

Reflect, Reset and Refocus: Game Plan for Hong Kong as an Asset Management Hub

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Nelson, honourable guests, ladies and gentlemen, good morning. It's my pleasure to speak to you today at the annual conference of the Hong Kong Investment Funds Association (HKIFA). The theme of this conference is "Re" – it's probably the shortest theme ever, and I like it. With this in mind, I title this speech "Reflect, Reset and Refocus – Game Plan for Hong Kong as an Asset Management Hub".

Reflections on market challenges in 2022

Let's start with **Reflections**. The investing landscape saw a tectonic shift in 2022 and asset managers now operate in a profoundly different environment from the past two decades. The abrupt end to zero interest rates and quantitative easing shook the markets, and this was compounded by the lingering impact of the pandemic. In many developed economies, interest rates soared to tame the inflation spurred by commodity prices and supply bottlenecks. Add to these a war in Europe, lockdowns in China and continuing geopolitical tensions.

Through most of 2022, market players found themselves in uncharted territory. Both equities and fixed income were hit hard, sending valuations lower for most public fund portfolios. Equities saw the worst year since 2008, losing 20% in value. Bond indices also recorded double-digit losses. A typical investor long in both would have lost money, regardless of allocation. Our Mandatory Provident Fund painted a similar picture, as the net asset value (NAV) of constituent funds fell more than 10% in 2022, according to the data from the MPF Schemes Authority.

A Reset

Despite this perfect storm, Hong Kong has shown resilience and seemed to have turned the corner late last year. Let me share with you a few encouraging signs for the asset management industry from the first quarter of 2023.

Firstly, for our sample of more than 400 licensed corporations with Type 9 licence, asset management income for the first quarter was flat year-on-year – a clear improvement from double-digit declines through all quarters of 2022. Secondly, the NAV of Hong Kong-domiciled funds has resumed growth since plumbing lows in the third quarter last year. NAV has rebounded for two straight quarters to US\$175 billion. Also, our fund flow data show net inflows into Hong Kong-domiciled funds for two straight quarters, totalling US\$7.5 billion¹,

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

¹ US\$3.6 billion in fourth quarter of 2022 and US\$3.9 billion in first quarter of 2023

after a mild outflow in the third quarter of 2022. This is an important gauge of investor sentiment. Thirdly, based on the HKIFA's data, retail fund sales to Hong Kong investors have put an end to five quarters of net redemption to return to positive territory.

It was as if the **Reset** button was pressed for Hong Kong at the beginning of 2023 when the city's last COVID restrictions were shed and the Mainland reopened its borders. Money market funds, short duration bonds, balanced funds and mandates from insurance companies all saw strong inflows, especially for those financial institutions with large retail networks.

But the investing terrain is still rough. Performance varies because it depends on the resilience of one's business strategies and portfolios against rate hikes and other headwinds. Asset managers have to navigate a real economy where high rates constrain credit expansion. The landscape only gets more complicated with US debt ceiling and regional bank concerns and tensions between the largest economies. However, we must not lose sight of the many opportunities driving innovation and sustainable investments. These include digitalisation, Web3 and generative AI, in addition to China's reopening.

Back when the cost of money was zero or near zero, a rising tide lifted all boats without calling for an active strategy, and you score regardless. When you are up against strong headwinds, as you were last year, playing defence is the only strategy. So far this year, the market is still fraught with uncertainty but it is showing good value at the same time. So there is a clear need to **Refocus** strategies to balance defence and offence. Moreover, with US Fed funds rate hovering above 5%, a clear strategy is essential to navigate the complex landscape, steer clear of the risks and harness emerging opportunities.

Strategy Refocused: growth in a complex landscape

Now the SFC, as a financial regulator, also needs a very clear strategy to navigate this landscape and bring Hong Kong to the next level as an international asset management hub and private wealth centre. Our strategy comprises four prongs, namely 1) onshoring, 2) platforms, 3) products and 4) technology and services.

1. Onshoring strategy – fund domicile structures

The onshoring of investment funds is one of our key strategies to develop Hong Kong as an asset management hub, as the city's biggest value proposition is in portfolio construction and management. Our efforts are bearing fruit: over the past three years, the number of Hong Kong-domiciled funds has increased 20% to more than 900. They now account for nearly 40% of all authorised funds. In the same period, more than three quarters of the new funds were Hong Kong-domiciled.

