

# **An Overview of the China Fund Management Industry**

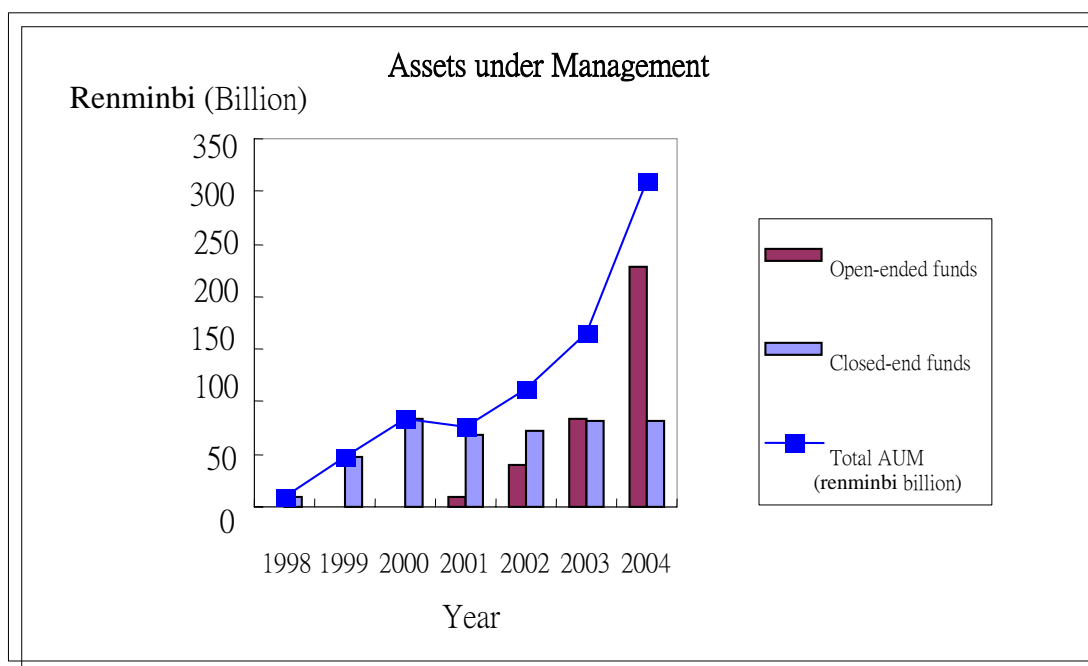
## Industry overview

The past decade represented one of the most rapid phases of growth for the China economy, with GDP registering an average annual growth rate of close to 9%. In the past five years alone, household wealth had doubled and per capita GDP had already exceeded the US\$1,000 level in 2004. The wealth creation effect unleashed by economic prosperity has in turn triggered the demands for investment products, including funds. Against this background, the Chinese authorities have been committed to developing a robust regulatory framework that can foster market development and at the same time, ensure that investor interest is well protected.

The first key piece of regulation that governs the fund industry - the Provisional Measures of the Administration of Securities Investment Funds - was promulgated by the China Securities Regulatory Commission ("CSRC") in 1997. The development of the regulatory framework reached a milestone in 2003, when the PRC Securities Investment Funds Law was promulgated which codified the existing raft of rules and measures into a comprehensive piece of legislation. Since 2004, a series of supplementary measures have been introduced to govern the set up, operation, sales, corporate governance, internal controls, disclosure, and staff qualification of the fund management companies.

During this period, the fund management industry has basically gone through three phases. The first phase, i.e. between March 1998 and September 2001, was marked by the predominance of closed-end funds. In 2001, the first open-ended fund was launched and this marked the beginning of the second phase during which the importance of open-ended funds prevailed over that of closed-end funds. At the end of 2002, the first joint venture investment fund company was set up, which heralds a new phase for the industry.

Despite the short history, the China fund management industry has witnessed steady growth and at the end of 2004, there were 45 fund companies, of which 13 were joint ventures. Altogether, they managed 105 open-ended funds with total assets of about 228 billion renminbi (about US\$28 billion) and 54 closed-ended funds with total assets of about 81 billion renminbi (about US\$10 billion).



Data source: [www.chinafund.com.cn](http://www.chinafund.com.cn), Guotai Asset Management Co. Ltd.

