Unlocking the Greater Bay Area potential for Hong Kong and mainland fund managers

Recommendations from the 2018 HKIFA and EY joint survey of the Hong Kong asset management industry

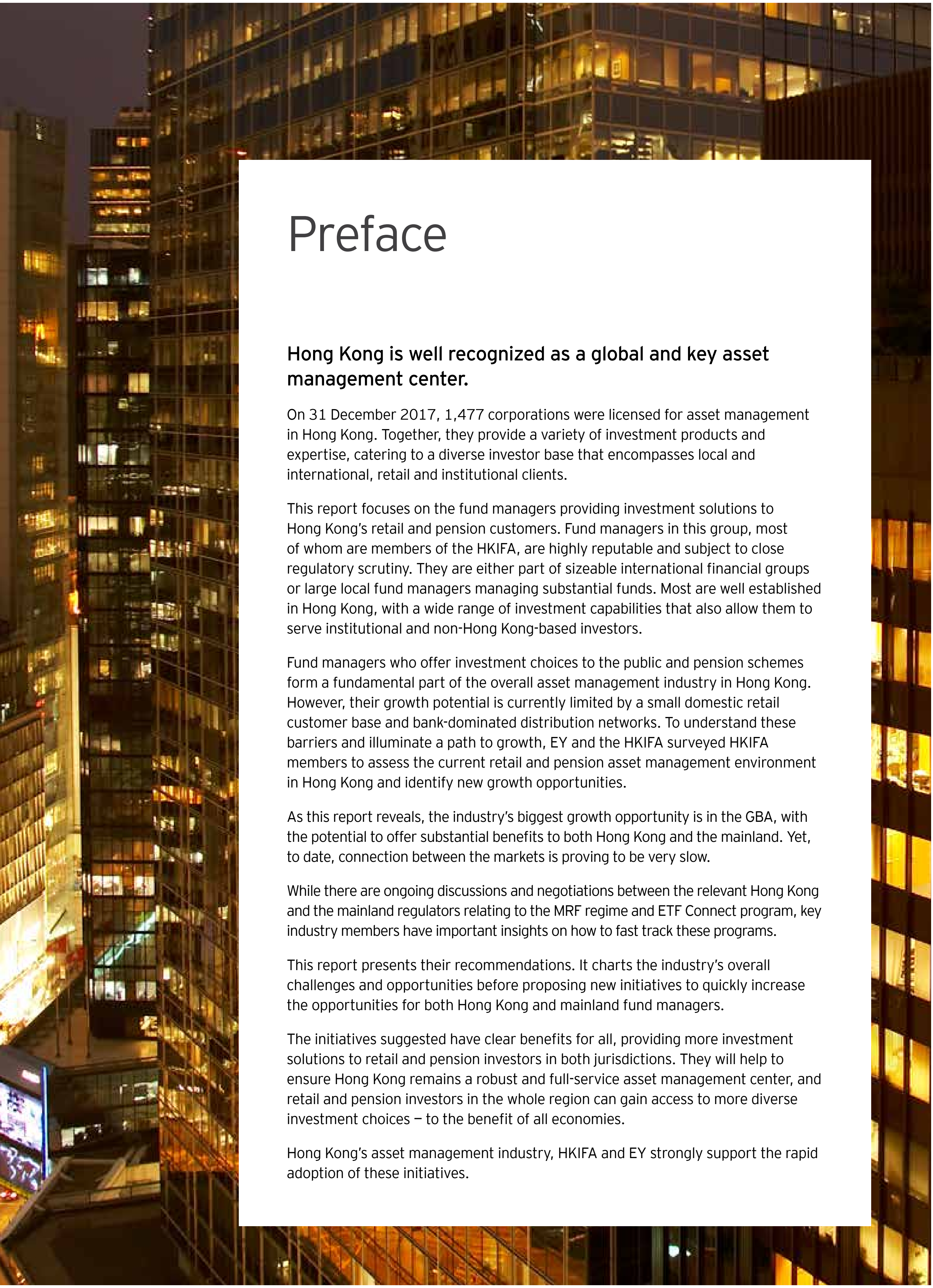
HKIFA 香港投資基金公會

EY 安永

Building a better working world

Contents

Thank you to all our survey respondents for their inputs, and to the executives who kindly agreed to be interviewed for this report. We hope our findings will prove useful to understand the challenges and opportunities facing the retail and pension asset management industry in Hong Kong, and to contribute to its development in the coming years.



Preface

Hong Kong is well recognized as a global and key asset management center.

On 31 December 2017, 1,477 corporations were licensed for asset management in Hong Kong. Together, they provide a variety of investment products and expertise, catering to a diverse investor base that encompasses local and international, retail and institutional clients.

This report focuses on the fund managers providing investment solutions to Hong Kong's retail and pension customers. Fund managers in this group, most of whom are members of the HKIFA, are highly reputable and subject to close regulatory scrutiny. They are either part of sizeable international financial groups or large local fund managers managing substantial funds. Most are well established in Hong Kong, with a wide range of investment capabilities that also allow them to serve institutional and non-Hong Kong-based investors.

Fund managers who offer investment choices to the public and pension schemes form a fundamental part of the overall asset management industry in Hong Kong. However, their growth potential is currently limited by a small domestic retail customer base and bank-dominated distribution networks. To understand these barriers and illuminate a path to growth, EY and the HKIFA surveyed HKIFA members to assess the current retail and pension asset management environment in Hong Kong and identify new growth opportunities.

As this report reveals, the industry's biggest growth opportunity is in the GBA, with the potential to offer substantial benefits to both Hong Kong and the mainland. Yet, to date, connection between the markets is proving to be very slow.

While there are ongoing discussions and negotiations between the relevant Hong Kong and the mainland regulators relating to the MRF regime and ETF Connect program, key industry members have important insights on how to fast track these programs.

This report presents their recommendations. It charts the industry's overall challenges and opportunities before proposing new initiatives to quickly increase the opportunities for both Hong Kong and mainland fund managers.

The initiatives suggested have clear benefits for all, providing more investment solutions to retail and pension investors in both jurisdictions. They will help to ensure Hong Kong remains a robust and full-service asset management center, and retail and pension investors in the whole region can gain access to more diverse investment choices — to the benefit of all economies.

Hong Kong's asset management industry, HKIFA and EY strongly support the rapid adoption of these initiatives.

Key findings

What’s stopping retail AUM growth?

Respondents cite a limited retail investor base and the dominance of banks as the main distributor as the two key challenges stymying the growth of their retail AUM in Hong Kong. They also mention distributors’ protracted and time-consuming process for selling funds.

They say that, although Hong Kong is a key financial hub with easy access and robust infrastructure, it is a relatively costly base to provide comprehensive investment management services from, compared with other Asia-Pacific locations. For the majority of respondents, expenses in business development, risk and compliance, and investment portfolio management have increased by more than 10% over the last three years, with more than 50% of respondents experiencing between 10%–50% higher costs.

Despite these challenges, many respondents express confidence in Hong Kong as an asset management center. They remain committed to maintaining their existing presence, but are mindful that Hong Kong must compete with other regional centers for additional resources.

Where will new growth come from?

Most respondents are investing, or plan to invest, in financial technology (FinTech) in the near future, with different firms in various stages of development. Such developments are usually driven and supported by their overseas offices. Robo advisory, online platforms and account opening automation are common areas of focus.

Fund managers are also aware that more online platforms and opening up distribution through insurance agents will improve efficiency and distribution coverage. However, they believe that such developments will require time and more investor education.

In contrast, most respondents have high expectations that in the next three years, the mainland will be the key source of AUM growth for asset management businesses based in Hong Kong, in terms of investment management, advisory services and distribution.

The industry proposes new initiatives to foster growth

Respondents greatly appreciate the initiatives undertaken by the SFC and the HKEX to foster growth, in particular: the Mainland-Hong Kong MRF regime; the Stock and Bond Connect programs; the proposed launch of active ETFs and the ongoing discussion of the ETF Connect program.

However, the industry can also see many difficulties in implementing these initiatives. Access to the retail mainland market via the MRF regime has been gradual, with eligibility requirements limiting the efforts of global managers to leverage their expertise. This hampers the growth of AUM.

Respondents believe there are important opportunities to grow the asset management industries in Hong Kong and the mainland by leveraging the GBA initiative, which will unite Hong Kong, Macau and the cities of Guangdong's Pearl River Delta in terms of capital, people, goods and services to create an interconnected region.

