ASSET SERVICER PANEL: FORM AND FUNCTION

The benefits of mutual fund recognition, the future of Ucits in the region and the prospects for improved fund processing were discussed by our roster of experts from asset servicing firms.

ANDREW GORDON, MANAGING DIRECTOR, ASIA, RBC INVESTOR & TREASURY SERVICES

How important is the opening of the Chinese interbank bond market to foreign investors and what are the technical issues involved?
The People’s Bank of China announced in February this year that it would open up the interbank bond market to more foreign investors, which represented another important step to open up the country’s capital markets. The interbank market has been valued at 35 trillion renminbi ($5.3 billion), with foreigners holding less than 2%. The ability to access the interbank bond market without needing a quota is a significant development for the opening up of China, and one that has generated significant interest and excitement. As foreign investment in renminbi assets rises, Hong Kong banks will get more opportunities to serve as intermediaries in asset allocation, which will also help deepen and expand the offshore renminbi market here.

Would you say the Shanghai-Hong Kong Stock Connect has been a success? How do you expect the scheme to evolve in future?
The highly anticipated Shanghai-Hong Kong Stock Connect scheme failed to live up to lofty expectations, partly because of last year’s volatile markets and trepidation around the health of China’s economy. As a result, expectations that foreign investors would rush to invest in Shanghai-listed shares have not materialised – yet. But some early impediments have since been removed and flows from institutional investors are reportedly improving. All eyes will soon move to the launch of the Shenzhen-Hong Kong scheme, offering more opportunities to trade Chinese stocks.

Fund flows up to March in the Mutual Recognition of Funds scheme were described by one industry figure as “pathetic”. Is this analysis fair?
It’s important to remember that the MRF scheme is still in its infancy, but it is slowly starting to gain momentum. Early 2016 was not an easy time to be selling exposure to the Chinese markets given the volatility. The few Hong Kong-based managers with quotas spent time building and educating their distribution partners. However, results from an RBC survey at the FundForum Asia conference showed strong support for the MRF scheme over the medium term despite the dominant position of Ucits in the region. One-third of those polled said MRF funds would be their fund product priority for Asia over the next three years and so far, each month has been better than the previous one. This was never going to be a large market overnight. Patience and focus on the basics is needed.

MARGARET HARWOOD-JONES, MANAGING DIRECTOR, HEAD, INVESTORS & INTERMEDIARIES TRANSACTION BANKING, STANDARD CHARTERED BANK

What is the future for Ucits funds in Asia in light of planned regional passporting schemes?
The various funds passporting initiatives in Asia are at an early stage of development, immature when compared to Ucits. Several major impediments, including absence of tax harmonisation and lack of any overreaching regulatory regime, currently prevent high adoption rates among managers. That said, we see their potential to disrupt the continued sales growth of Ucits in Asia. This will take time to become obvious, maybe four to five years or more.

Is there a risk that Asia becomes more fragmented as regional regulators protect their domestic funds industries?
A regulator playing the ‘home town’ card is not a new phenomenon. We have seen moves in this regard in both Taiwan and Indonesia, for example. At the same time, we see examples of

openness across the Asia region; evidence of wanting to do things differently, as admirably reflected in the initiation and implementation of the various passporting schemes. Many, many factors drive the regulatory agenda and it is not uncommon for apparent conflict to coexist quite happily.

What other regulatory developments are occupying your time?
We focus our time towards operating model design, including work ongoing to support the three Asia passport initiatives. Elsewhere, the Foreign Account Tax Compliance Act, and more recently Common Reporting Standards, as well as the ongoing review of Risk Based Capital measures in Singapore and Solvency II, have been front of mind – for us and for our clients.

OLIVIER PORTENSEIGNE, MANAGING DIRECTOR, FUNDSQUARE

How could fund processing become more efficient in Asia and what could regulators do to help?
Too much fund industry work is organised through point-to-point connections that are costly to organise and prone to error. A recent report by the consultancy Deloitte estimated that around €1 billion ($1.1 billion) is being wasted annually in Luxembourg alone. Using efficient hub-and-spoke models is the key to realising savings. You could argue that regulatory intervention could accelerate cost reduction, but an industry adoption with the support of associations would be, from our point of view, more favourable than imposing a solution to all actors. That is typically what happened in the US more than 30 years ago.

