The development of Hong Kong as an asset management centre
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Introduction

My aim today is to give you an update on the development of Hong Kong as an asset management centre.

The past couple of years have been very eventful for the asset management industry. Here in Hong Kong we launched the Mainland-Hong Kong Mutual Recognition of Funds (MRF) scheme in July 2015, and we have started authorizing some new products such as commodities exchange-traded funds (ETFs) and leveraged and inverse products. Those of you who have been following our agenda know that the Securities and Futures Commission (SFC) has also been conducting a holistic review of how the regulation of the asset management industry could be enhanced, including the regulations governing the conduct of asset managers and intermediaries.

In the international arena too, asset management has attracted a fair bit of the limelight in recent years. There has been ongoing coverage of the shifting asset allocation landscape, from active to passive funds. On the regulatory front, global regulators are working to agree on a framework to address the potential systemic vulnerabilities of asset management activities. The Financial Stability Board is expected to release its final recommendations on this framework soon, while the International Organization of Securities Commissions (IOSCO) is working towards giving more guidance to implement many of these recommendations in the next two years.

Rather than going through all these initiatives and regulations in turn, I hope to share the framework and guiding vision that we use to formulate policies to carry out our regulatory function in regard to asset management and, more importantly, to implement a new strategy for developing Hong Kong as a global, full-service asset management centre, complete with a full suite of services.

Hong Kong's traditional strengths

Before going into the specifics of asset management, it is useful to take a look at Hong Kong's financial industry as a whole to get a sense of where asset management sits.

When it comes to finance in Hong Kong, our equity market is often the first thing that springs to mind. This is hardly surprising. According to industry analysis, in two of the past five years, Hong Kong has won the top spot in the global IPO league tables[1]. This is largely due to listings from Mainland enterprises. Since the early 1990s, with the listing of the first H-share,

[1] "Hong Kong led the world in IPO funds raised in 2015", pwchk.com (4 January 2016)

Hong Kong has seen a host of Mainland listings, and these have allowed international investors to access one of the most dynamic and fastest growing economies in the world.

The rapid development of our equity market over the last 25 years has catapulted Hong Kong to one of the top spots in international finance. But this strategy is showing its age. Partly, this is because even though equity is high-profile, and stock trading and stock performance are always in the news, they are only a part of finance. We need to build our financial sector on a solid foundation. But considering the size and other features of the local market in Hong Kong, as the financial sector continues to grow it may become harder for the equity market alone to support it.

Another limitation has to do with the specific characteristics of the Hong Kong equity market. The listing of Mainland companies has been driving the growth of the market over the past two decades or so. As we all know, this is a result of the Mainland's reform and opening up and its need for external capital and expertise.

Most of the largest Mainland enterprises are now listed, either in Hong Kong, the Mainland or overseas markets. However, there are clearly a large number of Mainland companies that are still in need of capital and keen to come to the Hong Kong market. But the number of big-ticket listings that keep Hong Kong in the global IPO top spot is dwindling. And although most would argue that there are imperfections in the Mainland markets, they have a certain appeal to Mainland listing candidates, such as more attractive valuations and better liquidity.

On the other hand, overseas exchanges are keen on attracting companies from what would soon be the world's largest economy, and competition from these markets is challenging Hong Kong's position as the preferred listing destination for Mainland enterprises.

The way forward for Hong Kong as an asset management centre

We see a need for Hong Kong to diversify and broaden our coverage. In the past few years, a consensus has emerged regarding what we should be aiming at – risk management and asset management. Both of these aspirations build on the strengths of Hong Kong as well as on some broader trends.

This vision and strategy for Hong Kong's asset management industry has some broader macroeconomic underpinning. First, the growing wealth in the Mainland and Asia. Savers in Asian emerging markets are famously frugal – accordingly to World Bank data, the savings rates in Korea and India are 30%, whereas in the Mainland it is close to 50%. This is significantly higher than in the US, where it is about 20%. As these Asian economies continue to grow, they create an expanding pool of potential customers and a larger asset base for our asset management industry.

Second, there is now a growing recognition that capital needs to be employed in a more efficient manner. Many Asian jurisdictions are coming to understand the pitfalls of the lack of discipline in their previous approach to investment, as they begin to see disappointing results. Just as importantly, there is also pressure coming from an aging population. "Getting old before getting rich" is no longer a theoretical possibility but an increasingly pressing concern for Mainland authorities. Making sure that workers' savings work as hard as the workers do would contribute to resolving this conundrum. The asset management industry is expected to help channel capital to its most efficient uses.