The industry specifically recommends Hong Kong and mainland regulators collaborate to:

1. **Expedite and enhance the MRF initiative between Hong Kong and the GBA**

   This will involve:

   - Shortening the northbound approval process of each eligible Hong Kong domiciled fund for sale within the GBA by the mainland regulators to three months, in line with the average reciprocal processing time by the SFC under the MRF
   - Relaxing the 50% sales limit that can be held by investors in the host jurisdiction, which reflects the differences in population and size of the jurisdictions
   - Allowing Hong Kong-based fund managers to delegate investment functions to their overseas managers within the same group company, enabling investors within the GBA to benefit from global expertise

2. **Launch the ETF Connect program between the HKEX and the SZSE**

   As coordination between just two exchanges would be relatively easily to manage, this could be done quickly as an initial phase of the ETF Connect program. It would allow investors to benefit from more investment choices with these low-cost and liquid investment products.

3. **Enlarge the investment scope of the pilot income tax deferred pension insurance product initiative under the mainland's third pillar pension system**

   The scope would include approved northbound funds under the MRF regime and existing APIFs under the Hong Kong MPFA. APIFs and northbound approved funds under the MRF regime are managed under a conservative set of investment guidelines, making them suitable for mainland pensioners using a tax deferred scheme. Alternatively, in addition to the existing three regions, the GBA could be included under the Third Pillar Pension Tax Initiative, giving employees within the GBA access to approved northbound funds under the MRF regime and existing APIFs in Hong Kong as well.

   This initiative would:

   - Allow pensioners within the GBA or Shanghai, Fujian Province and Suzhou Industrial Park to diversify their investments leading to a bigger aggregate pension pool
   - Increase the AUM managed by APIFs, and potentially lowering costs

> "GBA would be well served to draw upon Hong Kong's asset management community, which represents a deep and diverse talent pool of resources with international experience."
>
> **Christine Lin**
> Wealth Asset Management Leader,
> EY
> Hong Kong

Clear benefits for both Hong Kong and the mainland

These and other connections between the Hong Kong and mainland retail and pension markets would:

- Give retail and pension investors in the whole region more investment choices
- Increase AUM and deal flows, leading to cost efficiencies – thereby providing more value for money for investors
- Create more opportunities for fund managers in the GBA to grow and develop their businesses
- Develop more professionals and expertise in asset management services
- Benefit the economies within the region
- Encourage more technological and operational improvements

These initiatives will also encourage fund managers in Hong Kong, especially the global managers, to establish more locally domiciled funds, which are currently eclipsed by the more universally recognized UCITS fund ranges.

> "GBA will create an urban cluster with a population of 70 million people and an economy of US$1.51 trillion. The opportunities for Hong Kong and mainland asset managers are significant."
>
> **Graham Douglas Turl**
> Chairman, HKIFA

Respondents request the involvement of FSTB

Respondents recognize that implementing these initiatives will not be without its challenges. It will require formal endorsement by local governments within the region and their collaboration on a broad range of topics. These include defining the GBA investor, which we propose should be based on the investor's residency status rather than the distributor's location.

Given the challenges, respondents believe the FSTB is the ideal authority to take the lead in cross jurisdictional negotiation efforts to spearhead the proposed initiatives with counterparties in the mainland Government. Industry is calling for the relevant regulators in both jurisdictions, and the stock exchanges in Hong Kong and Shenzhen, to form close working relationships and jointly develop economic policies, appropriate regulations and operational processes to implement these proposals.

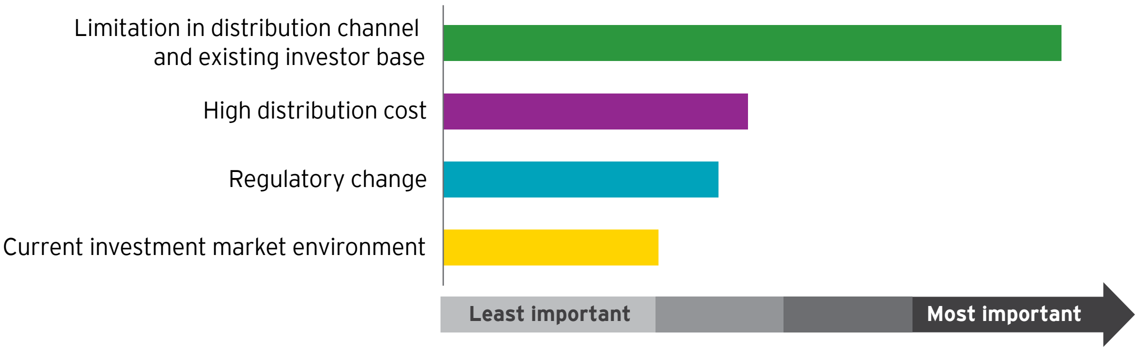
Fund managers from this survey have expressed strong support for these initiatives. Many have stated that they will participate in these new schemes once they have been approved, and will also hire more staff and boost their presence in the GBA.

Fund managers have collectively pledged their support and resources to support the Government, regulators and the exchanges in both jurisdictions in their efforts to bring on board these new initiatives.

The HKIFA and EY are also committed to support the development of these initiatives.

Challenges

Hong Kong-based fund managers are struggling with a limited investor base and distribution channels, and cost increases.



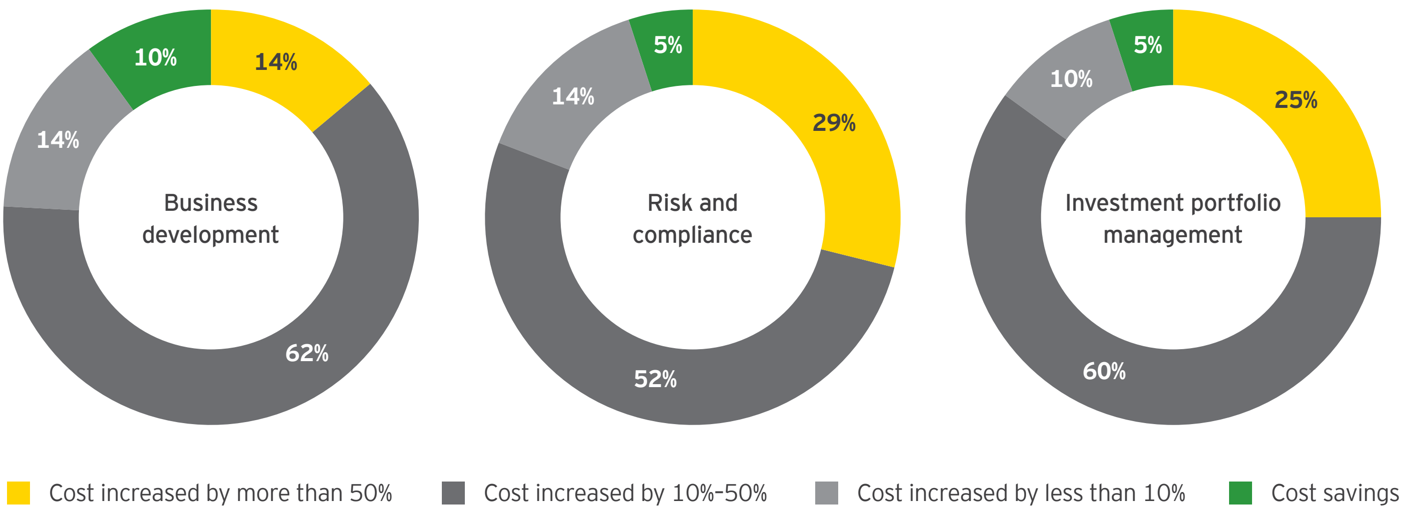
The potential of Hong Kong's domestic retail market potential is limited by its small population of 7.4 million, and having distribution concentrated through the banks, leading to high distribution costs.

At present, banks dominate the fund distribution landscape in Hong Kong with their extensive branch networks and high level of familiarity with local investors. In Hong Kong, about 80% of retail funds are sold through banks and 70% of all sales are made by just three banks.[1] The available shelf space and product types are limited as distributors are biased toward products that are simpler to distribute. This further restricts the choices available to investors.

In the last three years, most respondents report expenses increasing by at least 10% across:

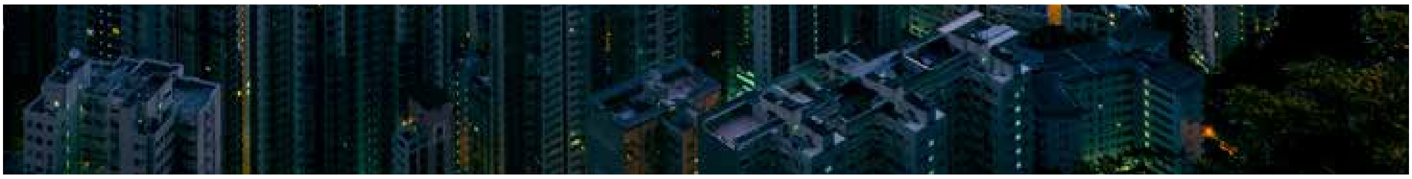
- **Business development:** These costs are necessary to develop and deliver new products, grow the AUM from new and existing investors, and manage ongoing products and investor relationships. Between March 2015 to March 2018, the SFC reported an additional 493 authorized unit trust and mutual funds.
- **Risk and compliance:** These costs continue to rise as more regulatory compliance requirements are enacted. Notable SFC regulation changes over the past three years include revisions to the Fund Manager Code of Conduct in 2018 and the introduction of the Managers-In-Charge regime in 2017.
- **Investment portfolio management:** These costs increased as more resources are required to manage and advise the increased AUM and products launched over the past three years.

