Investment Products – the New Landscape in Hong Kong
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Introduction

Good morning.

I’ve been asked to speak about the new landscape in Hong Kong for investment products.

For those in attendance yesterday, I was part of a panel discussion which touched on a few of the developments of common interest to most international asset management centres, such as preparations for UCITS IV and the current status of negotiations with respect to the proposed Alternative Investment Fund Managers Directive. These matters certainly have major implications for the Hong Kong funds industry. However, what I propose to do today is to touch briefly on some of the regulatory changes we’ve made in our domestic market. I will then devote time to sharing with you some thoughts on the opportunities open to asset managers and product providers as China takes steps to internationalise its currency.

Revised requirements affecting investment products in Hong Kong

General

First, let’s take a look at some recent changes to the regulatory regime in Hong Kong.

We’ve recently revisited our requirements for certain investment products that are offered to the public. Some of the measures we proposed were a response to the financial crisis. We also took the opportunity to modernise certain parts of our regulatory codes, remove outdated provisions and allow for more flexibility in areas where we felt this was justified.

The revisions are broad-reaching, covering collective investment schemes, structured products and investment-linked assurance schemes sold to the public in Hong Kong. There were also changes to the conduct of licensed or registered intermediaries distributing investment products. I’ll highlight a couple of the main product-related changes for you.

Changes to the regime for authorization of funds

We’ve made quite a few changes to the Code on Unit Trusts and Mutual Funds. The revised code now allows a broader range of permitted investments for certain funds, permits
alternative bases for calculation of performance fees, and caters for situations where the
timing of redemption payments may be affected by certain contingencies, such as restrictions
on market access or exits, or exchange controls. We’ve added specific requirements for
index funds and structured funds. We have also codified our policies and requirements
dealing with conflicts of interest, such as a requirement for independence between managers
of funds and the counterparties to the swaps or other instruments that are used by these
funds to achieve their desired exposures, criteria for indices to which funds are linked,
requirements for valuations, and rules around collateral and counterparty exposure. Some of
these issues are relevant to exchange-traded funds (ETFs), particularly synthetic ETFs. Hong
Kong is now the second largest ETF market in Asia (both in market capitalisation and
turnover). As seems to be the case in other major ETF markets in the world (notably the US
and European markets), we are seeing significant growth in the ETF market, and an
extensive use of derivatives by ETFs that track indices. The use of swaps and other
derivatives can limit transparency and affect a fund’s risk profile. Their use also raises
additional issues of counterparty risk and transparency in the type of collateral held, how it is
held and how it is managed.

Requirements for retail structured products

In the structured products area, we introduced a brand new code setting out requirements for
unlisted structured products that are offered to the public in Hong Kong. This code covers
eligibility of issuers, guarantors and product arrangers, responsibilities of key parties,
selection of counterparties to transactions underpinning the product, acceptable reference
assets or benchmarks, and rules for guarantees and collateral where these are used to
support the products. The code imposes continuing disclosure obligations with respect to
matters like financial reporting of key parties and material adverse changes. Issuers or their
market agents are required to make a market in their products throughout their term, subject
to reasonable limitations. And in the case of some longer-term structured products, issuers
and intermediaries are also required to provide investors with a cooling-off or unwind period,
or, in other words, an opportunity to cancel or unwind the transaction within the first few days
after making a decision to invest in the product.

Disclosure

Our regime governing offers of investment products in Hong Kong is disclosure-based. The
range of investment products available to retail investors is large, and getting larger. It is as
important as ever that investors are able to make informed decisions. Of course, investors
must assess potential investments in light of their own needs and financial situations.
However, they must be provided with all necessary information and it should be presented in
a way that they can reasonably be expected to understand. Where the nature of a product
does not lend itself easily to clear and simple disclosure and where it requires very extensive
risk disclosure, it may well be difficult for issuers to produce an offering document which
complies with applicable standards for publicly-offered products.

Central to our regime is the requirement that issuers of retail investment products must
prepare a user-friendly document summarising the key features and risks of each product.
We call this a Key Facts Statement or “KFS”, and it is a short, readable summary designed to
highlight for investors the key features, risks and costs of a product. You are of course familiar with the concept, as you are working on the Key Investor Information in the EU.

