Hong Kong-based RQFII quota holders may issue public or private funds or other investment products in Hong Kong using their RQFII quotas. They may invest in Mainland bond and equity markets, including the inter-bank bond and exchange-traded bond market.

China approved the RQFII program in December 2011 with an initial quota of 20 billion renminbi. The quota has since risen to 270 billion renminbi. There are currently 27 RQFII quota holders.

Hong Kong, the Next Luxembourg?

Insights | Institutional Investors

The Renminbi Qualified Foreign Institutional Investor (RQFII) scheme is a policy initiative of the Mainland Chinese authorities that allows qualified RQFII quota holders to use renminbi funds raised in Hong Kong to invest in the Mainland securities markets.

<table>
<thead>
<tr>
<th>Type of SFC authorized funds</th>
<th>Number of funds as of Mar 31 2012</th>
<th>Net Asset Value (USDMM) as of Dec 31, 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>995</td>
<td>436,280</td>
</tr>
<tr>
<td>Bond</td>
<td>330</td>
<td>324,078</td>
</tr>
<tr>
<td>Money Market</td>
<td>40</td>
<td>100,535</td>
</tr>
<tr>
<td>Diversified</td>
<td>78</td>
<td>32,345</td>
</tr>
<tr>
<td>Fund of Funds</td>
<td>82</td>
<td>7,817</td>
</tr>
<tr>
<td>Index</td>
<td>111</td>
<td>105,118</td>
</tr>
<tr>
<td>Guaranteed</td>
<td>22</td>
<td>712</td>
</tr>
<tr>
<td>Hedge</td>
<td>6</td>
<td>704</td>
</tr>
<tr>
<td>Other Specialized</td>
<td>17</td>
<td>6,284</td>
</tr>
<tr>
<td>Sub-Total</td>
<td>1,681</td>
<td>1,013,873</td>
</tr>
<tr>
<td>Umbrella Structure</td>
<td>182</td>
<td></td>
</tr>
<tr>
<td>Grand Total</td>
<td>1,863</td>
<td>1,013,873</td>
</tr>
<tr>
<td>Onshore Funds</td>
<td>261</td>
<td>33,408</td>
</tr>
<tr>
<td>Offshore Funds</td>
<td>1,602</td>
<td>980,465</td>
</tr>
</tbody>
</table>

Source: Hong Kong’s Securities and Futures Commission (SFC) and Hong Kong Investment Funds Association (HKIFA)
RQFII and Hong Kong’s Rise as a Regional Asset Management Hub

The growth and development of the RQFII program and signs that a Greater China fund passport may be in the offing not only bode well for the Asia Pacific investment industry, but they also lay the foundation for Hong Kong to become the heart of the region’s fund industry.

China is without a doubt the region’s biggest investment attraction, drawing players from around the globe who are eager to tap into the country’s growth story. That attraction has been a key driver for Hong Kong’s USD1.01 trillion fund management industry for many years, but new developments promise to offer even greater benefits for Hong Kong managers. The RQFII program makes Hong Kong the asset management gateway to China, further enhancing its existing position as the world’s leading offshore renminbi center.

The potential impact on the fund management industry is expected to be significant and could go well beyond Hong Kong and the Mainland. The mutual recognition of funds between Hong Kong and the Mainland, once established, could generate the momentum needed to create a Greater China fund passport and may eventually set the stage for an Asian passport, a China fund passport and may eventually make it a leading global asset management hub.

The pending introduction of mutual recognition of funds between Mainland and Hong Kong is another sign of strong policy support from both Mainland and Hong Kong governments to fortify Hong Kong’s strategic position as a leading offshore renminbi center and to make it a leading global asset management hub.

These developments, and the possibilities they represent, were at the forefront at a private meeting of a dozen top investment managers hosted by Citi in March. Senior executives from some of the world’s leading investment management firms discussed how the development of Hong Kong as a fund center affects their business, and what opportunities they see arising from the changes, both for investing and for raising assets.

This new opportunity clearly raises Hong Kong’s status as a regional asset management hub in comparison to other Asian jurisdictions.

A Revamped RQFII

On March 6, the China Securities Regulatory Commission (CSRC) issued new RQFII rules, replacing those issued in December 2011. The CSRC said the goal of the new rules was to further open the Mainland capital markets, support the international financial center status of Hong Kong, and enhance Hong Kong’s offshore renminbi market development.

“The CSRC will continue to expand the scale of the trial to attract more long-term foreign funds, to ensure the reform and opening of capital markets and its steady development,” the CSRC said in announcing the changes.