To promote onshoring, Hong Kong has introduced two new fund structures as alternatives to the trust form. The measures make it cost-effective and efficient for investment funds to set up business in Hong Kong. Tax exemption is provided for onshore private funds as in the case of offshore funds.

First, we introduced the regime for open-ended fund companies (OFC) in 2018 which was followed by enhancements such as lifting investment restrictions for private OFCs. The regime provides greater flexibility for open-ended funds to structure themselves in a

corporate form and offers profits tax exemption. OFCs can enjoy simpler set-up procedures and lower administrative costs.

Then, in 2021, the HKSAR Government launched the OFC grant scheme and the re-domiciliation regime for overseas corporate funds. Since then, interest in the OFC fund structure has surged. As of the end of March, both the number of OFCs in Hong Kong and the number of funds set up under this structure more than doubled from a year ago and we have processed four applications of private OFCs' re-domiciliation.

We expect this impetus to continue. For one thing, OFCs are covered by various Mainland-Hong Kong Connect schemes. We are now working with the Government to optimise the OFC regime in several areas, including winding-up procedures and anti-money laundering.

The second new structure is the limited partnership fund (LPF) structure, introduced in 2020. It is favoured by private equity funds and has been instrumental to building up Hong Kong as a regional investment fund centre. In addition to tax concessions, the framework provides freedom in the scope of investments and flexibility for capital contributions and profit distributions. The feedback on the new LPF structure has been very positive, especially from institutional investors, private equity and family offices in the Greater China region. As of the end of February, about 600 LPFs were registered in Hong Kong.

This year, we are also making a significant legislative change in our ongoing efforts to build up Hong Kong as an onshore asset management hub. This is the introduction of Type 13 Regulated Activity (RA) covering fund depositary services. RA 13 will take effect in October 2024 after completing the legislative process.

2. Platforms: Connect schemes with Mainland China

Next, I'll talk about "Connects" as a key platform strategy. As you know, mutual market access between the Mainland and Hong Kong is our vision and commitment for the long term. The various schemes already in place are pivotal to Hong Kong's status as an asset management hub. Many of these opportunities are only open to Hong Kong-domiciled funds, including the Mutual Recognition of Funds (MRF), ETF Connect and Wealth Management Connect. Investors in both markets stand to benefit from further coupling and product diversification.

Our strategy is to expand the sales footprint for Hong Kong-domiciled funds by building numerous conduits to reach Mainland investors. The first major breakthrough was the Mutual Recognition of Funds (MRF) scheme launched in 2015. As of the end of March, 37 Hong Kong funds were approved by the China Securities Regulatory Commission (CSRC) for sale to Mainland investors, and their cumulative net subscriptions amounted to RMB14.7 billion². For these Hong Kong funds, the MRF channel accounted for nearly half of their overall net subscriptions from the beginning of 2019 to March 2023. Asset managers from Hong Kong who participate in this scheme can build a brand name and a distribution network for their funds. This can pave the way for setting up their wholly-owned asset managers on the Mainland if they decide to do so.

In contrast to the MRF scheme, which brings fund products to Mainland investors, the Wealth Management Connect brings customers from the Greater Bay Area to the doorsteps of participating banks in Hong Kong. Launched in September 2021, Wealth Management

² In the southbound direction, 47 Mainland funds were authorised for sale in Hong Kong, with cumulative net subscription of RMB1.06 billion

Connect allows funds to tap into Guangdong Province, which has a population 10 times that of Hong Kong and a GDP similar to Italy or Korea.

For exchange-traded fund products, ETF Connect builds on the flagship Stock Connect scheme by including ETFs. ETF Connect was an instant success following its launch in July 2022. Even though only six Hong Kong ETFs are currently eligible, their daily southbound trading averaged \$1.8 billion in April and made up about 20% of their average daily turnover.

Of course, for all three Connect schemes, we see a need to scale them up, widen the scope of products and relax restrictions to create more headroom for fund flows. A lot of plumbing has been done, and we strive to bring these initiatives to new heights.

3. Products

The SFC aims to enable growth. We are keenly aware of the need to move with the times and meet investors' evolving demands by enabling more products in the market. Our current efforts centre around ESG, virtual assets and renminbi-denominated products.

On the ESG front, our main focus is on climate-resilient investment products. We aim to help channel capital flows to more sustainable areas of the economy. We also try to reduce greenwashing by ensuring products with a green label mean what they say. Despite the challenging market over the past year, it is encouraging to see the number of SFC-authorized ESG funds increase more than 50% year-on-year to 188 as of the end of March. Their total AUM was up 6% to US\$150 billion.

