MAKING SENSE OF MUTUAL RECOGNITION

Our panel discussed the benefits of passporting regimes, the role of Ucits in Asia and the disruptive effect of Alibaba. Chaired by Alan Chalmers and George Mitton in Hong Kong.

THE PANEL

DR KING AU
chief executive officer, Bank of China Hong Kong (BOCHK) Asset Management

NATHAN LIN
chief executive officer, GF International Investment Management

PHILIPPE SEYLL
member of executive board, head of investment fund services, Clearstream

IAN STEPHENSON
global head of fund services, HSBC

FANNY WONG
head of custody, Bank of China (Hong Kong)

SHELLEY YANG
managing director, head of international business, China Universal Hong Kong

Photography: Al Ling

Funds Global: What should asset managers do to prepare for mutual fund recognition between Hong Kong and China? What is the potential opportunity and what are the obstacles to overcome?

Nathan Lin, GF International: The biggest opportunity for us is that, for the first time, we would be able to advertise China-domiciled funds in Hong Kong. Under the current regulations in Hong Kong, we cannot make any reference to funds that are not authorised by the SFC [Securities and Futures Commission].

This is important because GF International was only established in 2010. Although the parent company is well known in China, we are a newcomer in Hong Kong and we face a branding issue. Mutual recognition will help us with branding and marketing.

Another difficulty we faced when we launched was that institutional investors weren't interested in strategies that only had a small asset base. Under mutual recognition, we can bring some of our larger funds here, which may be 10 billion renminbi under management or more.

King Au, BOCHK Asset Management: Some rules are yet to be clarified. For example, whether these Hong Kong-domiciled funds have to be physically managed in Hong Kong has not been clarified, nor whether internal outsourcing is possible.

For funds that invest overseas, it would initially be challenging to manage them out of Hong Kong.

> **AS A LOCAL PLAYER, WE HAVE AN ADVANTAGE BECAUSE WE UNDERSTAND THE CHINESE MARKET MENTALITY. THE CULTURE GAP GIVES US AN EDGE.**
>
> *Shelley Yang, China Universal Hong Kong*

The Hong Kong fund management industry is, up till now, mainly dominated by sales and marketing, and the manufacturing base is limited to basically Hong Kong, the mainland of China and Asian capabilities.

Fanny Wong, Bank of China (Hong Kong): Bank of China (Hong Kong) is part of a joint working group run by the regulators on both sides, so we have some information about this programme. Most of the details are not yet disclosed, but there are several things asset managers can do to prepare.

Hong Kong firms will have to consider if they have potential partners, such as external distributors, legal representatives, master agents and so on, to help build their brand identity in China. They also need to get an understanding about the local market practices, the unique requirements in China, and so forth, and must consider whether their existing products will be good enough to compete on the other side of the market.

Asset management companies of Chinese background may have more complex considerations – whether they have suitable products that can compete onshore; whether Chinese funds coming to Hong Kong would have any impact on their existing funds (structured under the RQFII/ QFII regime and focusing on the Greater China concept); in particular, whether funds from their parent companies would have any impact on their brand identities by confusing investors or generating synergies for the group as a whole. This would require some planning ahead.

Ian Stephenson, HSBC: We're assuming the rules will require there to be some substance in Hong Kong. That may mean some elements of manufacturing, but certainly operations. In either case, it's an opportunity for us as a service provider and, in terms of our existing clients, international managers in particular – we are seeing a lot of activity. Some are incorporating funds in Hong Kong or even changing the domicile of their funds, for example, from the Cayman Islands to Hong Kong.

According to SFC statistics, there was an almost 50% growth in the number of Hong Kong funds from March 2013 to March 2014. Clearly, managers are gearing up. The point about track record is important, and people are having to anticipate the rules, because my understanding is a one-year track record is needed to sell the product.

I agree that branding will be an issue in both countries. However, there's no doubt that international managers see huge potential in China, given the vast population and savings rate that exists there.

» THERE WAS AN ALMOST 50% GROWTH IN THE NUMBER OF HONG KONG FUNDS FROM MARCH 2013 TO MARCH 2014. CLEARLY, MANAGERS ARE GEARING UP. «

Ian Stephenson, HSBC

Shelley Yang, China Universal: Like other big Chinese asset managers, we have a platform of about 50 products, which is not fully open outside China. So this is a good opportunity, that mutual recognition and all these type of passporting programmes allow Chinese asset managers to bring their expertise outside China.

