Update on the SFC's Asset Management Strategy for Hong Kong

HKIFA Luncheon

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19 September 2018

First, I would like to thank the Hong Kong Investment Funds Association (HKIFA) for inviting me here today. The last time I spoke at this event, I explained what we were doing to help Hong Kong develop as a global, full-service asset management centre.

That was more than two years ago, so an update is well overdue.

Looking at the latest figures, the overall fund industry in Hong Kong is doing well. Our data for 2017 showed strong growth in total assets under management, with overseas investors accounting for a large share of fund inflows.

There was also another increase in the number of firms licensed for asset management. This implies more competition – and even more members for the HKIFA.

But there is always more to do as Hong Kong pursues its ambition as an asset management hub.

So today I will touch on where we are on mutual market access arrangements, retail distribution, derivative funds and, lastly, some thoughts on green finance.

Mutual Recognition of Funds

I will start with our initiatives around mutual market access. I know that for many of you, the ability to market funds outside of Hong Kong is a priority, especially in the Mainland.

We now have a number of these arrangements in place or under discussion with other countries, but the Mutual Recognition of Funds (MRF) agreement with the Mainland is still the most important.

When this was signed in 2015, it was the first time that funds from outside the Mainland had a real opportunity to sell to Mainland investors.

This kind of arrangement had no precedent, and we started in the expectation that it would take time to get up to speed. Three years on, things are on track. However we fully agree that the scheme merits further development.

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

We have therefore been in close contact with the China Securities Regulatory Commission (CSRC) not only to ensure the programme continues to operate smoothly, but also to discuss the way forward.

One topic which is frequently discussed amongst the fund industry relates to the approval process for “northbound” Hong Kong funds. This has in fact speeded up over the past year, with seven Hong Kong funds being approved over the past 12 months.

And of course it is relevant that the volume of northbound sales is still significantly larger than southbound sales, although this gap has been closing significantly in the last year. We will continue discussions with the CSRC about this, but we are confident that the accelerating trend of approvals will continue.

Now I have said that we recognised at the outset that MRF would take time to develop and we knew that this was not just about regulation. It was clear that the distribution capacity for these products in the Mainland could not be created overnight.

But as MRF is the only real route for foreign-branded public funds to be sold there, in my view it remains a key programme that we will continue to pursue very energetically.

Its value will become even more obvious as new products are developed and new investment channels open up. For example, you will have seen that the CSRC recently released rules relating to new Mainland pension investment funds. The first of these will adopt a fund-of-funds model and the CSRC has specifically allowed them to invest in Hong Kong funds through the MRF channel.

And just over a month ago we introduced the Open-ended Fund Company (OFC) structure in Hong Kong. Again, we expect that OFCs will take time to gain traction – after all they represent a choice for fund managers which some will take up, and others won’t. But of relevance to this choice is the fact that we are now exploring making these funds eligible for inclusion in MRF.

I should also mention that OFCs are already eligible under our MRF with Switzerland and we will also work to include them in MRF agreements with other jurisdictions.

Another industry conversation we have been alive to is that relating to overseas delegation. The issue here is that under current rules a manager of a Hong Kong MRF fund cannot delegate its investment management functions to anyone outside of Hong Kong.

This requirement was put in place because we explicitly wanted to promote on-the-ground growth of local investment expertise. This was part of the broader aim of developing Hong Kong as a full-service international asset management centre.

I should say here that although managers of Hong Kong MRF funds are not allowed to delegate, they can still appoint overseas sub-advisors. Nonetheless, we are well aware that the delegation model could be more efficient, particularly for large fund houses with a global presence.

One major consideration here is the recent growth of global strategy funds domiciled in Hong Kong. In light of this, we are now actively re-evaluating the delegation policy, including whether it might be allowed for these global and non-Asian funds. We plan to discuss this issue with the CSRC in due course to see whether this might be included as part of the MRF model.