Of course, the factors I just mentioned will have limited relevance to Hong Kong unless Hong Kong can take full advantage of them. This is where the SFC and our local industry come into play.

Diversifying and extending our reach in the value chain

The one idea that you have probably heard from my colleagues at the SFC, the Government and many others is that Hong Kong's asset management industry needs to diversify its products and service offerings, and extend its reach in the value chain.

So where are we now?

Asset management covers a wide range of investment services and activities – ranging from pooled investment services such as traditional public or mutual funds management and private funds management, to discretionary management accounts for institutional clients like pension funds, endowment and family offices, to investment advisory, private banking or wealth management services by private banks and insurance companies.

According to our annual Fund Management Activities Survey (FMAS), the combined fund management business in Hong Kong (covering mainly the asset management business of SFC-licensed firms, banks and insurance companies, private banking business of banks and fund advisory business of SFC-licensed firms) has almost doubled from US$1.2 trillion to US$2.2 trillion in the last five years.

In terms of Hong Kong's coverage of the asset management value chain, it has traditionally been and still remains a key fund distribution centre in terms of industry profile of personnel engaged in the business. Many of the staff in the industry work in product distribution or related services. Our FMAS consistently shows that of the over 34,000 industry staff, 70% or more are involved in sales and marketing.

No doubt, product distribution is an important segment of our asset management industry. But we need something more to sustain the next stage of growth.

One reason is size. Hong Kong is a relatively small market with a limited customer base. We are an open market and we have an amazing ability to attract capital from the Mainland and overseas. This explains why about two-thirds of the assets managed in Hong Kong are from overseas. However, most investors still prefer to invest through intermediaries in their home markets, which they may be more familiar with and have more confidence in. As for our local investors, the Hong Kong market is already quite saturated.

This is why we believe our next stage of growth will only come if we can extend our reach along the value chain and diversify the types of services that we can provide to the industry, to portfolio management, fund domicile, administration, transfer agent, valuation, accounting and other related professional services. Each link within the value chain has its own appeal. For example, portfolio management is generally seen as where asset managers' competitive advantages and intellectual capital lie and they make up the bulk of asset managers' value-added. On the other hand, back office activities such as fund domicile, administration and accounting generate a stable stream of income and are less affected by the vicissitudes of the market and the economy. Last but not least, many of these activities are highly scalable and their growth is not constrained by the size of the local market. We have recently seen some shifts in industry staff profile as a result of the growth of Hong Kong-domiciled funds

and the further opening up of Mainland markets as a result of the Stock Connect and Mainland-Hong Kong MRF initiatives.

Fund management and fund domicile in Hong Kong

We have been encouraging fund managers to come to set up and manage their funds in Hong Kong for some time. And we have made good progress. The number of asset management licenses granted by the SFC has been increasing over the past few years, exceeding 1,200 by the end of September 2016. The number of Hong Kong-domiciled SFC-authorized funds has been growing quite rapidly too, from less than 400 in 2011 to close to 700 now. The size of these funds also almost doubled during the period.

The growth in the past few years has largely been driven by the demand on the part of Hong Kong and international investors for Mainland and renminbi investment opportunities and the growth of Hong Kong as a pre-eminent offshore renminbi centre, and Hong Kong has a strong competitive edge in these areas.

In addition, we have successfully secured policy support that facilitates the development of our Mainland and renminbi investment products. For example, in 2011, the Central Government's Renminbi Qualified Foreign Institutional Investor (RQFII) scheme was first launched in Hong Kong, allowing overseas investors to invest renminbi in the Mainland bond and equity markets. Hong Kong managers were the first to receive approval and quotas to participate in the RQFII scheme, and Hong Kong has the largest quotas among all overseas markets. Stock Connect, a new cross-border scheme with which you are all familiar, has been in operation since the end of 2014 and will soon be expanded to cover Shenzhen. The scheme allows international investors to invest in the Mainland through Hong Kong. This was another shot in the arm as we continue to build up our asset management business.

Mutual recognition of funds

Notwithstanding our appeal and the headway that we have made, the factors that have historically inhibited the development of Hong Kong's asset management industry remain an issue, most notably the relatively small size of our market.