There are questions over the legal infrastructure, qualification and the priority issue that are in aggregation needed to reconcile with multiple parties – all this means Stock Connect has taken some of the momentum ahead of mutual recognition.

Stock Connect provides open access at the security level, so individual institutions can fully pick whatever they want to invest. But mutual fund recognition will provide an investment vehicle which is managed by asset managers, providing professional inputs on the investment. So, it's a different theme.

Philippe Seyll, Clearstream: One important thing that hasn't been mentioned is trust. After mutual recognition, foreigners will have to put their money not in Hong Kong but in a new territory, something that foreigners don't know. What's important for mutual recognition is that the infrastructure provides guarantees that when you put your cash into a vehicle, the vehicle is liquid, and when you want to get your cash back, you're going to get it.

Funds Global: Is it likely that Ucits funds will gain inclusion in the Hong Kong-China mutual fund recognition scheme in future? How do you see fund passporting developing?

Stephenson: It's going to take time

for that to happen. It would require interaction with a lot of different regulators, and that will not be easy with the Ucits regulators in Luxembourg and Ireland.

Wong: It's a two-way street. It also depends on whether the EU would be ready to accept China and Hong Kong funds. The current programme is a good example showing how bilateral flows can work in passporting, rather than multilateral flows, which will take a long time to achieve.

Au: If and when China opens up, it will provide the critical mass for mutual recognition and, hopefully, some of these Asian passporting concepts. Then, we will be in a much better bargaining position to request a similar concept of mutual recognition with Ucits.

Right now, if you look at Hong Kong, Ucits funds account for something like 90% of the market. European regulators don't have an incentive to open their markets to Hong Kong-domiciled funds, given the dominance of Ucits in Hong Kong.

Lin: Both the regulators in Hong Kong and China have a vision for this scheme to become a truly regional passport instead of a China-Hong Kong one.

Hong Kong will be the first step, then probably Taiwan and Korea can join, because they are some of the biggest retail fund markets in Asia.

Right now, we have different working groups. We have this Hong Kong-China plan, and we also have an ASEAN [Association of Southeast Asian Nations] one, and we also have the Taiwan market in discussion with the Australian market. We don't need three regional passports, we only need one. So, if this Hong Kong-China mutual recognition proves to be a success, the other market players may join in.

» TRUST IS IMPORTANT. AFTER MUTUAL RECOGNITION, FOREIGNERS WILL HAVE TO PUT THEIR MONEY NOT IN HONG KONG BUT IN A NEW TERRITORY, SOMETHING THAT FOREIGNERS DON'T KNOW. «

Philippe Seyll, Clearstream

Stephenson: The point about the manufacturing is important because, clearly, if that is part of the guideline, that's going to be a constraint. That would support Ucits funds, given the global nature of those products.

The progress with mutual recognition has been rapid. Other regional fund passporting initiatives, like the ASEAN or Asia-Pacific Economic Co-operation (Asia Region Funds Passport) schemes, have made little headway due to tax issues – and the lack of common currency and investor protection, among other things, limit the potential of such plans.

Wong: On the earlier point about market infrastructure, I would echo that for passporting to be successful, it requires the right infrastructure to be set up. I am optimistic that the mutual recognition programme could be one of the catalysts to make the Hong Kong market more paperless, in terms of fund servicing. That would improve efficiency.

Lin: Let me mention an interesting example on that point. In China, the account-opening process for our e-business is very simple. Anyone who has a bank account can open an account with us, and the whole process takes five minutes, because we believe that, if you have a bank account, then the bank has done its KYC [know-your-client compliance process]. We are comfortable with the KYC process of the bank, so to some extent we rely on it. As a result, e-commerce business ballooned in China, not just for us, but for the big players in the market.

Yang: Like the US, China is a home-based market. Investors tend to invest locally. Technology does provide a good facilitation for us. However, with a big home market, it's easier to be in compliance with our regulations. With multiple different regulators involved, it's more challenging to have multiple passporting – better to start one-on-one relations.

Funds Global: We've seen asset managers wake up with the Alibaba phenomenon, and all of a sudden, e-commerce has come to the fore in their minds. How will this change the market?

Seyll: Just two points on e-commerce and Alibaba. Alibaba found itself in a hot situation. They didn't plan to build an e-commerce financial system. They had a pile of cash and they

came up with a way to make use of it.

