Hong Kong Towards a new paradigm?

Annick Elias
Director
Advisory & Consulting
Deloitte

Christopher Stuart Sinclair
Director
Advisory & Consulting
Deloitte

"The best time to plant a tree was twenty years ago. The next best time is today." - *Chinese proverb*

Hong Kong, with its towering peak, its buzz of commercial activity and its mercantile DNA is a place where change may seem a constant. In such an environment it is perhaps strange to speak of 'game changers', and yet with the most recent developments in Hong Kong, that is precisely the case.

Hong Kong has always stood at a crossroads—both by its geography and its hold on place and time. The trading hub is as it ever was, possibly more vibrant, possibly enhanced by the competition that other Chinese cities create for it. The cultural window into China is as rich and perplexing as ever, with the melting pot of Chinese cultures and their interaction with the world beyond. Now, however, profound changes are also afoot in the financial infrastructure of Hong Kong. It will be interesting to see if Hong Kong will be able to take a place on the world asset management stage.

For many years, global asset managers viewed Hong Kong as a distribution centre. It has long been an important location for the European investment management industry: it was one of the first jurisdictions to embrace UCITS as an industry standard. This furthered the progression of UCITS at a crucial time when the Hong Kong preference for an OECD domicile carried local interest towards the European brand to replace previous BVI and Cayman products. Hong Kong is one of the first markets that come to mind when discussing the success of UCITS beyond the confines of Europe.

Indeed, it is probably fair to say that Hong Kong deserved better from UCITS, or rather, those responsible for their evolution; even today, the way in which UCITS legislation changed rapidly and without consultation still rankles, and is probably behind some of the longer-term initiatives that are now drawing our attention.

Talk, or at least serious talk, of Asian passports originated largely as a result of the implementation of UCITS III and its extended asset eligibility criteria. Certainly, there were good reasons for extending that eligibility; the rationalisation of the market, the increased use of the product by institutional investors, the added focus on performance that institutional investors brought with them—all these elements were features that, in hindsight, should have been appropriately articulated and discussed. Unfortunately. they were not, and significant reticence remains, especially on the permitted use of derivatives. This reticence was reinforced during the financial crisis by the use of such instruments inappropriately in other non-fund products. In addition, when UCITS, from being a stable and known quantity went through further iterations of UCITS IV and V in rapid succession, followed by talk of UCITS VI and a bewildering number of changes to be communicated to investors, some in Hong Kong felt that enough was enough.

At the same time, those who follow events and patterns in Hong Kong have noted a growing trend towards more regional activity in the Hong Kong market in recent years. While UCITS remain a staple, there have been signs—small at first perhaps, but growing—that there are also other forces at work. The number of Hong Kong domiciled products continues to increase year on year. Certain Hong Kong products such as Islamic funds enjoy unique positioning within the region, and the growth in popularity of ETFs has caused many to consider Hong Kong as a prime potential location for domiciling ETFs for regional distribution.

Accompanying these developments, which may almost be considered organic or natural evolutions to adjust to market circumstances, there have been other changes, at one and the same time political in inception, and responses to market needs and requirements. And it is those initiatives that are today giving a new dimension to Hong Kong's role and boosting its growth.

Two of these initiatives stand out as indicators of what the future may look like. These are "mutual recognition" and "Hong Kong-Shanghai Stock Connect".

Mutual recognition may be regarded as perhaps the first concrete initiative towards a 'passport' in Asia, and in this case it concerns Greater China. (There are other passport initiatives in Asia with greater geographic ambition, but their progress is likely to be slow and painstaking. Mutual recognition is the only one to involve China, and the one that has the potential to bear fruit almost immediately.) Put simply, mutual recognition is an initiative whereby funds domiciled and managed in Hong Kong may be distributed in China, and funds domiciled in the PRC (People's Republic of China) may be distributed in Hong Kong.

Mutual recognition may be considered as old news by some. The first announcement of its imminent arrival was made over two years ago, but it has still to see the light of day. Nonetheless for something that has yet to materialise, it enjoys an immediacy that has few equals.