An immediate priority is to provide guidance to the asset management industry on how they engage ESG service providers. In the longer term, we would like to see the development of carbon credit trading, more sustainability-related innovation, and more affordable decarbonisation driven by technology.

Another key focus is virtual asset products. With rising demand for these products in recent years, we have launched initiatives to support responsible innovation and the Fintech community. We authorised the first batch of ETFs that invest mainly in virtual asset futures traded on the Chicago Mercantile Exchange. They include the world's first Ether futures ETF and Asia's first Bitcoin futures ETF. And just two weeks ago, we released the guidelines for licensed VA platform operators. As with the VA futures ETF, we put in a number of guardrails to ensure investor protection, such as requirements on admission criteria for tokens accessible to retail investors.

The development of renminbi-denominated products is an equally important priority. These products are essential to the internationalisation of the RMB where Hong Kong plays a major role. Hong Kong has many strengths in this area, and these include our deep RMB liquidity pool, range of RMB products and derivatives and our market infrastructure. We will further cement our leadership as an offshore RMB hub by promoting the trading of securities in RMB and risk-management tools like RMB derivatives. The Stock Exchange of Hong Kong will launch the HKD-RMB Dual Counter Model for stock trading on 19 June. More than 20 leading companies that account for 40% of the daily stock market turnover will participate in the first batch. Listed funds, ETFs and REITs are eligible for the renminbi counter as well. I can also say that we are working with the CSRC to include the renminbi counter in southbound Stock Connect trading.

4. Technology and services

Now, let me move from products to technology and services. When preparing for this speech, I've asked a generative AI chatbot what asset management strategy would work under high interest rates. In just seconds, the chatbot suggests short-term bonds, dividend-paying stocks, value stocks, cash and cash equivalents and diversification. The response is classic but unremarkable. Also, because the bot isn't licensed with the SFC, it tells me to consult an investment adviser.

As the AI competition heats up, technologists compare generative AI to the discovery of chips. That is to say, we are on the cusp of another revolution that will change the way we live, work and play. Some worry it may replace content-creating jobs; if uncontrolled, it may even threaten humanity, as it already spreads fake news and images.

On one level, AI and machine learning are nothing new in the financial services space. Asset managers have used AI to construct portfolios, generate big data analytics, perform risk management, and increasingly, communicate with clients. As an information aggregator, AI can outperform any human brain but its output merely averages past experience and deals with "known unknowns". Clearly, this makes the human brain more valuable when it comes to strategic decision making and dealing with the "unknown unknowns".

Every one of us must learn how to work and live with AI. Early signs of AI playing a role in productivity gains abound. Over time, these may translate into growth of AUM and other business metrics. AI is fast gaining traction and will soon proliferate around us as it wins over skeptics by streamlining the routine work of financial advisory, portfolio construction and big data processing. It will free up time and capacity for asset managers to better strategise and perform.

More generally, technology and digital tools must be leveraged further to improve the clearing and settlement processes for funds as well as investor experience. In this area, the SFC embraces technology and is open to the idea of fund tokenisation going forward.

I believe generative AI can be used responsibly to augment, rather than replace, asset managers in strategic decision making. As a regulator, the SFC is guided by our philosophy to promote the responsible deployment of technology as long as it enhances market efficacy and transparency, cost savings and investor experience. However, at this stage, firms must take its output with a grain of salt, stay alert to AI-related risks and make sure clients are treated fairly. We expect licensed corporations to thoroughly test AI to address any potential issues before deployment, and keep a close watch on the quality of data used by the AI. Firms should also have qualified staff managing their AI tools, as well as proper senior management oversight and a robust governance framework for AI applications. For any conduct breaches, the SFC would look to hold the licensed firm responsible—not the AI.

Closing

In closing, I'd like to circle back to what I said earlier about the need to balance defence with offence. So far in 2023, we see signs of improvements. I have shared the SFC's four-pronged game plan to pursue a fund onshoring strategy, build Hong Kong as the premier gateway to Mainland China, diversify investment product offerings and embrace technology to enhance financial services and returns. I trust you have made your own game plan, so please keep your eye on the ball, and seize your chances to score when they arise.

Ladies and gentlemen, we have reflected, reset and refocused our strategy. I wish I could say you can relax in anticipation of a rebound in revenue. But unfortunately, the road to



recovery remains bumpy with economic headwinds and headline risks. That requires all of us to stay vigilant and, to use my favourite “Re” word, **Resilient**.

Thank you.