The key changes were a significant broadening in the types of managers who may qualify for RQFII, as well as allowing a wider variety of investment products under the scheme. The changes also brought RQFII rules in line with those of the Qualified Foreign Institutional Investors (QFII) scheme, which has been in operation since 2003.

While the two schemes are beginning to share many features, CSRC has made it clear that managers that have both an RQFII and QFII quota must keep those quotas separate and distinct. Exceeding one’s RQFII quota can result in a penalty, and in severe cases the manager could have their quota revoked entirely.

The new rules open RQFII to financial institutions registered in Hong Kong and the Hong Kong units of Chinese banks and insurers. Previously, only the Hong Kong subsidiaries of Chinese fund management companies and securities companies were qualified. Global managers who have key operations based outside Hong Kong, or only offer offshore funds, such as the undertaking for collective investments in transferable securities (UCITS) domiciled in Luxembourg or Ireland, will need to prove to the CSRC that they have a “major base of operations” in Hong Kong. This new opportunity clearly raises Hong Kong’s status as a regional asset management hub in comparison to other Asian jurisdictions.

Chinese financial institutions are still expected to receive preferential treatment in applying for additional RQFII quota, with non-Chinese institutions that have their main operation or business established in Hong Kong coming a close second. Although RQFII rules have been changed to open the scheme to a wider range of asset managers, the CSRC is still showing a preference for Hong Kong investment vehicles rather than offshore products. Products must also have renminbi as their main currency.

These developments bode well for the push to have more funds domiciled in Hong Kong. However, up to this point not many international managers have experience in creating or operating Hong Kong-domiciled funds because so few funds sold in Hong Kong are currently domiciled here. This means that international managers will need to sharpen up on Hong Kong’s rules and processes.

Thus it is important to partner with a service provider that is experienced in providing trustee and administration services to locally domiciled unit trust funds. “This would help managers to avoid unnecessary delays in launching new funds and to get more familiar with local requirements,” said Stewart Aldcroft, Senior Advisor, Investor Services, Asia Pacific, Securities and Fund Services.

Currently, most Hong Kong funds are established as unit trusts because restrictions in the Hong Kong Companies Ordinance on share buy backs and the reduction of share capital make companies with variable capital (i.e. mutual funds) impractical.

Hong Kong has an open architecture toward admitting and authorizing overseas funds that wish to offer their products to the Hong Kong retail
public, which has led to a lack of strong incentives for many of the global fund houses to launch Hong Kong domiciled funds. Currently more than 80 percent of the funds distributed to Hong Kong retail investors are domiciled outside of Hong Kong. Until now, the main reasons for launching a Hong Kong-domiciled fund (excluding REITs) was to distribute to Mandatory Provident Fund schemes (USD56 billion), sell ETFs (USD100 billion) or create immigration funds for Mainland investors or foreigners to apply for Hong Kong residency. The growth of the RQFII scheme along with rapid growth of Mainland-related asset management firms in Hong Kong gives managers another reason to look at Hong Kong as a domicile of choice for new funds.

Under the old rules, RQFII funds were required to invest 80 percent of their assets in fixed income securities, with no more than 20 percent in equities. In the new rules those restrictions are removed, allowing funds to practice a wide range of strategies, such as equities only. RQFII funds are now also allowed to invest in stock index futures. This is expected to be much more popular with prospective investors.

The CSRC also expanded the range of products to choose from, adding stock-index futures to the previously approved list of equities and bonds, including the inter-bank bond and exchange-traded bond market. RQFII funds will also be able to take part in initial public offerings, convertible bond sales and share placements.

The CSRC also simplified the application document for RQFII license applications. For example, the applicants no longer need to provide legal opinion and statement of internal control.

Hot Demand
In April 2012, the CSRC, the People’s Bank of China, and the State Administration of Foreign Exchange decided to add 50 billion renminbi to the quota of RQFII investment, allowing the pilot institutions to use it in issuing renminbi A-share ETF products that invest in A-share index shares and are listed on the Hong Kong Stock Exchange. In July 2012, the world’s first RQFII A-Share ETF, a renminbi-denominated physical A-share ETF, was launched and traded on the Stock Exchange of Hong Kong. It quickly became one of the hottest investment products of the year. There are now four RQFII A-Share ETFs listed in Hong Kong, representing about 46 billion renminbi in RQFII quotas.

With the mutual recognition of funds perceived as the next step in establishing Hong Kong as the Asian hub for fund management, the Hong Kong Government is looking to drive a vertical service model so that funds could also be administered from Hong Kong.