We may well ask what the catalyst was for the initiative in the first place. Was it, for example, a purely Chinese initiative in the context of the evolving relationship between Hong Kong as a special autonomous region and its larger parent, or was it a response to ham-fisted changes in foreign products such as UCITS? Certainly—as mentioned previously—a good deal of resentment was created by what was perceived as a rather high-handed approach to UCITS product evolution. Even as it became clear that mutual recognition is likely to one day become a reality, concerns arose from outside China over whether UCITS could benefit from the scheme in some way via master feeders or similar structures, and whether mutual recognition could potentially be extended to UCITS in general—rather than focusing on how asset managers should adapt to be a part of this new system.

The details have been slowly worked out and have emerged over the intervening period, and by definition they were not simple to formulate. By virtue of the diversity of funds that may be domiciled in Hong Kong, not all funds would be appropriate for an initial pilot in mutual recognition. We still do not know exactly which funds in each domicile will qualify, and what criteria will apply.

It has been interesting to see the international response to mutual recognition. Clearly, the draw of the PRC market, both for its current—but especially for its potential future size—is a powerful one. Given the success of UCITS in Asia, there has long been an aspiration, even a belief that in time, mainland China would open its doors and embrace UCITS as a standard, and it may still do so—one day. In the short term, however, it came as a shock and a reality check for foreign promoters, and foreign promoters of UCITS products in particular, to see a scheme gradually emerging that might exclude them from an opening up of the market in mainland China, and which would promote an alternative range of products 'over their heads'.

Although UCITS asset managers were slow to grasp the implications, clinging to the belief that UCITS would be eligible under the scheme at some point, the message is increasingly clear. If you want to participate in mutual recognition, then you need to both be in Hong Kong and manage Hong Kong domiciled products. The rest is detail.

There has been talk of an extension of mutual recognition to encompass UCITS. There are several stumbling blocks but the main ones are semantic and legal. Mutual recognition is what it says—first and foremost 'mutual'—the price for UCITS to be included in the scheme would be access to EU retail markets for Chinese-domiciled funds. The EU is certainly not yet ready for that, especially at a time when it is only just getting to grips with the issues surrounding the potential extension of the AIFMD passport for institutional or professional investors.

At the same time—also from an EU perspective—there is a major problem for products from one domicile to be included, and not all EU UCITS — this is a legal constraint. Member states are not entitled to conclude such agreements, which within Europe would infringe the freedom of the right of domicile. For Europe and UCITS it has to be all or nothing.

Although, as implementation of mutual recognition continues to be delayed, it is likely that talk of inclusion will continue, but it is feared that this will remain talk. To benefit from mutual recognition when it comes will require both presence and product in Hong Kong. Some asset managers have recognised this and are investing in establishing appropriate products already in the shadow of the Peak.

As mentioned above, mutual recognition has been long in the making (or relatively long, given the complexity and the potential impact of the undertaking), and at the time of writing there is still uncertainty as to when it will finally go live. There has been some speculation that one of the reasons for this delay has been to allow Hong Kong-Shanghai Stock Connect to start up first, with regulators and other stakeholders unwilling to have more than one major initiative going live at the same time.

Hong Kong-Shanghai Stock Connect was something of the opposite of mutual recognition. It seemed to emerge almost from nowhere, gather a momentum all of its own, and move so swiftly from concept to implementation that many in the market were taken by surprise. Stock Connect is an infrastructure solution that allows inward investment into China A shares listed on the Shanghai exchange via orders placed with Hong Kong registered brokers (the 'Northbound route') and for investors going through the Shanghai Stock Exchange to invest in the components of the Hang Seng large and midcap indices and other H shares not included in these indices.

In terms of the Northbound route, provided compliance with infrastructure requirements around custodial arrangements can be met, Stock Connect offers almost free access to the Shanghai market in China A shares for all comers, without the need to comply with RQFII and QFII requirements.

When considered in tandem with the depth of the offshore renminbi market in Hong Kong, via which Stock Connect investors can cover their purchases, and Hong Kong asset managers can hedge share classes to renmimbi for the PRC market, Hong Kong has quite suddenly moved from being a mainly distribution-oriented hub to having the potential to become a fully-fledged asset management centre—when mutual recognition kicks in.