Asset management is a scale business. Being able to spread a firm's research, transaction and overhead costs across a larger pool of assets under management brings down the expenses ratio of a fund, making it more attractive to investors. This is particularly true for passive funds, which are becoming increasingly popular. Passive funds tracking the same index have more or less the same underlying portfolio. Cost has thus become the key factor which determines how they perform relative to each other. But cost aside, scale confers some additional advantages. It allows the fund manager to develop expertise and capability in specific market segments and also to build infrastructure, such as trading and execution facilities.

A few years ago, we started expanding the markets for our funds, by more actively pursuing mutual recognition arrangements with overseas markets. Over the past ten years we have entered into a number of mutual recognition arrangements with various overseas markets.

Mutual recognition arrangements have an intuitive appeal. Different markets are good at different types of products and may have products on offer that are not otherwise available in the other market. By allowing cross-distribution of funds between different markets, investors

will have more and better choices. It should also expand the industry's business opportunities, as managers can start tapping into otherwise unreachable investors.

The success of a mutual recognition arrangement calls some key factors into play. Investor protection is one of them. Local funds and funds coming from abroad need to offer the same degree of investor protection. This entails comprehensive regulatory analysis as well as robust cooperation arrangements between home and host regulators, which take time to negotiate. Then there is tax, which eats directly into investors' returns and could tilt the playing field between local and foreign funds. And of course market factors are also crucial. Investors need to be interested in an overseas product. And there need to be intermediaries willing to distribute the products and also service the customers.

Our mutual recognition arrangement with the Mainland is the most noteworthy one we have entered into. Together with the China Securities Regulatory Commission (CSRC), we launched the scheme last summer. So far, the two authorities have authorized over 50 funds under the scheme, and close to RMB9 billion in cross-border investments have been made. There are issues that we will need to work on, such as the imbalance between north and south-bound capital flows and the implementation of the cross-border distribution of ETFs. Some of these issues will be worked out as market participants and authorities in the Mainland and Hong Kong gain more experience about the scheme, and market sentiment toward the Mainland improves.

But what is most important is that the operation of the scheme has been smooth and we have enhanced our closer working relationship with the CSRC in terms of information exchange and regulatory co-operation. And we will continue to work with the CSRC to continue to improve the scheme to bring mutual benefits to both markets.

We hope to replicate this mutual recognition of funds model to expand the investor base and attractiveness of Hong Kong-domiciled funds. We have been working intensively with authorities in a number of overseas markets in Europe, and we should be in a position to announce another MRF scheme very soon. The idea is to expand the range and size of the markets for Hong Kong asset managers, so that they find it more attractive to base and manage their funds in Hong Kong.

Delivering better value and putting clients' interests first

The industry sees the asset management business as a potential high growth area especially after the global financial crisis and the subsequent de-leveraging process and downsizing of banks as a result of tighter regulation. However, the growth of the industry has now attracted financial stability concerns from macro-prudential authorities.

But market access alone does not guarantee success. Ultimately, whether investors will be receptive to a product depends on whether it offers superior value for money and whether we can maintain the quality of the industry to meet investors' growing demands. This is an area that I would like to cover next.

If we take a step back and think about why investors invest in funds at the first place, two reasons stand out. First, professional asset managers are supposed to be able to deliver higher returns because of their financial knowledge, market insight, extensive research and other advantages. Second, fund managers should be able to help investors diversify in a cost-effective manner, by pooling investments from a large group of investors, reaping economies of scale and passing the gains on to investors.

Unfortunately, events in the past few years have cast doubt over whether the asset management industry has really been delivering on its side of the bargain, and have called into question whether the industry can continue its existing way of doing business.

The debate over funds returns

Ever since the birth of the efficient market hypothesis, academics have been questioning the ability of asset managers to consistently beat the markets. Over the past decades, such scepticism has spread from the academic fringe to the mainstream. It does not help that over the past few years, as markets sought to recover from the 2008 financial crisis, the major stock indices have consistently outperformed the majority of active funds. And this has been widely reported by the financial press.

Industry practitioners have put forward various theories to explain and justify this underperformance. Some suggest that the largest US and European markets are simply too efficient, leaving no room for managers to use their skills to capture the alpha. This group notes that active managers still add value when it comes to investing in emerging markets. Some others claim that the ultra-loose monetary policies pursued by many central banks are distorting markets and making conventional investment approaches less effective. This group argues that as normality returns, active managers would regain their advantage.