Percentage growth in expenses over the last three years (from 2014 to 2017)



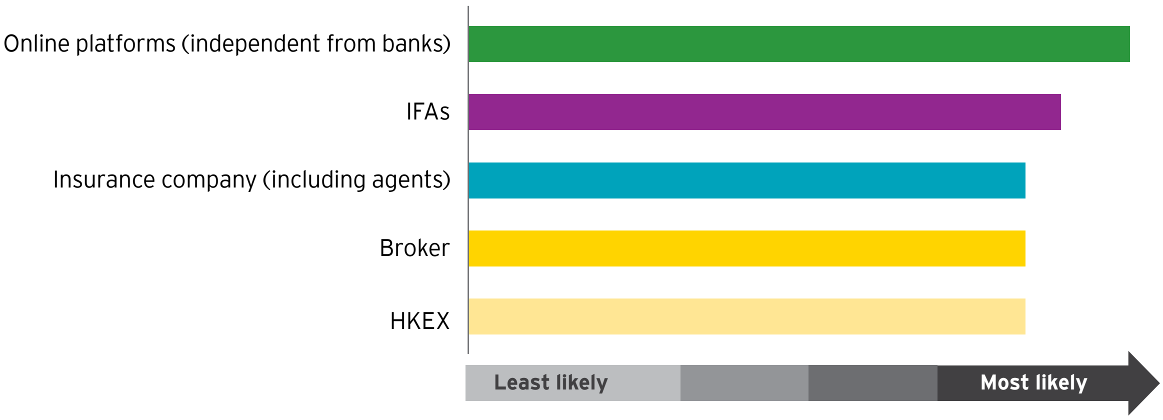
1. SFC – Speech on "Update on the SFC's asset management strategy for Hong Kong"

Opportunities



Part of the answer will lie in finding other distribution channels and leveraging FinTech, but this will not be enough. The biggest opportunity by far will be in developing the market in the GBA.

Introduce new fund distribution channels

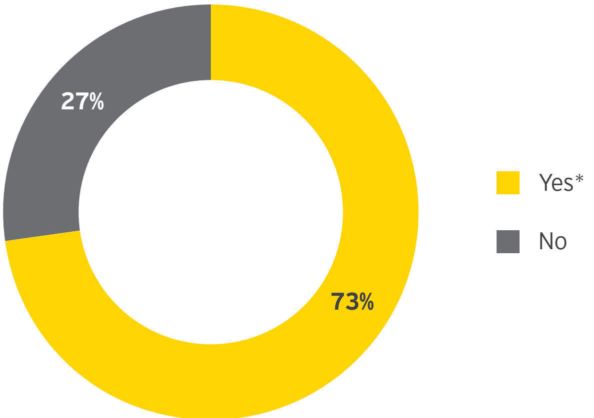


Fund managers rank online platforms as the best alternative to break away from the existing dominant distribution channel. While the usage of online platforms in Hong Kong is still at an early stage, the success of online platforms in the mainland is encouraging the Hong Kong fund managers to explore this channel. Fund managers are also considering the needs of the millennial generation and increased investor education to be more online-savvy.

Harness FinTech

Do you use or plan to develop FinTech within your organization?

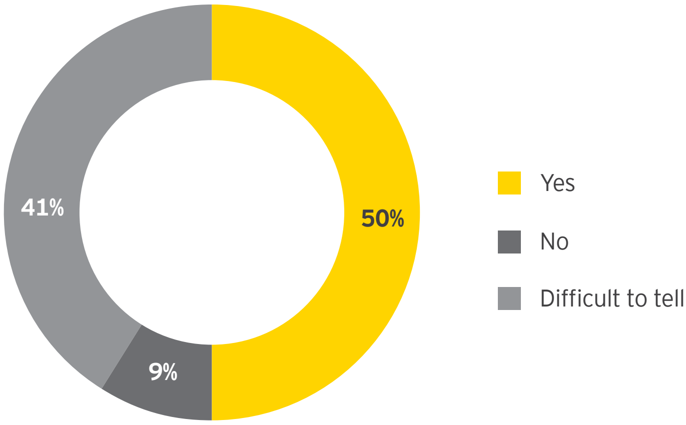
Almost two-thirds of our respondent are currently or will be engaged in FinTech developments. Most of these are initiatives driven by its global overseas offices. Their primary focus areas are: robo advisory, online platforms and automated account opening.



* Includes development of FinTech within Hong Kong and outside of Hong Kong

Will FinTech bring a breakthrough in fund distribution?

Despite the majority respondents having ongoing FinTech development, only 50% believe this is the answer to their distribution issues. Two in five (41%) respondents are uncertain about the issue given FinTech-related distribution channels are yet to reach a critical mass for wide use in Hong Kong, and related investor education remains insufficient. In addition, regulatory technology (Regtech) is being developed, giving market participants more unknown territory to navigate – all adding to respondents' uncertainty around the impact of FinTech.



Fast-track the development of the GBA

Respondents expect the development of Guangdong-Hong Kong-Macau GBA, formally signed under the witness of President Xi Jinping in July 2017, to unlock the region's significant growth potential.

The area, consisting of nine cities in the Pearl River Delta (Guangzhou, Shenzhen, Zhuhai, Foshan, Zhongshan, Dongguan, Huizhou, Jiangmen and Zhaoqing) as well as Hong Kong and Macau, is designed to rival the world's leading bay areas in San Francisco, New York and Tokyo. The initiative will leverage the diverse strengths of its constituent cities, including technology and innovation, finance, shipping and trade, advanced manufacturing, and hospitality. In the process, the GBA will also become an ideal place to live and work.

In 2017, GBA's population was 70 million, ten times that of Hong Kong. Its GDP of US$1,513 billion, was four times that of Hong Kong's US$341 billion.[2] The GBA area is covered by an extensive network of railways and highways, supporting commerce, trade and tourism within and outside the region. The area is now well on its way to become a "one-hour economic circle" with the commissioning of the Hong Kong-Zhuhai-Macao Bridge.

2. Hong Kong Trade Development Council (HKTDC) Research – Statistics of the Guangdong-Hong Kong-Macau bay area

"The bay area – a window of Chinese financial development – turns out to be the centerpiece in promoting overall economic growth."

Carrie Lam

HKSAR Chief Executive

Respondents believe that, in addition to the high level of transport connectivity among the GBA regions, close links should also be forged for financial services and economic developments. Such close connections and networks across key sectors will strengthen and benefit all the regions and will result in a globally leading area

"The essence of the Greater Bay Area initiative is to leverage the comparative advantages of the eleven cities to deepen cooperation, facilitate in-depth and organic integration, and to drive coordinated regional economic development."

James Lau

The Secretary for Financial Services and the Treasury of the HKSAR

Massive potential in GBA

At the *GBA Financial Forum* in Hong Kong on 29 August 2018, the HKSAR Chief Executive, Carrie Lam, spoke of the crucial role Hong Kong's financial sector has to play in the area.

Hong Kong's renowned status as an international financial center with a sizable pool of financial and investment professionals, international and regional service providers and global talent will enable it to take a unique role among GBA cities. Hong Kong's economic and judicial systems position it perfectly to act as a springboard for international and multinational corporations entering markets in China and Asia.

With world class infrastructure and close city bonds, Hong Kong and other cities in GBA are well-equipped to leverage each other's strength to establish a world-class, market-oriented business environment. The area has enormous potential to promote the free flow of talent, goods and capital across the region, while raising overall levels of economic efficiency, transparency and internationalization.

Industry recommendations to develop GBA

Enhance the Mainland-Hong Kong MRF regime

Background

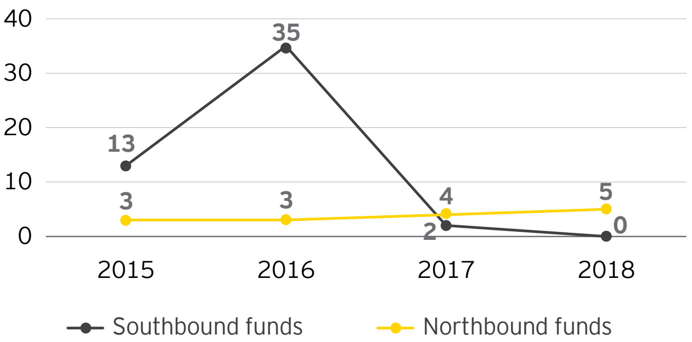
Implemented in 2015, MRF between mainland China and Hong Kong is a scheme jointly launched by the CSRC and SFC. Under the scheme, eligible mainland and Hong Kong funds can be distributed in each other's market through a streamlined vetting process. The CSRC and SFC set out eligibility requirements, application procedures, operational and regulatory arrangements of the MRF. They also established a cooperation mechanism for cross-border regulation and enforcement as well as a framework for exchange of information and regulatory cooperation to ensure that mainland and Hong Kong investors have equal protection.