What are the prospects for the Mutual Recognition of Funds scheme between Hong Kong and mainland China?
As at mid-May, 36 mainland funds had been approved for the Hong Kong market, with six funds given the OK for the return trip. Clearly these are early days, but given the size of the Chinese economy, determined action by the authorities could lead to a breakthrough.

What do you see as the main operational challenges facing Asian fund passporting schemes?
Asian players have an excellent opportunity to build efficient infrastructure at the beginning, rather than seeking to move a mature market towards a commonly agreed solution, as we are doing in Europe. Mutualised utilities could be organised on a genuinely pan-Asian basis. The main risk would be multiple actors in various countries launching similar initiatives at the same time.

STANLEY POON, HEAD OF SALES AND RELATIONSHIP MANAGEMENT, ASIA, MIDDLE EAST AND AFRICA, INVESTMENT FUNDS SERVICES, CLEARSTREAM

How could fund processing become more efficient in Asia and what could regulators do to speed up the process?
Over the years we have seen an evolution of fund processing in Asia. In the beginning, distributors were not too aware of the automation solutions and platforms available to them. Now, they have a very high awareness where project teams have been set up in some banks to streamline the processing of the full cycle of a fund trade from input to settlement and custody services. Most distributors throughout the region now understand the potential benefits that can be achieved in automating their fund flows and there is a genuine interest to look for a one-stop shop service provider to meet all their investment funds processing needs. The idea of cross-border fund distribution and the success of the Ucits brand, which is highly popular throughout Asia, has given the Asian regulators some insight to replicating the success of such schemes in the Asian region.

Mutual Recognition of Funds (MRF) between Hong Kong and mainland China was touted as an opportunity for Hong Kong to modernise and say goodbye to the fax machine. Has that happened?

This will take more time to fully automate the orders, settlement and custody operations for the funds under the MRF scheme. There is a link offered by the Central Moneymarkets Unit (CMU) platform to automate the order routing flows which is a step in the right direction, but there are also other ad hoc methods to send orders and settle trades between Hong Kong and China participants. We believe order routing and replacing the fax machine is the easy part, most of the cost savings and efficiency gains in the processing occur in the cash settlement, safekeeping and corporate action reporting further down in the trade cycle. China, domestically, is quite automated in this respect and can help drive a centralised model in order processing, settlement and custody to reap the benefits of automation in the full value chain for MRF. Hopefully, going forward, Clearstream can take a larger role in streamlining this process under MRF.

What are the main operational challenges facing Asian fund passporting schemes such as the Asia Region Funds Passport?
The Asian region is quite fragmented in terms of regulations, tax issues, language, market practice, documentation requirements and so on. Hong Kong and Singapore as international financial centres in the region are probably most similar in nature but apart from that, there are diverse issues which needs to be harmonised across most Asian countries in order for an unified Asian fund passport scheme to work. In respect to the Asia Region Funds Passport, a critical issue regarding tax between high and low-tax countries within the participating members definitely needs to be examined closer in order for it to work in practice. Localising documents for the respective countries that the funds are sold in will also be a key operational hurdle to ensure transparency of information delivery.

DAVID LI, MANAGING DIRECTOR, CACEIS, HONG KONG

What is the future for Ucits funds in Asia in light of planned regional passporting schemes?
Ucits has been dominant in Asia – particularly in Hong Kong, Singapore and Taiwan – for years, and there is still no equivalent product offered by any of the Asian passporting schemes. There is indeed much discussion on local distribution rules, regulatory interpretation and tax surrounding these initiatives, but resolving these issues can take years and requires co-operation among all the participating countries.

Is there a risk that Asia becomes more fragmented as regional regulators protect their domestic funds industries?
There is a risk of further fragmentation. Many local regulators are actually looking to build a wall around their industries. However, it is not only industry protection that is driving this fragmentation, the additional factor of investor protection is driving their efforts too. Following the collapse of Lehman Brothers and the associated crisis, regulators remain worried that by giving the Ucits brand a blanket acceptance, rather than assessing funds on a fund-by-fund basis, they may be leaving their domestic investors open to risky products. Yes, Ucits are highly regulated products, but they remain nevertheless foreign products over which those local regulators have little control.

What other regulatory developments are occupying your time?
The vast majority of the clients for which we act are European. When it comes to regulations that directly concern EU-domiciled investment products, Ucits and other European directives are key.