To me, the jury is still out on this active-versus-passive debate. I look forward to seeing more evidence from both sides. But it is really up to asset managers to convince investors of their value. In this respect, the regulator's role is not to take sides but to ensure that asset managers provide accurate, clear and comparable disclosure to allow investors to make a decision and to have access to a broad range of products and services.

Cost concerns

The second important reason why people invest in funds is the supposed cost-saving when building a diversified portfolio. Diversification is probably one of the few cardinal rules that all economic and financial professionals can agree on. Obtaining a diversified portfolio at a low cost is an oft-mentioned benefit from investing through funds rather than directly in individual stocks.

In the past few years, investors have become increasingly conscious about the costs of fund investment. This is partly a result of the interaction with the rise of passive investments, which promote themselves as low-cost alternatives to active funds. But more generally, investors and savers are becoming savvier and are starting to come to grips with the scale of the fees that they are paying, and how that affects the returns that they are getting.

In Hong Kong, this awareness is being fuelled by the ongoing debate over Mandatory Provident Fund reform. The asset management and pension industry used to champion the magic of compounding. Small amounts of money persistently squirrelled away over one's working life can be turned into a sum substantial enough to underwrite a comfortable retirement. This concept has now been called into question by some. For example, the Economist has recently done some calculations, and showed that a one-percentage-a-year fee charged by the asset manager would reduce the amount that the saver received at retirement by a quarter[2].

[2] Fund management – slow motion revolution", The Economist (11 June 2016)

In Europe, some regulators are studying so-called closet trackers, which are funds that pose as active funds, charge a high fee, but in fact invest according to some major indices. Authorities are mulling over what they should do about these funds.

Some market participants protest that regulators should not intervene in how much they charge, as long as the charges are clearly disclosed. This argument misses the point. Accusations of high fees, low returns, and asset managers benefiting at the expense of individual investors are undermining the industry's credibility and investors' confidence in the industry. Unless the industry starts taking these concerns seriously and puts investors' interests ahead of its own, investors will find alternatives – be they low-cost trackers or some fintech offerings, for example. In the longer term, investors' scepticism or even cynicism would undermine the sustainability of the industry. It is important that we all deal with these issues head on, by putting investors' interests first.

Improving the local market

Much of what I just said concerns principles and measures to ensure the longer-term health and development of the asset management industry. I would like to move onto talking about some of the more concrete initiatives we have been working on, which fall under three broad areas: product diversity, product distribution and market infrastructure.

Product diversity

As you know, product authorization is the bread and butter of the SFC's Investment Products Division. We strongly believe in providing a broad range of investment products to the investing public in Hong Kong subject to structural and disclosure requirements which provide an appropriate degree of investor protection. In the past two years, we have begun authorizing more innovative products for public offering in Hong Kong, to enhance the product selection in our market and to give investors more choices in this low-interest rate environment.

In April 2016, we authorized the first commodity futures ETFs, tracking the performance of the oil market. In February, we released a circular setting out our requirements for authorizing leveraged and inverse products and we authorized the first of these products in June. As of today, a total of 12 have been authorized, tracking markets in Asia and North America.

Right now, we are allowing leverage and inverse products tracking only non-Hong Kong indices. The intention is to first observe the trading and operation of these products, as well as investors' take up and understanding of them, before deciding on whether to broaden the universe. So far, the products have been running much as we thought they would. Their turnover and size have been relatively small, making up less than 1% of the market. But considering the novelty of these products and the fact that the products launched so far all track foreign indices, we believe this was to be expected. As we said in our February circular, we would conduct a review six months after the launch of the first leveraged and inverse products to consider opening them up for other underlying indices, including Hong Kong equity indices. We are now preparing for such a review.

Product distribution

Quite often, asset managers, and particularly the niche players and the newer entrants, tell us that the biggest challenge they face is in securing a distribution outlet for their funds. This is hardly surprising. Compared to other markets worldwide, Hong Kong has a concentrated

fund distribution market. Banks have an estimated 78% share[3], which is mainly captured by four major banks. This puts banks in Hong Kong in a strong negotiating position, allowing them to charge high up-front subscription fees and ongoing trailer fees. Cost aside, the limited "shelf space" at banks restricts investor choice as well as the availability of sales outlets for asset managers.