Key features of MRF regime for Hong Kong funds

Launch date	1 July 2015	
Eligible funds for CSRC's approval	Fund domicile	Hong Kong
	Registration	Under the Code on Unit Trusts and Mutual Funds of the SFC
	Types	Regular equity funds, bond funds, mixed funds, unlisted index funds or physical index-tracking exchange traded funds
	Track record	Established and has been authorized for more than one year
	Fund size	Not less than RMB200 million or its equivalents
	Strategy	Not primarily invested (more than 20%) in the China market
	Sales limit	Value of shares or units sold to mainland investors not more than 50% of the fund's total assets
Requirement on manager	License	Operate in Hong Kong, registered with the SFC with Type 9 (Asset Management) license
	Investment function	Can appoint sub-investment advisor but cannot delegate the investment management function outside Hong Kong
	Regulatory status	Not subject of any major regulatory actions by the SFC in the past 3 years or since the date of its establishment, whichever later
Sales quota	An aggregate net quota of RMB300 billion for in and out fund flows each way	
Number of eligible funds at launch date	Around 100 Hong Kong funds with aggregate AUM of RMB300 billion	

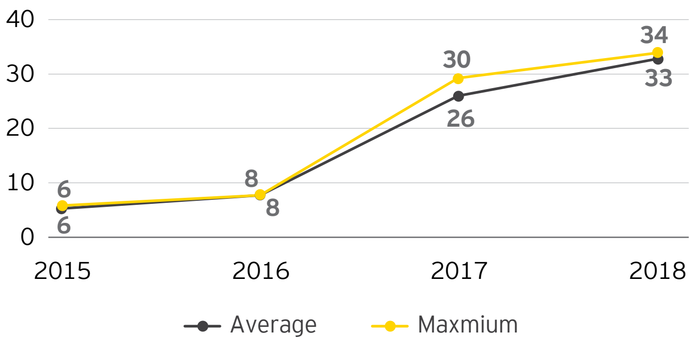
Overview of MRF regime statistics

Number of funds approved during 2015-18



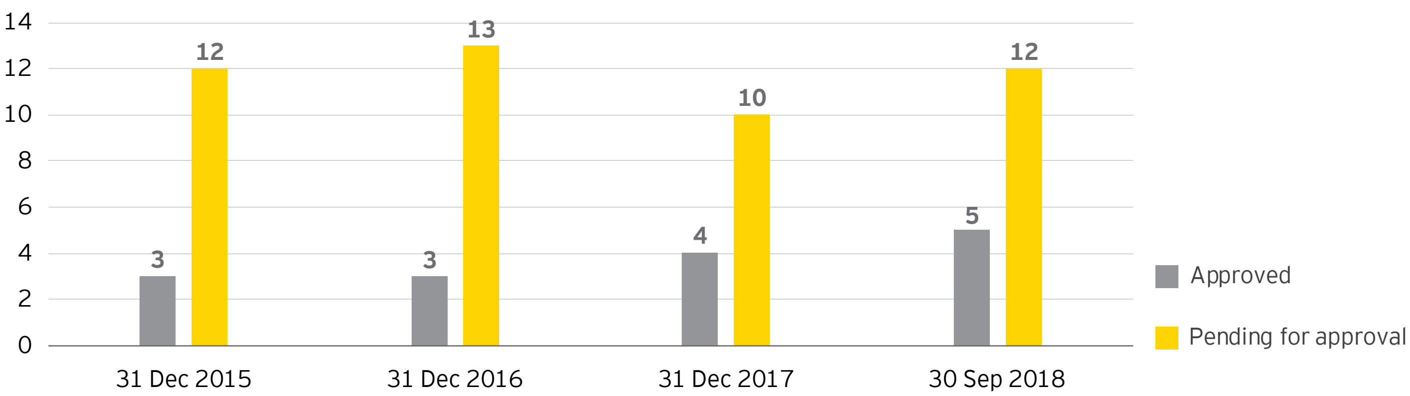
Source: SFC and CSRC (as of 30 September 2018)

CSRC's approval time (in months) for northbound funds approved in 2015-18



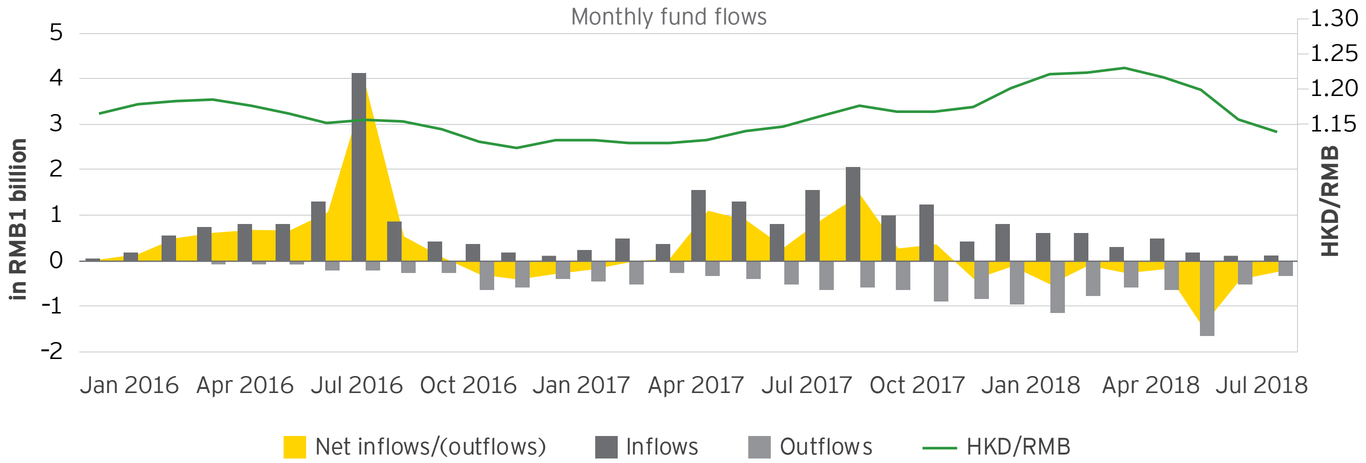
Source: CSRC (as of 30 September 2018)

Number of northbound funds approved and pending for approval



Source: CSRC (as of 30 September 2018)

Fund flows and performance of Northbound Funds



Source: The State Administration of Foreign Exchange (as of 31 August 2018)

	Date of approval	Fund size (HK$ million)	YTD % return	3-year annualized return
Northbound funds				
Hang Seng China Enterprises Index Fund	18 Dec 15	1,243	-4.85%	5.94%
JPMorgan Asian Total Return Bond Fund	18 Dec 15	18,575	-1.90%	2.49%
Zeal Voyage China Fund	18 Dec 15	2,302	-21.04%	6.93%
JPMorgan Pacific Securities Fund	18 Feb 16	4,926	-0.45%	15.68%
CCB International – China Policy Driven Fund	18 Feb 16	2,362	-20.26%	-9.06%
BOCHK All Weather China High Yield Bond Fund	6 Apr 16	1,625	-5.94%	5.95%
Schroder Asian Asset Income Fund	24 May 17	36,226	-2.45%	5.75%
Amundi HK New Generation Asia Pacific Equity Dividend Fund	28 Jun 17	262	-3.14%	9.90%
BOCHK Global Equity Fund	13 Dec 17	941	2.11%	10.17%
BEA Union Investment Asian Bond and Currency Fund	22 Dec 17	3,228	-2.28%	7.23%
BEA Union Investment Asia Pacific Multi Income Fund	1 Feb 18	4,145	-2.95%	5.39%
BOCHK All Weather Hong Kong Equity Fund	23 Apr 18	243	-15.83%	4.23%
Hang Seng Index Fund	23 Apr 18	2,533	-5.36%	10.97%
BOCHK Hong Kong Equity Fund	4 May 18	2,048	-5.89%	10.46%
Amundi HK – Growth Fund	17 May 18	391	-2.02%	9.28%
Market Index				
CSI 300 Index			-17.28%	-0.33%
FTSE China A50 Index			-14.33%	4.96%

Source: HKIFA Monthly Fund Performance Data and Reuters as of 31 August 2018

In terms of sales, the fund inflows from mainland investors to northbound funds was strong since its sale launch in 2016, with around RMB10 billion accumulated net inflows into northbound funds as of August 2018. But, it is well below the investment cross-border flows quota of RMB300 billion set under the MRF regime. This is partly because more investor education and brand recognition is required for the northbound funds.

