Analysis based on our daily newsletter, Conversations in Chinese Media (CiCM)

20/10/22

CiCM INSIGHTS

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Issue 8: Hong Kong - China ETF Connect Program

Hong Kong - China ETF Connect Program

The Joint Statement on the Inclusion of ETFs as part of Mutual Stock Market Access

- The China Securities Regulatory Commission (CSRC) and Hong Kong Securities and Futures Commission (SFC) have decided to include Exchange-Traded Funds (ETFs) that would be deemed eligible upon meeting the required criteria. According to the joint statement, in 2016, the CSRC and the SFC decided to include ETFs eligible for securities under the Stock Connect program. The Shenzhen Stock Exchange, Shanghai Stock Exchange, Stock Exchange of Hong Kong Limited along with the Clearing Corporation Limited, Hong Kong Securities Clearing Company, and China Securities Depository agreed upon the proposal in December 2021.
- With this initiative, investors in Hong Kong and Mainland China will be able to trade eligible listed ETFs and Stocks through local brokers or security firms. Issues that are not yet addressed in the ETF Connect joint statement like the applicable trading and clearing rules, eligibility of investors, cross-boundary regulations, liaison mechanism, and enforcement cooperation will be dealt with as per the Stock Connect program.

What are ETFs

- An Exchange Traded Fund (ETF) is an investment company through which investors can purchase a proportionate share in stocks, securities, and bonds. These ETFs can be traded through a broker on a stock exchange similar to individual equity securities. As a concept of an investment company, the ETFs are a recent innovation. ETFs provide the opportunity for investors to buy shares at a competitive price from a diverse range of securities. In other words, through ETFs, investors can pool their money into a fund that would be further invested in stock, bonds, or securities.

Eligibility Criteria for ETFs

- *Eligibility for Northbound Trading:*

1. Shanghai Stock Exchange (SSE)/Shenzhen Stock Exchange (SZSE)-listed ETFs are eligible for Northbound trading and can be traded in Renminbi (RMB) with a daily average Assets Under Management (AUM) in the last six months not to be less than RMB 1.5 billion.
2. These ETFs must be listed for more than six months.
3. The total weighting of A-shares in the benchmark index should not be less than

90% and the total weighting of Stock Connect Northbound eligible constituents should not be less than 80%.

- *Eligibility for Southbound Trading:*

1. SFC-regulated and SEHK-listed ETFs will be eligible for Southbound Trading if they are traded in Hong Kong Dollar (HKD) whose daily average AUM in the previous six months is not less than HKD 1.7 billion. It must be listed for no less than six months with the benchmark index launched for no less than one year. These must not be synthetic, leveraged, or inversed products and the total weighting in the benchmark index must not be less than 90%. The total weighting of eligible constituencies in Hang Seng China Enterprises Index (HSCEI), Hang Seng Index (HSI), Hang Seng Hing Kong- Listed Biotech Index (HSHKBIO) and Hang Seng Tech Index (HSTECH) should not be less than 70% and the total weighting in other benchmark indices should not be less than 80%.

ETF Connect as an Extension of Stock Connect

- The arrangements for ETF Connect are made on the lines of Stock Connect and follow the same fund operations, operational models, laws, and regulations. Here, it must be noted that with the Stock Connect program, China aimed for a common market between the Mainland and Hong Kong and the inclusion of ETFs is an extension program that has been in discussion to implement since 2016. Since Stock Connect has been a successful example of a system that supports the scheme of mutual market access, the ETF Connect can be a possible success due to this existing infrastructure.
- The eligibility of ETFs will be decided on factors such as the size of the fund and the index tracked by the fund should comprise the eligible stocks under Stock Connect. Further eligibility criteria will be announced and CSRC, SFC, Hong Kong, and Mainland China exchanges may alter the eligibility of ETFs as per operational performances. As means of investment, investors may trade ETFs only on secondary markets with no subscriptions or redemptions allowed. Further, the investment quota will be aggregated for calculative and administrative reasons.
- In 2021, the ETF assets in the region reached worth $300 billion. Due to this demand surge for ETF assets in China, the ETF Connect was launched with the goal of providing investors with access to a broader range of products apart from the domestic market.
- In this regard, the launch of ETF Connect comes at a crucial time for China. Due to the pandemic, China is focusing on revamping its economy and the inclusion

