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Development of ETFs in Asia and Implication to the Roles of Trustee

Activity in the exchange traded funds (ETFs) market in Asia is expected to increase even further this year, as the major promoters boost their product ranges in Asia and new local and global ETF managers enter the ETF market in Hong Kong. Recent events in regional and global financial markets may prove to be the catalyst required by ETFs to gain greater acceptance in Asia Pacific. As many retail and institutional investors have become disenchanted with traditional mutual funds during the recent market turmoil, investors value ETFs especially for their high product transparency, market liquidity, flexibility as a portfolio management instrument, and low total expense ratio.

Globally, ETFs hold over US$1 trillion in assets under management (AuM), the majority of which is held in North America and Europe. Global ETF AuM grew by 54.8% to roughly US$1.2 trillion in 2009. The US was the biggest market with AuM of US$793.6 billion in 2009, followed by Europe with US$242.6 billion, and Asia with US$70 billion. In Asia Pacific, there are approximately 300 ETFs out of a global total of over 2,500, representing just over 11%. While Asia is the smallest ETF market, it has been growing fast. In 2009, ETF AuM in Asia grew by 26.6%. The growth rate of Asia excluding Japan is even faster at 66.5%.

However, as the ETF market in Asia has grown substantially in recent years, there has also been a marked increase in the number of newcomers to the Asian ETF market, with both new fund houses and also global ETF providers starting to launch ETFs aggressively over the past two years. In Hong Kong, for example, in the first half of 2010 alone, we have seen at least four new ETF managers joining the market: China International Capital Corporation, Sensible Asset Management, Ping An and also Dacheng Fund. We would expect competition in the Hong Kong ETF market to further intensify in 2011.

The ETF market in Asia is also not one coherent market. There are substantial differences between countries in terms of market size, turnover, regulation, and ease of listing. It is not easy to predict how Asia-based ETFs will evolve in terms of product offerings and key markets. While we can look at development in the European and US ETF markets for clues, the investing culture in Asia will be different. For example, Asian investors typically do not like fixed income/money market ETFs: the smallest and least liquid ETF in Hong Kong is a money market ETF.

Taking a closer look at the ETF market development in Hong Kong, Hong Kong is the second largest ETF market in Asia with AuM of US$28 billion (excluding SPDR Gold Trust) and a total of 65 ETFs listed at the end of September 2010.

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With more than 30 ETFs currently applying for listing, 2011 is expected to be another year of strong growth of Hong Kong's ETF market.

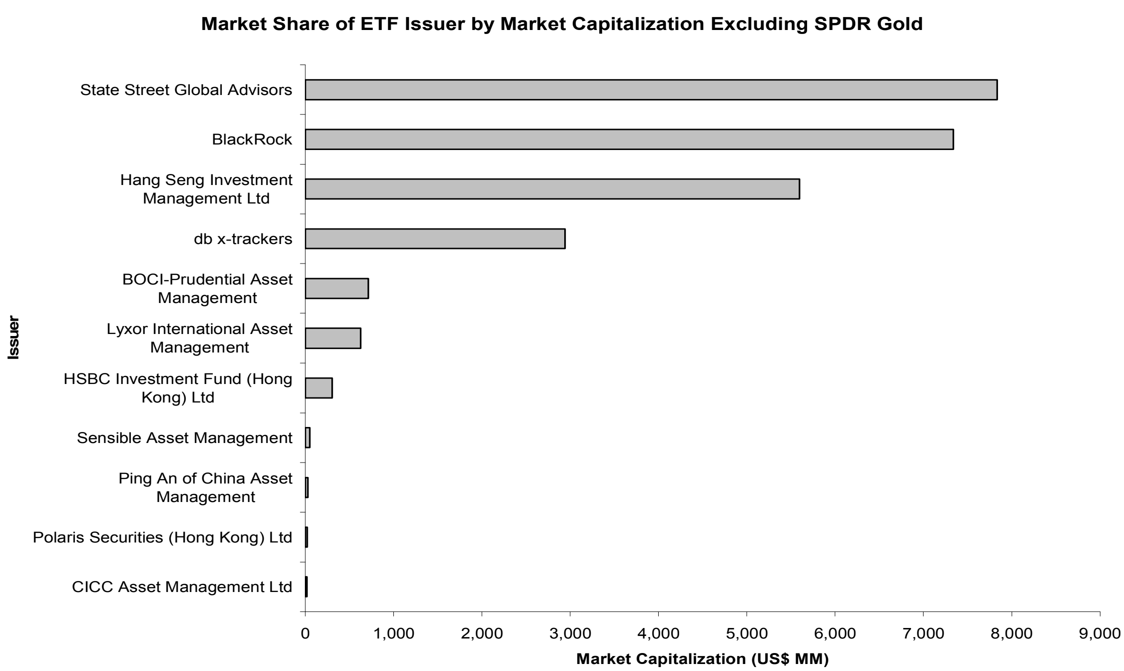
Hong Kong is the number one ETF market in Asia for stock market investors wanting to tap into China. Expected future inflows from QDII funds from China will also boost Hong Kong-listed investment vehicles, such as ETFs, which are benefiting from the improved market liquidity. Hong Kong is the top ETF market in Asia in terms of trading value with US$64.1 billion traded in 2009, compared to Japan with US$30.5 billion.

