different. Asset managers are not banks – they have fiduciary obligations, and the financial gains and losses lie with investors, not on asset managers’ balance sheets. The obvious caveat to this was to do with constant net asset value money market funds, which was a very different debate.

In the end, after IOSCO had made its position on this clear, the FSB announced last summer that it would defer the question of whether the G-SIFI designation should apply to large asset managers, and instead focus on the actual market behaviour of mutual funds in stressed scenarios. This would include liquidity management and the tools used to deal with

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1 International Organization of Securities Commissions.
redemptions. The FSB and IOSCO will also look at system-wide stress tests to try to identify any spillover risks, including to the banking sector.

This is a far better approach, recognising the fact is that it is not the institutions which are systemic but rather it’s the markets they trade in. This work on asset management activities is now well advanced and should see the light of day later in the year.

**Going passive**

The other big development in the global funds industry which all of you will be acutely aware of is the big shift to passive management.

Last year, inflows into passive funds in the US – such as low-cost trackers and ETFs – were four times larger than outflows from active funds. And passive funds now account for nearly one-third of US assets managed in mutual and exchange traded funds.

And there are other challenges to traditional active management. In 2015, the majority of US fund managers underperformed their US benchmarks. Over a longer period, more than 80 percent of large-cap funds and nearly 90 percent of small-cap managers failed to match benchmarks. And the numbers are similar for Europe. Incredibly, S&P found that all actively managed equity funds sold in the Netherlands failed to match their benchmarks over the past five years.

Moreover, the data shows how hard it is to consistently beat the market. According to S&P, of the US domestic equity funds in the top quartile by performance in 2013, only 4.3 percent were still in the top quartile two years later.

This is part of a larger debate about whether active managers are able to justify their fees. *The Economist* recently reported a Morningstar study that found that high fees are a predictor of underperformance.

In a new book, titled *Other People’s Money*, economist John Kay makes the point that “many users of the investment channel are now unlikely to earn any real return on their savings at all. This is the epitome of a financial system designed for the needs of financial market participants rather than the users of finance … this outcome is unlikely to be either politically or economically sustainable”.

Kay also talks about the disconnect between funds and real economy companies, which more and more are at odds over objectives and where finance is seen as contributing little to sustainable productivity and investment in a low-growth world. Kay therefore calls on asset managers to focus more on stewardship of the companies they invest in.

And with the move to passive investing, the obvious question is that if everyone is a tracker, who is making decisions about fundamentals?

We are looking to engage more with companies and a range of asset managers about the implications of this shift to passive funds, for both investors and companies, as well as the stewardship role of traditional active funds.

We are interested to see that some of the larger asset managers such as Vanguard and BlackRock have said that although they run passive investments, they are still going to be more involved in the companies they invest in.

At an SFC Regulatory Forum in February, Pru Bennett from BlackRock joined one of our panels. She noted that about two-thirds of the funds her firm has under management in this region are passive. But she was adamant that BlackRock is anything but passive about its
passive investments. She said that they try to understand how companies are governed and how they manage risks, and will get involved where necessary.

On this theme, I understand that HKIFA has sent its members a short survey on the SFC’s recently released “Principles of Responsible Ownership”. These Principles are voluntary. They aim to provide guidance on how investors should manage their ownership responsibilities in relation to investments in Hong Kong-listed companies, and to tell their stakeholders about their engagement policies. The main thrust is that effective engagement by investors generally leads to better-run companies. I encourage you to complete the survey as the results will be very useful for the HKIFA and the SFC to think about next steps. Thank you for your attention.