We have also heard from many in the industry about the 50% sales limit for MRF funds. This is the rule under which Mainland investors cannot hold more than 50% of the value of an MRF fund's total assets.

We are well aware of the arguments in favour of relaxing this limit. But as things stand right now, the total value of Hong Kong funds sold to Mainland investors under MRF is still well below 50%.

However, we will certainly keep an eye on how MRF develops and take the point up with the CSRC at the right time. So in this area I would encourage the HKIFA and its members to keep a close eye on the numbers and any changes in market structure as further data points for us to consider.

Exchange-traded funds (ETFs)

A related possibility in which many of you have an interest is "ETF Connect". Amongst other things, opening up this channel should be of relevance to big Mainland wealth managers and pension funds who may wish to allocate more assets globally.

We have been working very hard with the CSRC and the Hong Kong and Mainland exchanges to make this happen. As with many things involving the potential further opening up of the Mainland market, it has been very challenging to resolve the operational, legal, clearing and settlement issues.

These issues are more complex than they may first appear. Questions have also been raised about whether the costs may outweigh the benefits, which in turn may depend on the types of ETFs eligible to qualify. We will, however, keep working hard to resolve the outstanding issues to achieve this further expansion of Stock Connect.

Retail fund distribution

I now want to touch on what has become a familiar theme – problems with the distribution of funds to Hong Kong retail investors.

It has been obvious for some time that the distribution chain is extremely concentrated when compared with other global markets. There is also a lack of product diversity. It has been widely reported that in Hong Kong about 80% of retail funds are sold through banks and 70% of all sales are made by just three banks.

This raises a number of familiar concerns: limited investor choice, lack of market competition, high barriers to entry for fund managers and products as well as high trailing commissions and costs.

Some of our recent reforms could help. We have enhanced point-of-sale transparency about conflicts of interest. We also introduced new rules governing the use (or abuse) of the term "independent" by intermediaries. New guidance has been issued on the design and operation of online distribution and advisory platforms. And we have consulted the market about equivalent rules for face-to-face distribution.

And I should be clear that we are keeping overseas developments in this area under careful review, including the longer-term effects of the Retail Distribution Review in the UK as well as the MiFID[1] II reforms.

But these improvements will only have a limited effect absent deeper structural changes to the distribution chain.

Along these lines, many of you will be aware that we have been exploring the feasibility of an exchange-based, business-to-business online fund distribution platform.

This promises significant benefits. It would provide much better access to “shelf space” for product distribution. It would introduce a measure of standardisation and automation which could improve operational efficiency and make it possible to send information to investors more easily and transparently. There is also the potential for fund managers to use the platform to launch new financial technologies.

At the same time, we understand that the industry has some reservations. Not least, there are no successful examples of this idea in any overseas markets. It is also likely to take some time before brokers who are new to the funds market can be ready to join. There are concerns that the platform may disrupt existing distribution arrangements, and that the consequences of this are unknown.

There are also legitimate worries about the costs of setting up and running the platform as well as the potential take-up and utilisation rates by fund managers and distributors.

So I should be clear that it would be very difficult for this project to move forward successfully unless there is demonstrable commitment and buy-in from the industry.

We nevertheless remain optimistic about the potential of this project. So, in order to bring discussions to a head, we are pushing for the finalisation of a concrete model with a view to conducting a robust cost-benefit analysis and validation assessment with the industry. This evaluation would also need to take into account new market developments, including the new virtual banking channel.

UT Code Review

Last December, we launched a Consultation on Proposed Amendments to the Unit Trusts Code.

Major feedback from the fund industry focussed on our proposals about funds which use derivatives, specifically whether they will be subject to enhanced distributor obligations as derivative or complex products.

Our original proposals were aimed at providing clear guidance on the treatment of investments in derivatives by retail funds, and this took account of retail investors’ expectations for plain vanilla funds. We also sought the views of fund distributors.