STEVEN XAVIER CHAN, MANAGING DIRECTOR AND REGIONAL HEAD OF REGULATORY, INDUSTRY AND GOVERNMENT AFFAIRS, ASIA PACIFIC, STATE STREET

What is the future for Ucits funds in Asia in light of planned regional passporting schemes?
Ucits will continue to be popular and an important fund vehicle in the region. However, many fund managers are seeking an alternative and will find the China-Hong Kong Recognition of

Funds (MRF) and other Asia funds passports attractive options. It will take some time for the MRF and other schemes to develop and they will need to increase in scale to create a critical mass of participating economies.

Is there a risk that Asia becomes more fragmented as regional regulators protect their domestic funds industries?
There's always a risk, but Asia is no different than other regions. It took the European Union 40-50 years to achieve regional integration. Notwithstanding Asia's geographical, political, economic and socio-cultural differences, the region has made tremendous progress on regional regulatory co-ordination and collaboration. For example, at global financial bodies such as IOSCO, Basel and FSB, there are Asia-specific working groups of regulators to strengthen co-ordination of policies and positions.

What other regulatory developments are occupying your time?
We will continue to focus on over-the-counter derivatives reforms, recovery and resolutions regimes, anti-money-laundering/know-your-client, cyber security, data privacy, outsourcing and regulations related to the asset management industry, market infrastructures and technology developments. We are also monitoring the Shenzhen-Hong Kong Stock Connect, the MRF and other Asian fund passporting initiatives.

LAWRENCE AU, EXECUTIVE ADVISOR, ASIA-PACIFIC, BNP PARIBAS SECURITIES SERVICES

How important is the opening of the Chinese interbank bond market to foreign investors and what are the technical issues involved?
It is a big step forward in China's renminbi internationalisation agenda. Previously, access to the market was restricted to foreign investors with a QFII or RQFII quota, which is granted after completion of a three-step approval process from the China Securities Regulatory Commission, the State Administration of Foreign Exchange, and the People's Bank of China taking between 12 and 18 months at a minimum. This process clearly had its inefficiencies.
Now, having the People's Bank of China as the sole regulator overseeing the scheme, and using a simple filing process instead of quota application, the change cuts through the cumbersome traditional investment routes.
In addition, the scheme has removed lock-up period and restrictions on the repatriation of funds – a constant source of complaint among QFII/RQFII investors.

Would you say the Shanghai-Hong Kong Stock Connect has been a success? How do you expect the scheme to evolve in future?
Given that it's a first attempt to allow foreign investors to invest into the onshore A-Share market without quotas and only controlled by a daily market gross limit, the Shanghai-Hong Kong Stock Connect has been a reasonable success.
It has attracted new investors who did not have QFII or RQFII quotas while giving flexibility to investors who did have quotas, leading to product innovation. Regulatory authorities that are more stringent in governance, such as Luxembourg and Dublin, are getting comfortable in approving Ucits funds to invest via the Stock Connect.
The Stock Connect has gone through a spectacular boom and bust of the A-share market in its first one-and-a-half years of operations. It is still very much in its formative phase, learning from experiments and errors for improvement.

Fund flows up to March in the Mutual Recognition of Funds scheme were described by one industry figure as "pathetic". Is this analysis fair?
Let's look at the facts. As at the end of April, the three northbound MRF funds from JP Morgan Asset Management, Hang Seng Asset Management and Zeal Asset Management together raised 1.36 billion renminbi ($208 million) in the first four months of 2016, according to the State Administration of foreign Exchange. While the figures are not super, they are getting more encouraging each month. There is a clearly increasing interest from China-based investors for northbound funds for risk diversification.
The gradual build-up is not a surprise, as asset managers need time to understand the MRF process and to develop distribution partnerships in China with banks, securities houses,

financial advisers and online platforms. At the same time, these distributors in China need to learn how to promote the northbound MRF funds. There is an education process taking place.
There has been muted interest from Hong Kong investors for southbound funds, raising only 55 million renminbi ($8.4 million) in aggregate over the three months. The fund launches coincided with the collapse of the A-share market and adverse timing was a big factor.
A sharp focus on product differentiation will be required to get investors' attention.