Challenges under the current MRF regime

The approval process

Southbound funds (eligible mainland funds to distribute in Hong Kong)

The SFC uses a two-stream, fast-track approval process that takes around one month for a standard fund's approval. On 30 September 2018, 50 eligible mainland-domiciled funds had been approved by the SFC.

Northbound funds (eligible Hong Kong funds to distribute in mainland China)

The CSRC's application process has been taking longer than the stated approval period of 6 months, reaching up to 34 months in some cases. In 2018, the CSRC started to speed up its approval process, with 5 funds being approved. On 30 September 2018:

- The CSRC has approved 15 eligible Hong Kong-domiciled funds which were applied under the MRF regime in 2015.
- There are 12 eligible funds pending for the CSRC approval.
- Around 180 Hong Kong-domiciled funds meet the eligibility requirements of the MRF regime.[3]

Limited product types

For the 15 northbound funds, Asia-focused strategies dominate the list, with fewer than five funds investing under a global strategy. Respondents say the homogeneous nature of products is mainly due to the MRF regime requirement that does not allow fund manager to delegate its investment management function outside Hong Kong. This delegation restriction prevents global fund managers from introducing a diversified pool of products managed by overseas experts to mainland investors.

In a strategy updated on 19 September 2018,[4] Mr. Ashley Alder, the Chief Executive Officer of the SFC, stated that the SFC is well aware that the delegation model of sub-advisors could be more efficient, particularly for large fund houses with a global presence. In light of the recent growth of global strategy funds domiciled in Hong Kong, the SFC is actively re-evaluating the delegation policy. It plans to discuss this issue with the CSRC in due course to see whether this might be included as part of the enhanced MRF model.

The 50% rule on sales limit

The MRF regime allows northbound funds to gather up to 50% of its total assets from mainland investors. When the value of shares or units in the fund sold to mainland investors is approaching the 50% rule, the fund manager must notify the regulators in writing immediately, and suspend subscription or apply a fair arrangement to apportion subscription orders until the 50% rule is reached.

With only eight northbound funds approved before December 2017, when there was good market performance and net inflows from mainland:

- **JPMorgan Asian Total Return Bond Fund**, which has been dominating MRF sales, imposed a temporary subscription cap from August 2016 until February 2017 amid strong inflows from mainland investors.
- **BOCHK All Weather China High Yield Bond Fund** also suspended its subscriptions in the mainland from 20 May 2017 to 5 July 2017 as its assets gathered onshore approached the 50% rule in terms of overall fund size.

Most respondents agreed that the 50% rule limits their northbound fund penetration among mainland investors. It also prevents global fund managers from building a compelling business case as to why global head offices should invest resources into the MRF strategy, when there are other more attractive opportunities in the mainland and other Asian markets. It was also mentioned that the Hong Kong retail market is limited by its small population size of approximately 7.4 million, compared with over 1.4 billion in the mainland.

Master agent arrangement

Under the MRF regime, the sales of northbound fund to mainland investors are conducted through the mainland distribution partner of the Hong Kong fund manager, also known as the "master agent." Most respondents are concerned that:

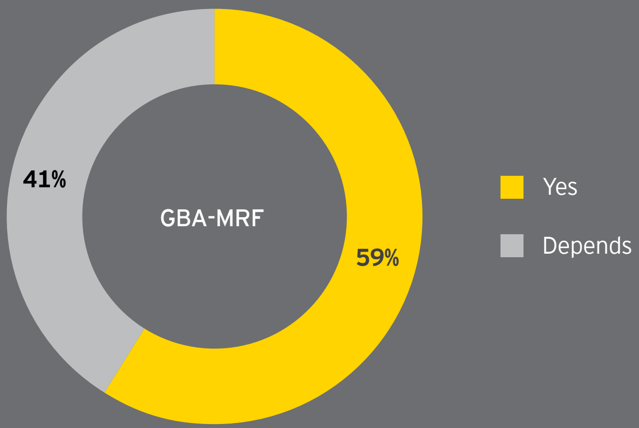
- The distribution environment, model and infrastructure are different between Hong Kong and the mainland, which takes time and resources for them to build up the network, increasing distribution costs.
- The master agent arrangement limits the flexibility of the Hong Kong fund managers to advertise northbound funds to mainland investors directly or educate investors.

3. Based on the funds' net asset values published on the latest annual or interim reports, excluding (i) the funds primarily investing into China A or B shares, and (ii) the funds approved/pending for approval under MRF

4. SFC – Speech on "Update on the SFC's asset management strategy for Hong Kong"

Recommendations

1. Expedite the approval process
2. Relax the 50% sales limit
3. Allow delegation of investment management function to overseas manager



Despite the recent net outflows, Hong Kong fund managers remain committed to the MRF regime. Applications of seven eligible Hong Kong-domiciled funds were submitted to the CSRC in year 2018, representing 58% of total number of funds pending for its approval.

Our respondents recommend enhancing the MRF regime by:

- Accelerating approval times
- Relaxing the 50% sales limit
- Giving permission to delegate investment management functions to fund managers outside Hong Kong

This will introduce greater fund choices for mainland investors, increasing inflows to the northbound funds.

Next step: GBA-MRF?

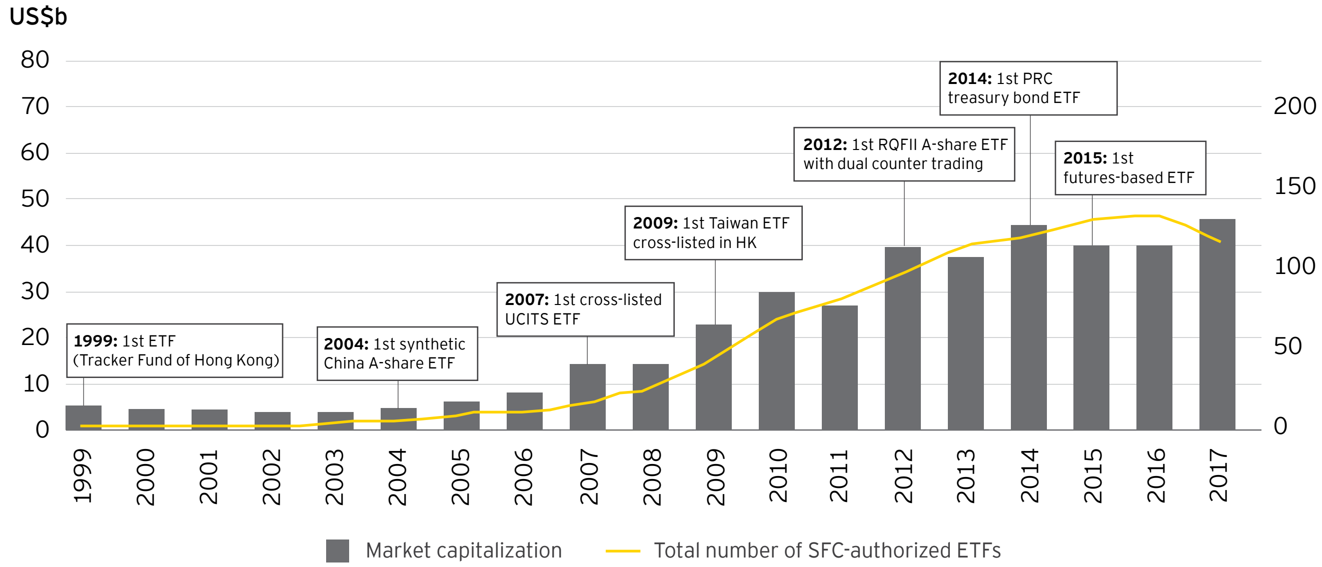
The industry supports the proposed GBA-MRF initiative. Most respondents commented that Hong Kong fund managers have invested a lot of time and resources to participate and support recent mainland initiatives, such as WFOE, QFLP, and PFM licenses. Although they still look forward and welcome new and enhanced initiatives, they have higher expectations that such initiatives and enhancements can be implemented easily and effectively to deliver practical and beneficial solutions to investors.

Kickstart the ETF Connect

Background

In 1999, HKEX launched the first Hong Kong ETF. This opened the door for retail and institutional investors to passively invest in financial instruments in different exchanges around the globe. Since then, Hong Kong has continued attracting issuers, liquidity providers and investors. Today, Hong Kong is one of the leading ETF markets in Asia. It is the second-largest ETF market in Asia in terms of market capitalization and the fourth in terms of ETF turnover.