We are acutely aware of the consequences of such concentration in product distribution. We are working to clarify the existing suitability requirement in the context of interactive communications between intermediaries and clients, as well as how the suitability requirement should be implemented across different business models (such as in the context of exchange and online fund distribution platforms and robo-advice, as well as in the more traditional brokers' channel).

We hope that by clarifying the relevant regulatory regime in relation to online funds distribution and advisory platforms, we could encourage the use of new channels for fund distribution, such as electronic and online platforms, and also broaden the channels through which products would be made available to investors.

Market infrastructure

The third prong that we have been working on is market infrastructure.

The SFC and the Government are doing a lot in this area, including working on the introduction of a new legal fund structure for "open-ended fund companies", for which we are busy preparing the draft subsidiary legislation and a related code for public consultation.

Another area that is now particularly relevant is the training and expertise of our financial practitioners, which are one of Hong Kong's greatest assets. In August 2016, the Government launched the Pilot Programme to Enhance Talent Training for the Asset and Wealth Management Sector, which provides financial subsidies for industry practitioners to attend training courses to enhance their professional knowledge and competency. The SFC, together with organisations such as the HKSI, also organise training programmes to enhance practitioners' knowledge of financial products and the regulatory regime, as well as seminars to share regulators' latest thinking.

Market development and regulation

I have covered a lot today and I haven't really talked about regulation yet. Regulation, however, is relevant to every aspect of my speech. Our vision of developing Hong Kong into a fund management and domicile centre hinges on investors' willingness to accept and invest in our funds, and for this the quality of our regulation is a key factor.

Our plan to secure mutual recognition arrangements with more overseas markets also depends on our ability to demonstrate that Hong Kong has a robust regulatory regime and that we stand ready to defend investors' interests, regardless of whether the investors are based in Hong Kong or abroad. While we are open to consider authorizing new products and opening up new product distribution channels, our first priority has always been to make sure that investors' interests and the integrity of the market are well protected. This is the thinking

[3] Risk-focused Industry Meeting Series - Asset Management: Looking Forward, SFC (January 2015)

behind, for example, the requirements that we imposed on leveraged and inverse products before we started considering them for public offering in Hong Kong.

In respect of new regulations, on 23 November we launched a consultation on our proposals to enhance the regulation of the asset management industry in Hong Kong. The proposals were formulated following a review of major international regulatory developments, and taking into account observations and views of industry stakeholders.

The proposals cover topics including commissions and independent advice, securities lending and repurchase agreements, safe custody of fund assets and liquidity management, and where needed we have proposed amendments to the Fund Manager Code of Conduct and certain Code of Conduct provisions. In particular, we propose to enhance disclosure of on-going commissions that may be received by intermediaries from product issuers (eg, the trailer fees fund managers typically pay to sales agents from their management fees) at the point of sale. Also, we are proposing that intermediaries may not represent that they are "independent" if they receive any fees or commissions from product issuers.

We often hear about the trade-off between market development and regulation. But in fact, market development and regulation go hand-in-hand, and development unaccompanied by suitable regulation would not be sustainable. Asset management is different from other sectors within the financial industry in a fundamental way. In banking and insurance, the client and the firm are in a counterparty relationship. However, in asset management, the firm is the fiduciary of the client. An asset manager has significant discretion over the money that its client has entrusted to it. In return, it is expected not only to act honestly and diligently, it is also required to act in the client's best interests.

The 2008 global financial crisis tainted the financial industry's reputation and the public's trust in it. Confidence and trust play a big part in finance, a lack of which contributes to some of the difficulties the industry is facing today. To a certain extent, the shift to passive investment reflects investors' distrust over asset managers' ability to deliver good returns. Both globally and locally, pension-related reforms have been controversial because savers feel that their money has not been well-managed and that they have been overcharged. Regulations are important because they ensure proper behaviour, which fosters trust and promotes longer-term market development. The SFC is committed to building Hong Kong into an international asset management centre. Our effort would come to fruition only if our market participants, including many of you that are here today, share our vision and act accordingly.

I hope this is a useful overview of how we see the future of Hong Kong's asset management industry. Just as importantly, I hope I have been able to demonstrate that good business ultimately depends on maintaining high standards and the development of high-quality markets. This is something we should all strive for.