Despite the investment restrictions prescribed by the rules and regulations, the industry has been able to offer a wide array of products with different risk and return profiles. In terms of number of funds, about 70% were equity funds, 14% were bond funds, 9% were balanced funds; and 5% were money market funds. More product types have been offered of late, such as ETFs and LOFs.

The number of fund investors has witnessed steady growth. According to the Securities Association of China (“SAC”), the number of unit-holders has increased from 2.4 million in 2003 to 4.3 million in 2004. Funds are distributed primarily through commercial banks, which assume the lion’s share of fund sales (60%). Securities companies and direct sales channels each take up about half of the remaining 40%.

In terms of industry structure, there is a relatively high degree of market concentration, with the top ten companies accounting for about 57% of the market share. Most of the top ten were from the first batch that was approved to be set up. However, the importance of JVs has been growing: they launched 12 open-ended funds, or 24% of the total number of funds launched in 2004. Under the WTO protocol, eligible foreign partners can, from December 2004, hold a maximum of 49 per cent of a joint venture, up from the initial maximum of 33 per cent. With the increase in the maximum level of foreign ownership, it is expected that more foreign fund houses would contemplate setting up JVs or increasing their stakes in the existing JVs.

Previously, commercial banks were not allowed to set up fund management companies. However, the restriction has basically been relaxed this year with the promulgation of the Measures governing the establishment of fund management companies by commercial banks. Subject to specific rules and guidelines, commercial banks (including state owned commercial banks and joint stock banks) can now apply to set up fund management companies. It was reported that on a pilot basis, three banks, namely Industrial and Commercial Bank of China, China Construction Bank and Bank of Communications, have received approval to set up

fund management companies.

In addition, in April 2004, the China Insurance Regulatory Commission promulgated the Provisional Measures governing insurance asset management companies, which lay out the framework for the establishment and operation of these companies. All these developments portend that more players will be able to participate in the China fund management industry. While this would spell keener competition, it would also mean that more investment management expertise and product choices will be made available, which will be in the interest of Mainland investors.

#### Challenges and opportunities

As at the end of 2004, China's GDP already reached 13.6 trillion renminbi (about US\$1.7 trillion). While the rate of growth may moderate, the economy is expected to continue to enjoy robust growth.

Chinese households continue to put substantial savings in bank deposits. As at the end of 2004, bank savings (including both renminbi and forex) held by individuals exceeded 12 trillion renminbi (about US\$1.5 trillion). The CPI in the first quarter of 2005 went up by 2.8% on a year-on-year basis, vs. the saving deposit rate of 0.72% and fixed deposit rates which range from 1.71% (3 months) to 3.65% (5 years). Against this background, depositors are keen to look for alternative investment tools. Funds represent an alternative that more and more depositors have turned to, which augurs well for the fund management industry.

On the institutional side, a key area for growth is pensions. China has a long-term shortfall in pensions funding. In 2004, people aged 65 or above accounted for 7.6% of the population. The World Bank estimated that this will go up to 22% in 2030. With an ageing population and increasing life expectancy, the dependency ratio is expected to deteriorate substantially in the next two decades. In 2004, the Ministry of Labour and Social Security promulgated the rules on corporate supplemental pensions, a voluntary scheme which aims to supplement the basic pension provisions. As at the end of 2003, about seven million employees in China were already covered by some form of occupational pension schemes. Assets of these schemes reached 50 billion renminbi (about US\$6 billion) by the end of June 2004 (if one includes insurance products, the total asset size will amount to about 100 billion renminbi or about US\$12 billion). With the establishment of a regulatory framework for corporate supplemental pensions, it is expected that each year will bring in new assets of 60 billion renminbi (about US\$7 billion), which will provide a huge potential for all eligible players, including fund managers.

Apart from the change in the demographic structure, the size of the China pension deficits also depend on the types of permissible investment and the returns that can be obtained from these assets. Under the interim measures promulgated in 2001, the National Social Security Fund ("NSSF") is permitted to invest up to 40% of its assets in stocks & equity funds, up to 10% in corporate bonds; and no less than 50% in bank deposits and government bonds, etc. In practice, a substantial portion has been invested in bank deposits and government bonds. As at the end of 2004, NSSF had total assets of over 171 billion renminbi (over US\$20 billion), 43% of which were invested in fixed-income securities, 39% in bank deposits, 11% in publicly traded equities and 7% were in unlisted shares. Returns have only been marginal - the return in 2004 was 3.1%. The NSSF has been keen to look for alternative vehicles to

achieve higher risk-adjusted returns. It has been approved in principle to invest overseas and once the rules governing overseas investment have been finalized, NSSF will invite companies to bid for the mandates.