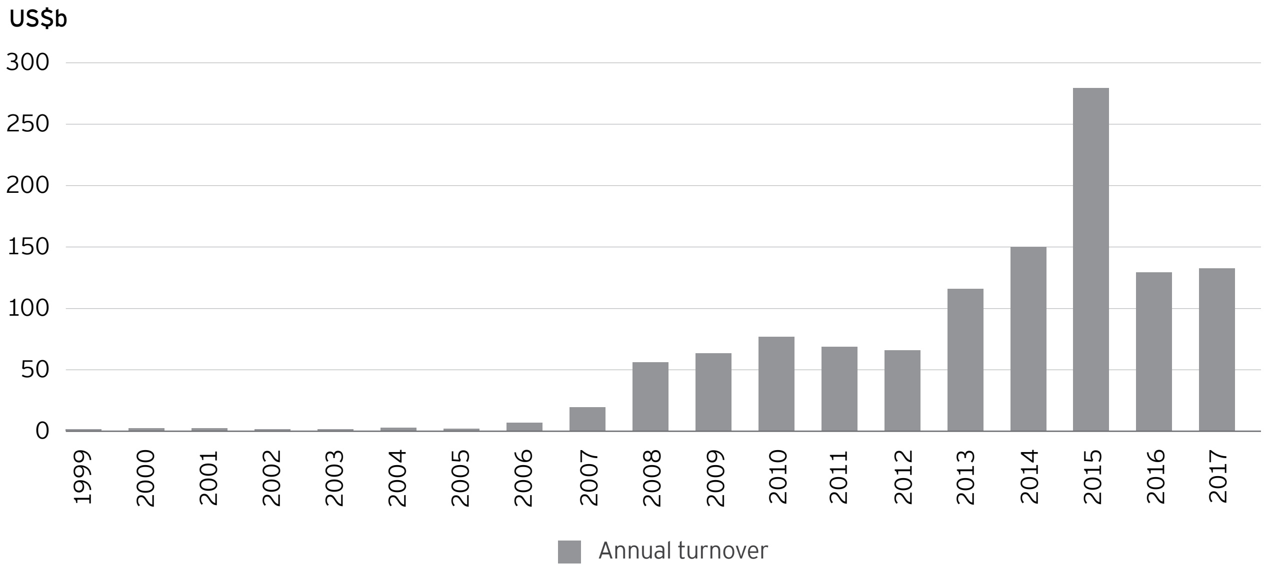
Market capitalization and number of SFC-authorized ETFs with significant events in the Hong Kong ETF market (1999–2017)



Source: SFC and HKEX

In the past 10 years, the market capitalization of ETFs listed in Hong Kong has grown more than three times, from US$13.6 billion in 2007 to US$46.1 billion in 2017. In the same period, annual turnover increased more than 10 times with annual turnover of US$137 billion in 2017 and achieving a record high of US$280 billion in 2015. The contribution of ETFs to the Hong Kong stock exchange market's turnover has also grown six times from 0.9% in 2007 to 5.8% in 2017.

Annual turnover of SFC-authorized ETFs (1999–2017)



Source: SFC and HKEX

However, the liquidity and turnover of the Hong Kong ETF market are comparatively lower than in other leading ETF markets, such as US, UK and Japan. This is why the HKEX is "working very hard" on ETF Connect, a cross-border scheme that would give Chinese investors exposure to overseas assets through ETFs listed in Hong Kong.

ETF products in Hong Kong and Shenzhen

Hong Kong: As of September 2018, 112 ETFs were listed in Hong Kong, with aggregate AUM of more than US$40 billion and an average daily turnover of more than US$380 million. More importantly, these ETFs track a wide range of indices across the global financial markets, including Mainland China, Hong Kong, Taiwan, the US, the UK, Germany, Russia, Brazil, Japan, South Korea and India. The variety of ETF products tracking different international financial markets allows investors to diversify their portfolio into different economies and asset classes.

Indices tracked by certain Hong Kong ETFs	Markets	YTD % return	3-year cumulative return	5-year cumulative return
Hang Seng Index	Hong Kong	-12.59%	33.30%	21.56%
Hang Seng China Enterprises Index	Mainland China	-10.41%	17.14%	6.80%
Markit iBoxx ABF Pan Asia Index	Pan-Asia ex-Mainland China, ex-Hong Kong	-5.26%	14.24%	6.94%
MSCI Total Return Net USA Index	US	4.54%	57.87%	85.02%
FTSE China A50 Index	Mainland China	-12.13%	27.27%	61.01%
CSI 300 Index	Mainland China	-18.87%	7.37%	42.75%
MSCI All Country Asia ex Japan Index	Asia ex-Japan	-6.07%	33.90%	34.93%
MSCI China Index	Mainland China	-17.72%	38.11%	29.75%
FTSE Vietnam Index	Vietnam	-2.58%	51.70%	55.65%
Nifty 50 Index	India	-2.71%	37.51%	90.58%

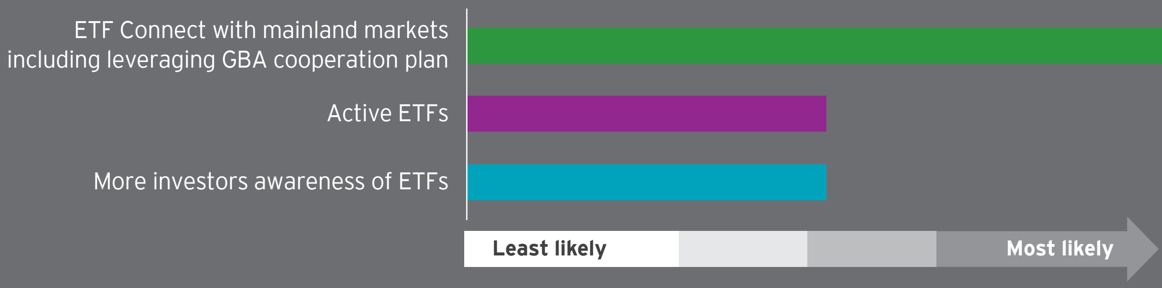
Source: Bloomberg and Reuters (as of 30 September 2018)

Shenzhen had its first ETF listed back in 2009. The Shenzhen ETF market predominantly focuses on Mainland China listed equities markets. As of September 2018, 54 ETFs were listed in Shenzhen, with a total AUM of almost RMB76 billion (approximately US$11 billion) and an average daily turnover of less than RMB1 billion (approximately US$144 million). Of these 54 ETFs, 52 focus on the Mainland China equities market.

Indices tracked by certain Shenzhen ETFs	Markets	YTD % return	3-year cumulative return	5-year cumulative return
SZSE 300 Index	Mainland China	-28.36%	-8.70%	25.55%
SZSE CHINEXT 50	Mainland China	-28.75%	-41.58%	-14.57%
Hang Seng Index	Hong Kong	-12.59%	33.30%	21.56%
SZSE 100 PRICE INDEX	Mainland China	-28.24%	1.76%	26.16%
SZSE SME PRICE INDEX	Mainland China	-32.36%	-20.67%	13.43%
CSI Consumer Staples Index	Mainland China	-13.75%	66.59%	101.36%
CSI All Share Health Care	Mainland China	-19.13%	-0.10%	33.01%
CSI 500 Index	Mainland China	-30.68%	-21.60%	23.96%
CSI 300 Index	Mainland China	-18.87%	7.37%	42.75%
CHINEXT PRICE INDEX	Mainland China	-24.97%	-32.23%	3.17%

Source: Bloomberg and Reuters (as of 30 September 2018)

Recommendations



Respondents would like to see the ETF Connect succeed and develop. They suggest this could be started quickly, as an initial step, by connecting HKEX and the SZSE.

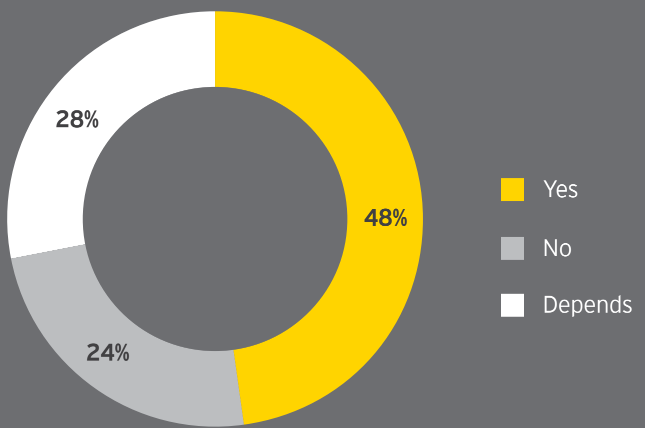
Open the ETF connect via SZSE

To improve liquidity, broaden investor base and expand product diversification, the HKEX and SZSE could join forces and create a connected ETF market. The combined market would be able to offer a wide range of products with exposures to different international financial markets, benefiting investors trading on both exchanges. This momentum would also drive growth in AUM, boost market liquidity in the region, broaden the investor base and satisfy investors' demand for portfolio diversification.