[1] Markets in Financial Instruments Directive.

In the past few months we have been working with the industry to identify when the use of derivatives could reasonably be considered as risk mitigation, including hedging and netting, or gaining efficient market access, without creating "real" leverage in funds.

This has not been easy. Derivative strategies can be terrifically complex, types of derivative instruments vary widely and hedging assumptions are often subjective. In fact one of IOSCO's[2] major projects is to try to pin down a consistent global measure of leverage in funds – an apparently simple goal which has revealed a host of challenges about different or patchy data sources and unclear methodologies.

We continue to believe, therefore, that a clear, overall limit on derivatives investments by plain vanilla retail funds is necessary.

We now think that good progress has been made in reaching a consensus. This includes the circumstances where derivatives usage could reasonably be excluded from the overall limit of a fund's net asset value (NAV). In our original proposal, plain vanilla retail funds' derivatives, excluding netting and hedging, would have been subject to a limit of 50% of the fund's NAV. We are now working on final refinements to identify those derivatives which would be excluded from this limit – basically those that are not used for leverage in order to amplify returns. We plan to issue consultation conclusions before the end of the year.

Before then, we will also issue guidance to include examples as well as criteria for excluding some derivatives from the investment limit.

We will also publish a list of SFC-authorised derivative funds so that distributors can clearly identify which are subject to additional suitability assessments.

Green finance

I just have time to touch on one more topic. With the extreme weather we have been seeing around the world (not least on Sunday in Hong Kong), climate change and global warming is back in the headlines. It has also given new impetus to an old debate about responsible investing.

Investors increasingly recognise that strong environment, social and governance (ESG) standards are a proxy for overall management quality and long-term sustainability. Companies with high ESG standards are likely have less exposure to environmental accidents or regulatory breaches which could impose significant costs and harm their brand reputation or other intangible assets.

At the same time, many studies have now found that ESG factors actually boost risk-adjusted returns, and at worst only have a neutral impact.

Growing interest in this area has created a situation where more investors want in, but there is a lack of truly sustainable investment opportunities.

With these trends in mind, the SFC has been looking closely at global developments in green finance and what they may imply for Hong Kong.

[2] International Organization of Securities Commissions.

First, it is evident that more countries and regions are pursuing serious, detailed green finance agendas. The Mainland regulators issued their “Guidelines for Establishing the Green Financial System” in August 2016. The European Commission came out with a very ambitious Action Plan on Sustainable Finance in March 2018. These are only two of many examples.

It is easy to see how Hong Kong is ideally positioned to align with the Mainland’s green finance initiatives, and also to connect the green finance flows between the Mainland and the rest of the world. Our overall view is that although much work has been done in the area of green bonds, other important areas of green finance have been neglected. We need to catch up to become a leader in a hitherto niche area which will be shortly become an important component of mainstream finance.

So what are the main areas we are looking at?

First, environmental disclosure by listed companies. Asset managers have told us that they need quality ESG data from companies that is comparable in order to make better investment decisions. The Mainland is moving towards mandating that listed companies make environmental disclosures in 2020. We should not be far behind – ideally in lockstep or ahead.

Second, we are examining asset managers’ integration of ESG factors into their own investment processes. Asset owners are becoming more vocal in asking ESG-related questions as part of hiring or retaining asset managers, and the “E” element of this is becoming dominant.

It is no longer enough for asset managers to simply make the claim that they take ESG factors into account, without disclosing a robust methodology to investors. French regulators have already enacted far-reaching legislation to address this, and there are signs that this has already driven behavioural changes far beyond France.

Another advance is that countries are now developing consistent disclosure or labeling guidelines for green investment products. The SFC has already authorised 21 funds which focus on climate, green, environmental or sustainable development, and new applications keep coming. We will therefore be evaluating ESG disclosures more closely, and aim to engage with the industry on this front a little down the track.

Thank you.