We have started to implement the KFS requirement. The industry has made good efforts to meet the new requirements. The feedback from investors has been positive. In Hong Kong, we want the KFS to make good use of diagrams, charts, graphs or other illustrations where they may be helpful to investors. On the risk side, we require a narrative approach rather than a risk-rating system. The KFS is intended to be read with or form part of, and not to supplant, the offering document for the product.

RMB-related developments

I want to turn now to other developments that are significant for the Hong Kong market, namely steps being taken by China to pave the way towards further internationalisation of the renminbi (RMB), how this is likely to impact upon investments and investment assets worldwide, and the role Hong Kong is playing in this process.

Internationalisation of the RMB is a very clear national strategy for China. Over the last 24 months, much has been written and published by experts both inside China and around the world on this subject. I will not attempt to provide another rendition here. Suffice it to point out that a country that is the world’s second-largest economy, largest exporter and third-largest importer has to start pricing and settling some of its trades in its own currency.

The first main steps towards internationalisation of the currency were taken in July 2009, when China officially launched a pilot scheme for settlement of cross-border trade in RMB between a handful of Chinese cities and several other countries and territories outside the Mainland of China including Hong Kong. But those outside China were not immediately enthusiastic in taking up this option. There just weren’t enough real and effective tools for foreign traders to manage their currency and interest rate risks.

Preconditions for internationalisation of the RMB

For the RMB to become an internationally-accepted and circulated currency, there are two key preconditions. First, those outside the country who wish to hold the currency must be able to obtain and transfer RMB without impediment. Second, there must be a market-driven demand for the currency. There need to be channels available for RMB held offshore to be used, not just for trade settlement purposes but more importantly, for investment, or as a means of value storage and accretion. In other words, apart from the need for a stable exchange rate, there should be abundant investment opportunities for holders of the currency to “work their money”.

Increasing overseas RMB liquidity

China has over the last several years taken gradual steps to address these two issues. Hong Kong has been handpicked as the experimental ground for pilot programmes and controlled
tests. Hong Kong is both part of China and an international financial centre with a mature and open market and a world-class legal system. It is therefore uniquely placed to help China experiment and manage the risks along the way.

The process started as early as 2004 when banks based in Hong Kong (and Macau) were allowed to open RMB deposit accounts for individuals. Each individual could exchange up to RMB20,000 per day, and the deposit-taking banks could clear these RMB positions with the People’s Bank of China. So far, outside the Mainland of China, only banks in Hong Kong (and on a much smaller scale, Macau) have been allowed to operate this programme. There were many restrictions regarding holding and use of the currency. Many of these restrictions were removed in July this year. Apart from individuals, companies and institutions (including brokers, fund managers and institutional investors) are now allowed to open RMB accounts for all general purposes. Even more importantly, funds can be freely transferred between RMB accounts in Hong Kong for any purpose. As a result, aggregate RMB deposits in Hong Kong have risen dramatically. As at the end of July 2010, total deposits were RMB103.7 billion (US$15.48 billion), compared with RMB62.7 billion (US$ 9.36 billion) as at the end of 2009. This rise of over 60% in RMB deposits is significant considering that the RMB is a restricted currency with very limited circulation outside the Mainland of China. As a result of the new measures, it is now feasible in Hong Kong for insurance premiums or investment subscription amounts to be denominated and paid in RMB, for securities to be traded, cleared and settled in RMB and for coupons and dividends to be paid in RMB. As Hong Kong continues to bring more RMB products to the market, we expect that aggregate RMB circulation in Hong Kong will continue to rise.

To further boost RMB liquidity overseas, the People’s Bank of China entered into swap arrangements with other countries, and further expanded the scope of permitted RMB cross-border trade and services settlements.

With these measures, the volume of RMB trade settlements worldwide has continued to increase. Interestingly, over 75% of these transactions have been done through Hong Kong. This is not surprising, given Hong Kong’s superior infrastructure and expertise dealing with the Mainland of China.

Increasing avenues for investment in RMB

I should note that, before the liberalisation measures, Hong Kong started developing an offshore RMB bond market in 2007. The universe of issuers comprised mainly Mainland Chinese banks. In 2009, we had a landmark issuance by the Chinese Ministry of Finance of RMB treasuries of two- and three-year tenors, a first outside the Mainland.