The top ETF managers in Hong Kong are State Street Global Advisors, Blackrock, Hang Seng Investment, Deutsche Bank and BOCI-Prudential (see Chart below).

In the 2010 budget, the Hong Kong government extended stamp duty concessions in the trading of ETFs to cover funds that track indices comprising not more than 40% of Hong Kong stocks.

Although this will benefit only a handful of ETFs listed in Hong Kong (as the majority of the cross-listed ETFs in Hong Kong are already exempted from stamp duty), this move will continue to reinforce the Hong Kong government's commitment to enhance the competitiveness of Hong Kong as a major ETF hub in Asia and will help encourage development of new ETF products that use Hong Kong stocks as their underlying assets.

Perhaps the most significant development in Hong Kong ETFs over the past few years has been the growth of A-share ETFs, both in China for domestic investors as well as in Hong Kong for international investors. The most popular fund amongst international investors has been the iShares FTSE Xinhua A50 China Fund (2823 HK). The WISE CSI 300 China Tracker (2827 HK) has also gathered about US$1 billion in AuM, although this is approximately a sixth of the size of the iShares product. The fact that these ETFs can and do trade at premium and discounts to net asset value (NAV), depending on the availability of the qualified foreign institutional investor (QFII) quota and institutional demand, makes them almost unique among ETFs.



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However, one of the main challenges facing the ETF market in Hong Kong is the need to reduce counterparty risk. This is particularly relevant for China market-access ETFs which are structured using derivatives. The Hong Kong Securities and Futures Commission (SFC) has imposed the requirement for collateral to mitigate counterparty risk, which has resulted in higher costs. The use of China market access derivatives is also vulnerable to China policy changes on the use of derivatives to access the mainland market from offshore. With anticipated broadening of the QFII scheme in China, we expect ETF managers to apply for direct market access to China A-shares over time to reduce structuring ETFs using derivatives.

Several important ETF market trends are expected to emerge in Hong Kong in 2010:

- As more Chinese fund management and securities companies establish their international presence in Hong Kong, we expect to see these Chinese entities launch Chinese A-share or Hong Kong equity-based ETFs. As of the end of March 2010, there are two Chinese ETF managers in Hong Kong: BOCI-Prudential and China International Capital Corporation Securities. We expect the Chinese managers in Hong Kong to increase to more than ten by the end of 2010.

- With the internationalization of Renminbi (RMB) in Hong Kong, we also expect China to launch mini-QFII scheme in Hong Kong that will allow the creation of the first RMB denominated A-share ETF in Hong Kong that will have direct holdings in China without the use of derivatives. We will expect the first RMB ETF will be listed in Hong Kong by end of 2011.