PATRICK WONG, HEAD OF CHINA SALES AND BUSINESS DEVELOPMENT, HSBC SECURITIES SERVICES

How important is the opening of the Chinese interbank bond market to foreign investors and what are the technical issues involved?
The size of China's interbank bond market is $6.6 trillion (43 trillion renminbi) as of the end of December 2015, according to ChinaBond, Shanghai Clearing House. It is the world's third-largest fixed income market in the world after the US and Japan.
Foreign investor participation is currently very low. As of the end of December 2015, there were only 306 foreign investors participating in the market. Less than 3% of Chinese government bonds were held by offshore investors. In contrast, offshore investors held 48% of US government bonds. In order for China to create a more dynamic bond market and lessen its reliance on bank lending, foreign investor participation needs to increase.
Renminbi fixed income products still offer an attractive yield, with ten-year Chinese government bonds yielding 2.9%. However, the main challenge to foreign investors is how to assess credit, as the onshore ratings are very different from offshore. Moreover, there are many uncertainties around bankruptcy proceedings. Availability of hedging instruments is important, both in interest rate risk and credit risk. Trading hours is a challenge for non-Asian based investors. Clarification of tax treatment for investment in the interbank bond market is also key before foreign investors fully expose themselves in China.

Would you say the Shanghai-Hong Kong Stock Connect has been a success? How do you expect the scheme to evolve in future?
The Stock Connect programme provides a platform to give interested investors an easy way to access the China A-shares market. It has been a successful launch, which has allowed market players to gain exposure to A-shares without applying for a QFII or RQFII licence and quota. The fundamental issue of utilisation still rests with the investor's views on the A-shares market.
Previously, there were some technical issues with regards to beneficial ownership as well as pre-delivery of stock, and the majority of Ucits assets could not access China A-shares via this channel. The Hong Kong and Shanghai exchanges have both taken steps to address and resolve these issues. With the continuous enhancement of the programme, including the Special Segregated Accounts model as well as DVP [delivery versus payment], I am confident that utilisation will increase when we see a more stable market growth.

Fund flows up to March in the Mutual Recognition of Funds scheme were described by one industry figure as "pathetic". Is this analysis fair?
Mutual Recognition of Funds is a platform for fund passporting and I would argue it has been a successful launch. While we are yet to see the demand, there were significant increases in northbound flow, meaning Hong Kong funds distributed in China, in March this year (aggregated sales
in February were $6 million, which has been increased to $80 million in March). Brand-building for Hong Kong managers in China takes time, but we have seen that first-mover advantage is key.
Another area which the industry is working on is pushing for relaxation on some of the eligibility criteria, such as investment management delegation outside Hong Kong, as well as expansion of investment strategies. If these criteria are relaxed, the number of eligible funds for distribution will significantly increase, which will provide more choice to retail investors.

SCOTT MCLAREN, HEAD OF BROWN BROTHERS HARRIMAN (BBH), HONG KONG

What is the future for Ucits funds in Asia in light of planned regional passporting schemes and initiatives such as Mutual Recognition of Funds between Hong Kong and mainland China?

Ucits has a decades-long record as a popular, trusted and dynamic funds framework. Though it faces new challengers in the form of domestic structures or, more broadly, passporting schemes, a BBH survey of leading asset managers shows it will remain a very attractive option for many years to come.

At the same time, we see such substantial growth opportunities in the Mutual Recognition of Funds (MRF) initiative between Hong Kong and mainland China that we recently set up a trust company in Hong Kong to service Hong Kong-domiciled funds, the only domicile permitted for distribution into China through the scheme.

The number of Hong Kong-domiciled unit trusts in the SAR rose 374% to more than 630 as of end-2015, from 170 in 2009.

Is there a risk that Asia becomes more fragmented as regional regulators in, for instance, Taiwan, adopt rules to protect their domestic funds industries?

On the one hand, some jurisdictions have introduced rules to nurture their local funds service segments, but on the other, many jurisdictions across the region are expending great efforts to harmonise rules.

For example, MRF, the ASEAN CIS funds passport, and the Asia Region Funds Passport (ARFP) are designed to facilitate cross-border distribution of funds across multiple jurisdictions.

Though it’s early days, the MRF funds approval rate is accelerating at a faster pace relative to the other Asian passporting schemes.

Apart from issues already mentioned, what are the major regulatory developments that are occupying your time?

As a cross-border expert focused on Greater China, we think the potential inclusion of Hong Kong-domiciled ETFs in Stock Connect, a cross-border initiative launched in 2014 that links the Hong Kong and Shanghai stock exchanges, would further boost Hong Kong’s attractiveness as a domicile, as Hong Kong-listed ETFs would then be made available to Chinese investors.

Other developments that would likely increase flows are the inclusion of Shenzhen Stock Exchange in Stock Connect, the inclusion of A-shares in MSCI’s influential emerging markets index, and evolution of the MRF cross-border model.

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