Secondly: that they were paying 6% was impressive, but the point is, were they successful in selling other products, or getting flows through their e-commerce financial platform? No.

In Europe, we say that funds are sold rather than bought, and I don't see any evidence that it is different here.

Lin: While I have every respect for the innovative ideas of Alibaba, I don't see them as our competitor. It seems to me that the Alibaba model is a competitor for the banks, or for the traditional distributors, rather than for managers. The core competency of an asset manager is its manufacturing capacity. Alibaba was acting as a distributor rather than a manufacturing house.

Alibaba has an advantage over the banks, because if you want to buy a mutual fund in a bank, the minimum you can subscribe is 1,000 renminbi ($160). For Alibaba, because of the nature of its business, you can put together even a few dollars and invest the money in the money market fund.

For us, our true competitors would be firms such as China AMC, Harvest, China Universal.

Funds Global: Initial trading volumes on the Shanghai-Hong Kong Stock Connect were relatively low, with many investors opting to wait and see. What must happen for trading volumes to rise? What is the outlook for the scheme?

Stephenson: Stock Connect worked on day one. There are some well-known processes that make it tricky to invest – the settlement process, for instance – but these are being reviewed and amended. We think the scheme was a success.

In terms of Ucits, European regulators are beginning to take the view that the risk is relatively minimal, and that trustees will be more inclined to allow investment through that route.

Yang: The flow of transactions is pretty healthy. It's a successful programme, adding another layer of access to China to the world. Regulators have recognised the operational issues and, now the first Ucits product was recognised by the CSSF [Commission de Surveillance du Secteur Financier, the Luxembourg regulator], it should lead to more understanding on this issue.

Lin: One of the major reasons why MSCI dropped the idea of including China A-shares in its emerging market index was that, at the time, not many international players had a RQFII [renminbi-qualified foreign institutional investor] quota.

Leading global managers were also a bit concerned over the whole quota allocation process, transparency, and how much quota goes to whom.

But with Stock Connect in place, and going well, and with the expectation for Shenzhen to be included, the major index companies will have more reasons for inclusion.

» HONG KONG WILL BE THE FIRST STEP, THEN PROBABLY TAIWAN AND KOREA CAN JOIN, BECAUSE THEY ARE SOME OF THE BIGGEST RETAIL FUND MARKETS IN ASIA. «

Nathan Lin, GF International Investment Management

Funds Global: Is the market becoming more comfortable with the custody arrangements in Stock Connect?

Wong: Not necessarily. The stock exchange is working on an initiative to address those. The latest model would include special segregated accounts to address the issue about pre-delivery. But it hasn't addressed the beneficial ownership issue, about collective ownership of a bunch of A-share holdings by a common nominee. Whether that sort of ownership can be proven in a PRC [People's Republic of China] court is yet to be seen.

However, we have to remind ourselves that Stock Connect merely aims to build a trading link. It has achieved its objectives already. Whether it has a lot of volume or not is driven by profit-making opportunities.

Au: Apart from the ownership issue, there are also regulatory requirements that fund managers have to comply with, such as revamping the prospectuses to put in place the new risk-disclosure statement. That takes time. Also, from an investment perspective, there isn't an urge to go into A-shares right now, especially given the strong market rally since last October. That has prompted a lot of institutional investors to reconsider their China exposure.

Funds Global: How important are Ucits funds to your business? Do you see them as a mark of credibility in asset management, or do you think the cost of launching Ucits funds outweighs their value?

Lin: If we are going to tap into the European market as a newcomer, no doubt Ucits is the way to go. We're in the process of setting up two Ucits strategies and we hope to get the funds out in the middle of the year.

Au: If you want to access Europe, you have to have a Ucits fund range. However, instead of setting up our own platform, we have chosen to work with our distribution partner, Citibank, on a co-branded fund.

We believe finding the right distributors in Europe is very important. Setting up a Ucits platform is just a matter of cost, but having access to markets is about distribution, and that's why we decided to work with Citibank as our distribution partner.

Yang: We launched our first Sicav last year. Although it's expensive, that investment in money and time is necessary to get distribution and client access.

In terms of distribution, we use a different model. We rent our local partner's compartment with our own brand.

Stephenson: A number of Chinese firms came to Europe about three years ago, people like China Asset Management, and they didn't really get traction. The big issue was distribution and differentiating themselves in the marketplace.

There's certainly a second wave coming, and it's going to grow as China moves towards MSCI recognition. From a global player's point of view, it's probably one of our most active pipelines.