Demand was so strong that most of the RQFII ETFs were closed for purchase after their debut because they reached their quota. Many had their quotas raised, and eager investors quickly snatched up the extra capacity.

The demand has not been driven by past performance but instead by the potential for future gains and relatively low valuations offered by the A-shares market. The returns on RQFII funds in 2012 averaged 3 to 4 percent, well below the alternative of a 22 percent gain in the Hang Seng Index.

Changes in the rules dictating what RQFII funds can invest in will help address the issue of “mono-offering”, which became a problem because strict asset allocation rules offered managers little room for creativity in creating a variety of different investment products.

Changes in the rules dictating what RQFII funds can invest in will help address the issue of “mono-offering”, which became a problem because strict asset allocation rules offered managers little room for creativity in creating a variety of different investment products. This lack of diversity undermined interest from investors. Hong Kong’s Securities and Futures Commission (SFC) is now working with CSRC to ensure product diversity by preventing all ETFs tracking single/similar indices.

Mutual Recognition
The next big step in Hong Kong’s development as an asset management hub is mutual recognition of fund registration between Hong Kong and the Mainland.

Mutual recognition means that qualified SFC-authorized funds domiciled in and operating from Hong Kong would enjoy the status of “recognized Hong Kong funds”, and qualified Mainland funds would enjoy the status of “recognized Mainland funds”. These recognized funds could then obtain authorization and be sold directly in the other market.

This would be an important first step in creating an Asian fund passport, which has been under discussion for many years without becoming reality. An Asian fund passport would greatly reduce registration and administration for regional fund managers, who must now meet varying registration requirements and processes in the different markets across Asia Pacific.

While discussions to create the basis for mutual recognition are still at a technical stage, progress is being made. Separately, Mainland and Taiwanese authorities are expected to meet in the coming months to discuss Taiwan’s possible role in the RQFII scheme, which indicates progress in bringing Taiwan into a mutual recognition agreement.

Taiwan hopes to have an RQFII investment quota of 100 billion renminbi for Taiwan-funded financial institutions, and Mainland authorities are considering permitting qualified Taiwan residents to invest in the Mainland’s capital market under the RQFII program.
Opportunities Ahead
Changes in RQFII rules and steps toward mutual recognition between Greater China markets have sparked a huge amount of interest and queries from Chinese securities firms, global managers and possible new entrants into this exciting asset management market.

Citi expects to see a marked rise in the number of international banks and fund houses based in Hong Kong who apply to participate in the RQFII scheme. Not only does this bode well for the Hong Kong asset management industry, but an increase in the number of institutional investors, such as insurance companies and fund houses, will add stability and long term funding to the Mainland equity and fixed income markets.

More players, together with recently relaxed asset allocation rules under the RQFII scheme, will also result in a growing variety of renminbi investment products available to investors. New products in the pipeline include ETFs tracking new indices. Together, the new RQFII developments and progress toward mutual recognition create a significant draw for the global fund houses to establish their hub in Hong Kong to take advantage of these developments.

"Citi's local market presence in the Greater China markets allows Citi to be at the forefront of these developments. We will continue to contribute to discussions with local regulators and market participants to help advance these developments," said David Russell, Regional Head, Asia Pacific, Securities and Fund Services.

Citi is one of the largest custodian banks in Hong Kong, and has offered local and global custody services since 1975. Citi is also an approved trustee for Hong Kong Mandatory Provident Fund (MPF) and SFC funds and has been providing fund administration and trustee services since the implementation of the MPF system in 2001.

Citi offers integrated solutions to serve customers who demand convenience from comprehensive product suites. For example, Citi is the first and the only provider to offer end-to-end solutions for ETF issuers, combining market making, seed capital, custody, accounting, administration, and trustee services. Citi provided this solution suite to help launch the world’s first RQFII A-Share ETF in July 2012.

Citi is among the most active inter-bank players in the CNH market and one of the first few market makers in deliverable CNH options. Besides foreign exchange, Citi offers a comprehensive package for CNH investors that includes custody, fund services, remittances, and cash management. Citi is also an active market participant in “dim-sum” bonds.

“Clearly, it is an exciting opportunity for the asset management industry to leverage Hong Kong’s unique platform to access Mainland China securities markets, currency and investors,” said Jervis Smith, Regional Head, Client Sales Management, Financial Institutions, Asia Pacific, Securities and Fund Services. “We look forward to supporting the development of the Hong Kong funds industry and delivering a full suite of products and services to enable managers to benefit from these opportunities.”

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