- In May 2009, the Hong Kong SFC signed a side letter to a bilateral MoU with the Taiwan Financial Supervisory Commission (TFSC) to allow cross-listing of ETFs in the two markets. As a result, Polaris Securities was the first to launch a Taiwan market ETF in Hong Kong in September 2009 and a Hong Kong-listed China ETF in Taiwan. We expect additional Taiwan ETFs to be listed in Hong Kong in 2010.

- We expect continued expansion of market access to Hong Kong-listed ETFs. For example, there is no Latin American ETF listed in Hong Kong and this gap will be filled soon.

- We also expect listing of multi-market ETFs which will allow investors to invest simultaneously in multiple Asian markets through one ETF.

- With the launch of Hong Kong Mercantile Exchange and the rapid development of commodities-based ETFs in Japan, commodities ETFs in Hong Kong should become increasingly popular in 2010.

While these market developments present significant business opportunities, they also pose challenges to trustees/custodians in Hong Kong. Firstly, as there is increasing concern over ETF that is based on derivatives instruments, e.g. swap or p-note based, as trustee for the ETF in Hong Kong, investors will expect trustee to exercise due care to perform accuracy test on the valuation of these derivatives instruments and also to ensure that the collateral requirement that may be imposed by SFC in Hong Kong will be implemented accordingly. There is also the need for trustee to expand the service scope to cover other asset classes such as commodities to meet future requirement in Hong Kong as commodities gain popularity in Asia.

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Secondly, with the internationalization of RMB, trustees in Hong Kong will also need to be familiar with and be equipped with Chinese capable team in order to be in the position to support Chinese RMB denominated ETF in Hong Kong, this will require the trustee/custodian to be able to support funds launched in Hong Kong with settlement process that link with sub-custodian in China and China Securities Depository and Clearing Corporation (CSDCC).

While the ETFs in Hong Kong will shift from single market to multi-market, trustees in Hong Kong will also need to be equipped with fund services capabilities to support valuation of underlying asset in different time zones, e.g. U.S. and Europe, and this will require a robust global fund services infrastructure to be in place to support this.

As the ETF market in Hong Kong will increase in its breadth and complexity, trustees/custodians will also be expected to play a central role in assisting ETF managers with the listing process. This involves in-depth knowledge of local listing regulations and disclosure requirements.

The role of a participating dealer (PD) and Market Maker (MM) is critical to support the continued growth and development of ETF products by enhancing open market liquidity through the creation/redemption process. The continuous offering of shares is a mechanism to keep premiums and discounts to Net Asset Value minimal. For example, if ETF shares are trading at a market premium the Market Maker will 'create' and offer ETF shares at a market premium compared to the cost of securities that comprise the creation/redemption basket. (The basket is the securities required for payment of the ETF shares.)

While many factors lead to the ultimate success or failure of an ETF product, once clients determine the product that meets their exposure needs they will then focus on the liquidity that can be sourced.

While liquidity in single stocks is typically defined as either historical traded volume or depth of market, an ETF's screen-based liquidity only tells half the story. When considering liquidity, clients need to consider the underlying liquidity of the composite securities of the ETF as well. By utilizing the creation/redemption facility, PDs will source a vastly wider pool of liquidity allowing end clients to gain the notional exposure they desire at significantly reduced implementation costs. Providers should look to their MM partners to create fair and efficient markets that will lead to a better cross section of market participants, providing tighter, deeper markets.

As the Hong Kong ETF market further matures, demand for ETFs from institutional and retail investors will only grow as more investors realize the cost, market access and liquidity advantages of this investment vehicle in Asia Pacific. The number of indices in Asia Pacific across all asset classes and geographies will increase as fund managers continue the trend of diversifying into ETFs. A demand spike can be expected as more indices and supporting regulations become available across the region and as more options become available to a more conscious investor class in Hong Kong. While the growth in ETF market in Hong Kong present significant opportunities, trustees/custodians will also need to invest in upgrading their capabilities to support this growing segment in Hong Kong.

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Source of AuM data is based on market capitalization, and as available from website of various stock exchanges and Citi's own research

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