Immediately after the July liberalisation measures, foreign issuers started using the Hong Kong RMB bond platform. Last month, McDonald’s Corporation, based in the US, issued RMB200 million notes in a private placement to Hong Kong institutional and professional investors to support its growth in China. The note provides a 3% coupon and is due in September 2013. Separately, Deutsche Bank has just announced that it recently completed its first RMB bond offering in a RMB200 million self-led deal.

As demand for RMB investment products continues to grow, companies from all over the world who have needs for RMB would likely use the Hong Kong platform to issue bonds. You
will no doubt be interested in prospects for RMB-denominated fund products. I’m pleased to
tell you that in August, we authorized the first RMB-denominated fund for public distribution in
Hong Kong with subscriptions and redemptions settled in RMB. The fund assets are primarily
tended to be invested in RMB-denominated debt instruments issued outside the Mainland.
While the universe of such debt instruments is currently very small, the launch of this fund
nevertheless underscores the important fact that Hong Kong’s market infrastructure can well
support publicly-offered RMB investment products. We expect to see further increases in the
breadth and depth of the market for RMB investments products in Hong Kong. In fact, the
next major breakthrough will likely be in the listed products area.

Facilitating the flow of offshore RMB back onto the Mainland

The Mainland Government has made it very clear that its intention is for Hong Kong to
become the premier offshore RMB centre of China and to be a testing ground for reforms and
measures to open up avenues for trading and investment in the currency. While the July
measures have enabled the RMB deposits in Hong Kong to be put to use in new products in
Hong Kong, the ultimate prize must be for this pool of offshore liquidity to be able to directly
tap into the opportunities in the Mainland market.

The RMB is not a freely convertible currency. Capital account convertibility is still restricted.
Foreign investors who wish to invest in the Mainland market can only do so after they have
obtained an investment quota under the Qualified Foreign Institutional Investor, or QFII,
regime. As you may know, QFII quotas are precious. Currently, only 98 foreign institutions in
the whole world have been granted QFII quotas, with an aggregate investment quota of
US$17.7 billion. These investors must first remit foreign currency for conversion into RMB
before they can make RMB investments in Mainland markets; they cannot directly remit RMB
to the Mainland for investment.

In mid-August this year, the People’s Bank of China announced that, henceforth, qualified
commercial banks based in Hong Kong plus central banks and monetary authorities all over
the world may directly invest in RMB in China’s inter-bank RMB bond market. Quotas are of
course required. This is a monumental step forward as it provides an opportunity for not just
central banks but more importantly commercial banks through Hong Kong to participate in the
RMB14.9 trillion (US$2.2 trillion) Mainland Chinese inter-bank bond market. This move finally
builds a “linkage” between the pool of offshore RMB with Mainland China’s capital market.

While only a finite number of market players can directly participate in the Mainland bond
market, there are no explicit restrictions on the bond investments made by these participants.
This may, therefore, provide an opportunity for product providers to structure and offer in
Hong Kong investment products that offer reasonable yields and are linked to quality
Mainland debt instruments.

Expectations are now high that the next opening may well be an experiment with a small-
scale QFII-like quota in RMB, allowing direct investments into Mainland exchange-traded
instruments. This is expected to be introduced on a pilot trial basis in Hong Kong as an
experiment for further gradual opening up of the Mainland capital markets. This will have
significant implications not just for the RMB internationalisation process but also for the
eventual goal of capital account convertibility.
Closing remarks

These are exciting developments, but what do they all mean for the world's investors and their asset managers? For the world's investors, they now have, through Hong Kong, a brand new investible currency. For their asset managers, they may create a new range of RMB products using the Hong Kong platform. As is the case with all new products, asset managers must use not just their skills and capacity for innovation, but also their commitment to excellence and their willingness to put their clients' interests first. This is an exciting journey. I hope you will all join us on board to make the journey successful and rewarding. And of course, we must not forget that while the developments for the RMB are a very important story, this is only part of a bigger story. That story is China, a country that has registered an average GDP growth of 10% per annum over the last 10 years. As China continues to grow and accumulate wealth, the Chinese people will increasingly need experts such as yourselves to help manage their wealth. And of course, much of that wealth will be in RMB.

Thank you.