The two measures, taken either in isolation or in conjunction, do not truly constitute a policy or strategy. Indeed, it wouldn't be unreasonable to ask if there is any link between the two, save perhaps an overall and guiding intent to reinforce and develop Hong Kong as a financial centre. One is oriented towards the creation of a capacity—for asset management; the other is the provision of a favourable or necessary infrastructure.

However, there is a link, at least to some degree—if only in effect. From the standpoint of global asset managers, mutual recognition and Stock Connect have almost at the stroke of a pen put Hong Kong front and centre in terms of both inward and outward investment in China, while also acting as enhancements, rather than competitors, to other pilot schemes and initiatives to bring China closer to the fully accessible capital markets of the world.

Where next for Stock Connect?

If we follow the logic that Stock Connect is the pilot for a more general liberalisation of foreign access to Chinese markets and could follow the incremental route taken by the QFII and RQFII systems, what are the next steps that may be anticipated?

The first of course is straightforward and is not even subject to conjecture: Shanghai is only one of the trading venues in China for A shares, and not all companies are listed there. The other major, and relevant, exchange is Shenzhen. An extension of Stock Connect, or perhaps a 'second' Stock Connect is in the making to encompass Shenzhen, and the general manager of the Shenzhen Stock Exchange has said it will include representative stocks from the main board, the small and medium-sized enterprises board and the ChiNext growth board. At present, it is thought that the scheme could be approved in the first half of this year for implementation in the second half. The design of the scheme is understood to be complete and awaiting approval from central government.

To benefit from mutual recognition when it comes will require both presence and product in Hong Kong

There is no 'one approach' to China, of that Hong Kong is well aware. There are other initiatives pending full implementation, or waiting to take their place in the development of China's cross-border investment aspirations. These include the QDLP (Qualified Domestic Limited Partner) and the QFLP (Qualified Foreign Limited Partner) schemes, both of which may open up alternative routes for distributing fund products in China, and neither specifically reserved to Hong Kong. However, Hong Kong is also conscious that it is uniquely placed as one of the privileged routes for inward and outward investment into China. At a time when RQFII and QFII quotas favour direct contact with the mainland, Stock Connect in its current and future form gives Hong Kong unique access. And at a time when QDII finally offers a way to distribute UCITS in China, mutual recognition will place Hong Kong in a uniquely privileged position.

None of these advantages will be written in stone—but Hong Kong can be relied upon to maximise the benefit that may arise from even a temporary advantage. In the same way as we can expect to witness the rise of Chinese banks and asset managers as a force to be reckoned with on the world stage, we will also see Hong Kong develop its own asset management industry to be the 'alternative force' in the region. Hong Kong is still a part of China, and still aligned with the overall aspirations and intentions of China, but it is also unique, flourishing and has its own special role to play.
Hong Kong has been a magnet for traders for decades – even millennia. The vastness of the territories just across a narrow stretch of water, the endless horizon of the Middle Kingdom, and that indefinable sense of promise that seems to rise above the towering Peak are as much of a draw today as they were when traders first discovered Hong Kong. And if those traders were attracted by the deep waters and safe anchorage of the natural harbour beneath the Peak back then, they will now seek to navigate other deep waters towards a safe haven in an increasingly complex world of global investment.

An extension of China, a part of China, or a special and autonomous region with its own future charted before it, Hong Kong can be many things to many people. What it represents for asset managers worldwide is an inescapable signpost on the global asset management map that it will be increasingly difficult to ignore.
The question that each has to answer is: what is the best way to participate in this new dynamism and the opportunities it offers?

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To the **point**:

- Hong Kong has a special relationship both with China and with the world – it is not exclusive in many ways but it is unique
- The strengthening or creation of a thriving asset management industry in Hong Kong is a key objective
- Reinforcing the trading architecture through Hong Kong in both Stock Connect and renminbi trading is another key objective
- The two initiatives Mutual Recognition and Stock Connect represent a significant milestone in the development of Hong Kong as a fully-fledged financial centre
- Stock Connect will be extended to include Shenzhen – possibly this year already
- There will be other Chinese initiatives – not all will involve Hong Kong
- Hong Kong will have to fight for its place in the sun. It intends to. Mutual Recognition and Stock Connect will give Hong Kong some of the weapons it needs