Similarly, insurance companies had, hitherto, been only allowed to invest in the domestic capital markets. In terms of asset mix, they have also been putting a substantial portion of their assets into bank deposits and government bonds. The China insurance market has been growing at an annual rate of 30% in recent years. In 2004, total assets of the Chinese insurance companies exceeded 1,000 billion renminbi (about US\$120 billion). To better manage the fast-growing insurance assets and to cater for the need for diversification to provide a better match for liabilities, Chinese insurance companies have been looking at investment opportunities both locally and abroad; and the Provisional Measures released in August 2004 which allow insurance companies to invest part of the proceeds abroad represented an important milestone to facilitate this process.

The Chinese authorities had also introduced the Qualified Foreign Institutional Investor (“QFII”) Scheme, which allows eligible foreign financial institutions to invest in renminbi denominated listed shares, bonds, securities funds and IPOs. There are now 26 approved QFIIs and the total quotas approved amounted to US\$4 billion. The experiences derived from the QFII program, as well as those gained by NSSF and insurance companies in overseas investment would help pave the way for the introduction of the Qualified Domestic Institutional Investors.

#### The role of Hong Kong in the growth of China fund management industry

The aforesaid developments highlight the substantial growth potential for both domestic and international fund management companies. Hong Kong is placed in a strategic position to contribute to this process, in particular to provide a platform to facilitate the Mainland counterparts to have international exposure and to develop a framework that is in line with international best practices. Hong Kong is a leading fund management center in Asia – it is an open market, with many international fund companies establishing its headquarters or other forms of presence here. It has an open architecture that allows products from different jurisdictions to be promoted and marketed to the general public in Hong Kong – in fact, 95% of the Hong Kong Securities and Futures Commission (“HKSF”) authorized funds are offshore in nature. Thus, Hong Kong has already had the infrastructure and a pool of international expertise – both on the retail and institutional side - on which the Mainland counterparts can capitalize. The expertise covers investment management, risk management, compliance, marketing and distribution, investor education, product development and innovation, as well as back office administration.

These expertise and experiences will be useful to the development of China’s institutional and retail markets. For instance, on the institutional market, the Hong Kong market has a long track record in discretionary investment management services and the experiences would be of great relevance to the Mainland counterparts when the latter develops this market segment. On the retail side, with increasing competition, Mainland fund companies are faced with the formidable task of product development and broadening the distribution channels, and these are the areas that we can provide substantial input, too.

On the regulatory front, the retail HKSF authorized funds framework as well as the

Mandatory Provident Fund System are well-tested and can serve as useful examples to our Mainland counterparts when they further enhance their system. To enable the Mainland industry participants to have first-hand-experience of international practices, it would be useful if products are made available to enhance their understanding of the operation of international investment funds. We have proposed that to provide more investment options to Mainland investors, the authorities can, on a pilot test basis, consider making available HKSFC-authorized funds to investors in the Mainland who have foreign currency accounts. In view of the foreign exchange control in China, a special share class, for example C-class, can be created for these investors, such that subscriptions and redemptions are limited to specific eligible financial institutions within the country and must be carried out on-shore. This mechanism will enable Mainland investors to invest in HKSFC-authorized funds, which invest in a wide array of investment instruments and markets. These funds, which are under the auspices of the HKSFC and the scrutiny of trustees, have been used extensively by institutional and retail investors in Hong Kong and abroad. They can act as a cost effective and efficient tool for Mainland investors to diversify and to gain access to international investment management services.

In a nutshell, we believe that the China fund industry is poised to experience exponential growth; and Hong Kong, with its pool of international expertise, geographical proximity, cultural affinity and linguistic similarities, will be able to contribute to its development by providing a platform that further facilitates our Mainland counterparts to develop a framework that takes into account the unique characteristics of the China market and adopts international best practices and standards.

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