Assuming the eligibility requirements of ETF Connect would be the same as those for the existing MRF regime,[5] as of September 2018 we identified:

- **There are 35 eligible non-China focused ETFs**, representing 28% of the total 97 non-China focused ETFs in Hong Kong, with aggregate AUM of around HK$257 billion (US$33 billion).
- **There are 27 eligible non-Hong Kong focused ETFs**, representing 50% of the total 52 non-Hong Kong focused ETFs in Shenzhen, with aggregate AUM of around RMB71 billion (US$10 billion).

- Fourty-eight percent (48%) of respondents said they are likely to participate in the ETF Connect program.
- Twenty-eight percent (28%) of respondents said they will wait for more information about the program before deciding.
- Twenty-four percent (24%) of the respondents said they will not participate as ETF products is not their business strategy in Hong Kong.



5. Based on the ETFs net asset values published on HKEX and SZSE, with fund size of not less than RMB200 million, and the fund does not primarily invest in mainland markets (for Northbound funds) or the Hong Kong market (for Southbound funds)

Extend the scope of China's pension reform

Background

Mainland China has a three pillar pension system:

- **First pillar:** This comprises the Government's mandatory pensions and the NSSF. More than 0.9 billion people participate in this pillar with AUM of more than RMB7 trillion. More than 30 offshore fund managers are currently authorized to manage the NSSF.
- **Second pillar:** This includes the Enterprise Annuities for private sector and occupational annuities for public sector, with an AUM of more than RMB1.3 trillion.
- **Third pillar:** This is the voluntary and private savings pension scheme. This pillar consists of pension insurance products and pension target securities investment funds, but is still in its infancy. Private pension asset data is not well disclosed.

The third pillar of China's pension system is the most promising for investors as it gives them flexibility and control over their investments. Private pension insurance offers an attractive alternative for retirement savings, which provide long-term stability in the future.

We see a high potential for rapid growth in this third pillar of the mainland China's pension system, as the Government introduces reforms and increases awareness of longevity risk and retirement needs.

Recent reforms

The regulations shaping the pension system are continuously evolving. As part of the third pillar, the Government announced a pilot income tax deferred pension insurance product initiative (Third Pillar Pension Tax Initiative) in Shanghai, Fujian Province and Suzhou Industrial Park in Jiangsu Province in 2018, which encourages people in these regions to invest in pension insurance products with tax benefits. Included in the Announcement on Launch of Pilot Income Tax Deferred Pension Insurance Products (issued on 2 April 2018), it is considered to include retail funds in the investment scope one year after the launch of the pilot. This is expected to boost pension assets and support the long-term development of the pension system for China's aging population.

Voluntary and private savings pension scheme vs. APIFs

	Voluntary and private savings (mainland China) third Pillar		MPF and its underlying APIFs (Hong Kong)
	Tax deferred pension insurance product	**Pension target securities investment fund**	
Main features	▶ Voluntary pension system	▶ Voluntary pension system	▶ Mandatory pension system ▶ As on 30 June 2018, aggregate AUM of all schemes: HK$852 billion ▶ As on 30 September 2018, a total of 319 APIFs
Product design	▶ **Fixed-return product:** They offer a fixed yield (annual interest rate), subject to monthly valuation. ▶ **Guaranteed-return product:** These are traditional pension insurance products with total return consisting of minimum guaranteed rate of return and sharing of insurer's profit, subject to monthly or quarterly valuation. ▶ **Floating-return product:** These are products with returns varying according to the actual circumstances of investment, subject to weekly valuation.	▶ Pension target securities investment funds (pension funds) operate in the form of fund of funds (FoFs) or other forms recognized by the CSRC. ▶ The underlying sub-funds (approved northbound funds under MRF regime included) are permitted to invest in money market, fixed income or equity instruments. The asset allocation to each type of instruments varies by different products and corresponding strategy. ▶ Pension funds can adopt target date strategies to adjust asset allocation with the target date approach or target risk strategies to control the portfolio risk as indicated in the prospectus.	▶ Floating-return products: The returns of these products vary according to the circumstances of the investment, subject to daily valuations.

	Voluntary and private savings (mainland China) third Pillar		MPF and its underlying APIFs (Hong Kong)
	Tax deferred pension insurance product	Pension target securities investment fund	
Withdrawal	▶ Benefits can be withdrawn in an annuity at retirement. ▶ Withdrawal before the retirement is generally not allowed.	▶ Investments can be redeemed at the end of the predetermined target date or holding period.	▶ Benefits can be withdrawn as lump sum or by instalments at retirement. ▶ Withdrawal of accrued benefits is only allowed when scheme members reach their retirement age. ▶ Accrued benefits may be paid before members reach their retirement age in the event of: early retirement, permanent departure from HK, total incapacity, terminal illness, small balance (less than HK$5,000) and death.
Tax benefit	▶ The income tax deferral pension insurance product initiative was launched in April 2018, piloted at Shanghai, Fujian Province and Suzhou Industrial Park in Jiangsu Province. ▶ Investors get a deduction from their individual income tax to invest in the products, up to a value of RMB1,000 (per month) or 6% of their salary, whichever is lower. ▶ Tax on investment income is deferred to the withdrawal date. ▶ At withdrawal: the first 25% of the benefit payment is tax free, and the remaining 75% is charged at a lower tax rate of 10%.	▶ No special tax benefits have been announced by Government.	▶ Employees can claim tax deductions for their mandatory contributions made to an MPF scheme, subject to a maximum amount of HK$18,000 for each year of assessment. ▶ Voluntary contributions made by employees will enjoy tax concessions as proposed in the 2018/2019 Budget delivered by the Financial Secretary of HKSAR. Further details, including the effective date of the proposed tax concession, are subject to the clarification by the Hong Kong Government. ▶ Employers can claim tax deductions for the mandatory and voluntary contributions made for their employees, to the extent that they do not exceed 15% of the employee's total emoluments.
Investment types and investment restrictions	▶ Insurance companies may entrust tax deferred pension insurance funds to qualified investment managers to perform investment management. ▶ Separate investment accounts should be set up and maintained, separated from self-owned fund and other insurance products. ▶ Insurance companies should establish a comprehensive management system, including internal control and risk management mechanisms, and conduct periodic reviews on asset management, asset allocation, business strategies and risk status. ▶ Tax deferred pension insurance funds should comply with the existing regulations on the utilization of insurance funds in terms of investment proportion limit, investment ability and investment management, unless otherwise regulated by other provisions issued by China Banking and Insurance Regulatory Commission.	▶ Highlights of the underlying sub-funds in pension FoFs (approved northbound funds under MRF regime) include: 1. The operation period of the sub-fund shall be not less than two years; the average quarter-end net asset of the sub-fund in the most recent two years shall be not less than RMB200 million. 2. Where the sub-fund is an index fund, ETF or commodity futures fund, the operation period shall be not less than one year, and the quarter-end net asset of the fund disclosed in the most recent periodic report shall be not less than RMB100 million. 3. The sub-fund has clear investment strategies and stable returns in the medium-long term with low volatility. 4. The sub-fund management company and the fund manager of the sub-fund have no serious violation of laws or regulations in the most recent two years.	▶ Investments in money market fund, guaranteed fund, bond fund, mixed assets fund, equity fund and index fund are permissible. ▶ The spread of investment must be such that the total amount invested in securities and permissible investments issued by any one person may not exceed 10% of the total funds of a constituent fund. ▶ Bank deposits and currency exposure must have at least 30% of its assets in Hong Kong dollars. ▶ Funds can invest in shares listed on approved stock exchanges, investment grade debt securities or certain forms of convertible debt, and to a limited extent, listed warrants; the funds may also, within limits, engage in hedging through certain financial derivatives. ▶ Employer-sponsored scheme may not have more than 10% of their assets in shares or other securities of, or issued by, the participating employer or its associates. ▶ No borrowing of securities is allowed. ▶ Borrowing of money is permissible only under certain limited conditions.

Source: MPFA, CSRC, State Administration of Taxation, National Council for Social Security Fund, Ministry of Human Resources and Social Security, China Banking and Insurance Regulatory Commission

Recommendations

Extend the scope of China's third pillar pension scheme

We recommend enlarging the investment scope of the pilot income tax deferred pension insurance product initiative under the mainland's third pillar pension system.

This is already being signaled by the CSRC's recently released rules relating to pension target securities investment funds. Under a FoF model, the CSRC will allow investment in the limited number of Hong Kong northbound funds approved under the MRF regime.