» A SINGLE PASSPORT IS SOMETHING STILL FAR AWAY. MUTUAL RECOGNITION IS SOMETHING IMMINENT. SO WE CATCH WHATEVER WE CAN AT THE MOMENT. «

Fanny Wong, Bank of China (Hong Kong)

It is quite complex to establish some of these products. Every client that comes along starts something different. For us as a service provider, we've got a lot of R&D going into this. Also, Chinese asset managers are learning Ucits products from their European counterparts and service providers, so there's a learning curve. Certainly, it's our most active area of development – connecting Chinese managers with Luxembourg, Dublin, UK.

Seyll: One question on Ucits and mutual recognition. They don't seem to connect. Is there a tension between the two?

Wong: At this stage, it's too early to tell how the whole ecosystem will evolve. But a single passport, as mentioned, is something still far away. Mutual recognition is something imminent. So we catch whatever we can at the moment.

Lin: Ucits funds make up a big proportion of the industry in Hong Kong. The regulator here has a kind of fast-track arrangement – a recognised regulatory regime list, which includes five or six jurisdictions. Both Luxembourg and Dublin are on the list but unfortunately the People's Republic of China is not one of them. As far as I know, this arrangement is not reciprocal, which means that Ucits do not have any fast-track arrangement for Hong Kong-domiciled funds.

Even with mutual recognition between Hong Kong and China, a fund authorised in Hong Kong can't be sold in Europe. So there's a disconnection here.

Seyll: When the first Ucits came through, no one believed it would be a success – apart from Luxembourg. Now, there are envious countries such as France, Germany and so on, which would

have loved to be at the centre of the scheme, because we're talking about serious money, tax levies and so on. For Asian markets, there's a big potential.

Lin: Yes, it is in the best interests of the Asian countries to have a passporting system, but there are many difficulties to overcome before they can bring out a unified one. The challenges for the Asian countries are much bigger than for the European countries because, after all, they have a single currency zone. And tax will be another major issue.

Seyll: But that was the case in 1990 when the Europeans started Ucits. We didn't have one single currency, and the differences in taxation are still an issue.

Yang: Mutual recognition between China and Hong Kong is a unique process because it's within one country, just between two different markets. The fundamental value of Ucits in the Asian countries, especially China or Hong Kong, is to get access – brand-wise and solution-wise – to Europe, between different country and market. Those are two different things.

Funds Global: How does the internationalisation of the renminbi support the growth of Asia-based asset managers? Can this trend aid such firms as they seek to build a global business?

Yang: As a local player, we have an advantage because we understand the Chinese market mentality. The culture gap gives us the edge to understand the market.

Wong: This is one of the most important policies of China. The offshore renminbi market is moving from the Asian time zones towards the US time zone.

You see all those offshore renminbi centres now being designated, and the renminbi is now the fifth-largest payment currency in the world. That means offshore renminbi is accumulating outside of China, and there's a natural need for investment opportunities. That's why there are so many renminbi bonds being issued globally.

Au: The tipping point is when energy and commodities are quoted in renminbi. Qatar became the first renminbi clearing centre in the Middle East. That has a significant implication, because China imports more than 30% of its LNG [liquefied natural gas] from Qatar. I don't think setting up the first offshore renminbi bond market in the Middle East is a top priority for Qatar.

Look at Russia, too. Because of the trade embargo, China could surpass Germany as the largest consumer of Russia's natural gas in a few years' time. It's only natural for China to demand some of these energy contracts be settled in renminbi.

» CHINA COULD SURPASS GERMANY AS THE LARGEST CONSUMER OF RUSSIA'S NATURAL GAS IN A FEW YEARS' TIME. IT'S ONLY NATURAL FOR CHINA TO DEMAND SOME OF THESE ENERGY CONTRACTS BE SETTLED IN RENMINBI. «

King Au, Bank of China Hong Kong Asset Management

Seyll: We bet on it too. We have an MOU [memorandum of understanding] between Deutsche Börse and Bank of China. Deutsche Börse is the largest stock exchange in the world, and striking a partnership with a commercial bank on a specific market is not something we do every day. There's something strong behind it – this is the surge, or the expected growth, in renminbi.

Wong: This is a win-win scenario. Not only for the Asian managers, but also for global managers, which can consider adding renminbi into their existing funds, or can even replicate their successful products in renminbi alone. fg