Potential next steps might be for mainland regulators to:

- Allow tax deferred pension insurance products to also invest in the existing approved Northbound funds under the MRF regime and APIFs in Hong Kong, which would create far more choice for mainland employees, leading to a larger aggregate pension pool

  Respondents believe this suggestion would be acceptable to all parties as APIFs and northbound funds under the MRF regime in Hong Kong are managed under conservative set of investment guidelines, making them suitable for mainland pensioners using a tax deferred scheme.

- Extend the Third Pillar Pension Tax Initiative to include the GBA

  Then the mainland authorities could consider permitting the GBA's tax deferred pension insurance products to have access to approved northbound funds under the MRF regime and existing APIFs in Hong Kong. Given GBA's population is more than nine times that of Hong Kong's, this would increase AUM considerably, lowering costs.

About our survey respondents

Who are the respondents?

Our respondents manage 1,289 out of a total of 2,015 retail funds in Hong Kong, accounting for 75% of the aggregated global fund size US$1.2 trillion.[6] They are also responsible for more than 75% of the Hong Kong MPF market.[7]

For the majority of respondents, their Hong Kong-based offices manage, advise on and distribute more than US$10 billion AUM as on 31 December 2017. These AUM figures has mostly increased by more than 10% during the past three years.

Majority of those managing and advising on more than US$1 billion employ more than 40 staff in their Hong Kong offices. Many have more than 100 staff. The headcount figure has increased by more than 10% during the past three years.

Geographically, most of the AUM are attributable to their Hong Kong offices through management, advisory and distribution services, and are derived from Hong Kong and the mainland.

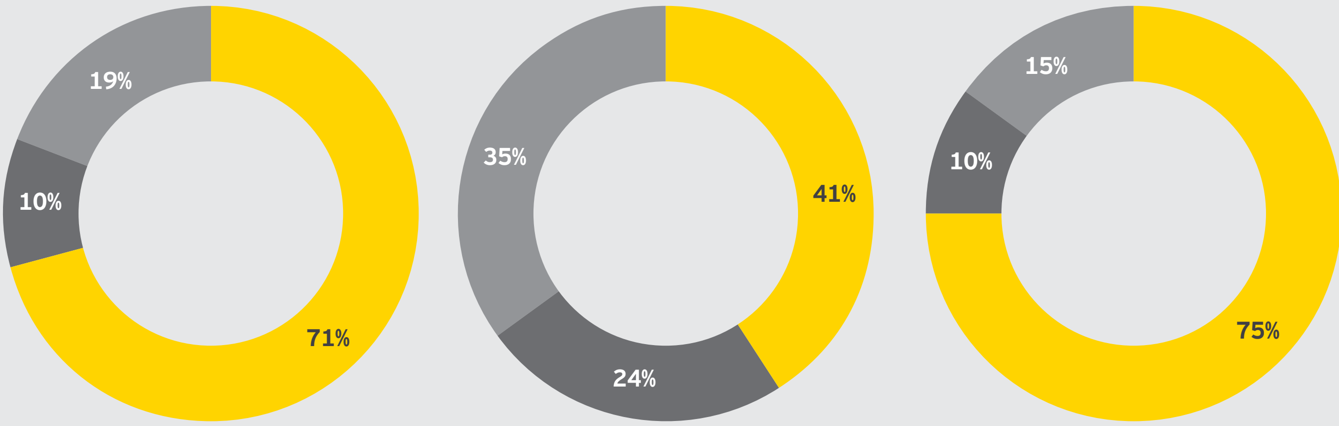
6. SFC data as of October 2018 and HKIFA — Monthly Fund Performance Data as of August 2018
7. Willis Towers Watson — MPF market share as at 30 September 2018

AUM size

AUM – Hong Kong office manages and advises

AUM – Hong Kong office distributes

Percentage of growth in AUM over the past three years



AUM – Manage

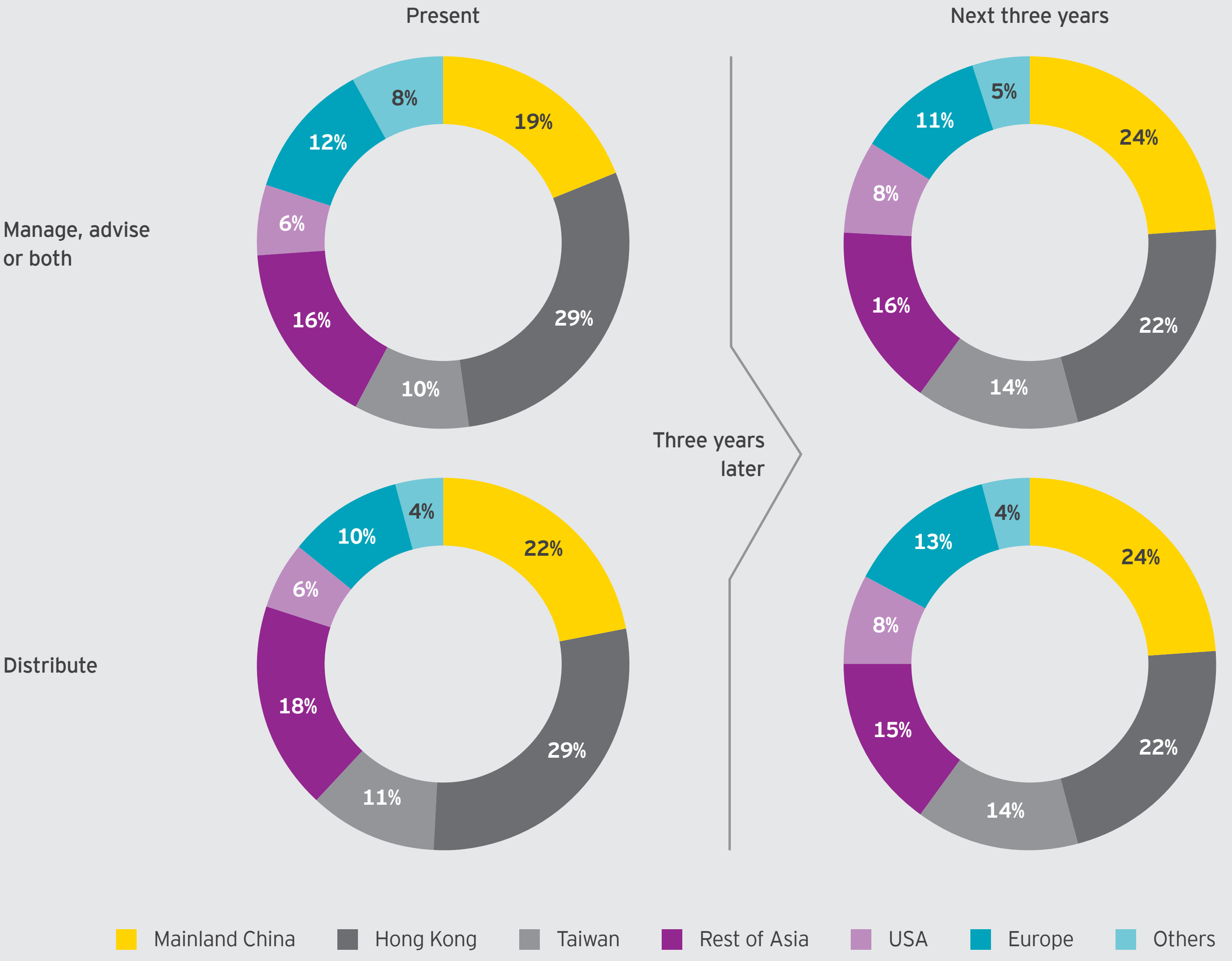
AUM – Advise

AUM – Distribute

More than 10% 0%–10% Negative growth

Most respondents reported that the AUM they manage and distribute has increased, with a significant majority reporting growth of more than 10% over the past three years. A few reported a decline in AUM due to terminating products.

Present and future source of AUM in Hong Kong



Glossary

APIFs	Approved Pooled Investment Funds
AUM	Asset under Management
CSRC	China Securities Regulatory Commission
ETF	Exchange Traded Funds
FinTech	Financial Technology
FSTB	Financial Services and the Treasury Bureau
GBA	Greater Bay Area
GDP	Gross Domestic Product
HKEX	Hong Kong Exchanges and Clearing Limited
HKIFA	Hong Kong Investment Funds Association
HKSAR	Hong Kong Special Administrative Region
HKTDC	Hong Kong Trade Development Council
IFA	Independent Financial Adviser
MPF	Mandatory Provident Funds
MPFA	Mandatory Provident Fund Schemes Authority
MRF	Mainland-Hong Kong Mutual Recognition of Funds
NSSF	National Social Security Fund
PFM	Private Fund Manager
QFLP	Qualified Foreign Limited Partner
Regtech	Regulatory Technology
SFC	Securities and Futures Commission
SZSE	Shenzhen Stock Exchange
UCITS	Undertakings for Collective Investment in Transferable Securities
WFOE	Wholly Foreign-Owned Enterprise
YTD	Year-To-Date

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