of ETFs in the Stock Connect can make that possible. It must be noted that the program allows a common market for both China and Hong Kong, which is likely to gain a lot of attraction from international investors. Therefore, China can bring more investments into the country by allowing a broader market since the majority of the eligible ETFs are from Mainland China. The performance of ETF Connect is expected to be consistent with that of Stock Connect but due to the current rigid eligibility criteria, the performance has been slow. Since, ETF Connect is an expansion of the existing facilities under Stock Connect, so the scheme does not allow cross-border sales or marketing of ETFs. If combined with the rigid eligibility criteria for ETFs, the scheme has become very narrow. However, companies that want their ETFs listed in Mainland China to connect to Hong Kong can get authorization from the Securities and Futures Commission (SFC) under the current regulatory framework. Considering this possibility, it is likely that the number of eligible ETFs for the scheme will increase. Therefore, while the launch of the schemes has been slow, it is possible that it would gain pace in the future.

Benefits for Investors

- The ongoing trading has favoured Chinese funds and the imbalance has already been called out. This imbalance is caused because the eligible ETFs in China are greater than the Hong Kong-listed peers. As of now, there are only 4 eligible ETFs in Hong Kong while China has 83 and therefore has more products for the investors. Therefore, it is likely that mainland China would attract more foreign investments in ETFs than Hong Kong.
- China's ETF market is valued at 1 trillion yuan ($ 149.25 billion) and focused on local markets allowing fund managers in Mainland China to gain as per the current eligibility requirements. To fix the imbalance, the industry hopes that the regulators will ease the regulations for Hong Kong's benefit.

Opportunities for Cross-Border Trading

- ETF Connect will increase capital to the home and offshore markets in both Hong Kong and Mainland China. This would diversify the profiles of investors and will improve the liquidity of financial markets making them more stable. Here, the program is likely to be more attractive to institutional investors globally because the cost of ETF trading is lower than stocks and it increases opportunities for more cross-border investment.
- Experts and commentators have stated that indices such as the HSCEI, HSTECH, and HSI, are to be included in the first batch of the program. Further additions to the program may include the Global X Hang Seng High Dividend

Yield ETF, Tracker Fund of Hong Kong, and the Ping An of China CSI HK Dividend ETF.

- This program will allow offshore investments in specific industries of China. For the investors in Mainland China, the program allows investments in ETFs holding secondary listings in Hong Kong, such as Alibaba and Baidu.
- Hong Kong is critical for China's financial development. With its 14th Five Year Plan (FYP), China aims to enhance Hong Kong as a global offshore RMB business hub that would connect the Chinese financial market with the world. The program will also boost the confidence of international investors in both markets.

Future Prospects

- Shenzhen Stock Exchange of China and the Singapore Exchange (SGX) have moved to set up a cross-border link for exchange-traded funds (ETFs) designed to open up more avenues of investment options in both markets. The Memorandum of Understanding (MoU) for the cross-border link will allow the respective stock exchanges to develop and promote the ETF markets in both China and Singapore for cross-border investments. If this mechanism brings benefits to Singapore, it will likely be an incentive to other countries in the region to join such a mechanism.
- With this, China can further open its markets beyond Asia and diversify its cross-border opportunities as Chinese securities regulators have also announced future plans of expanding the Shanghai-London Stock Connect to further include the financial markets of Switzerland and Germany. Under this scenario, China can integrate its economy with other major economies.

Understanding the Political Undertone of calling ETF Connect a "gift package"

- The announcement for ETF Connect converged with the 25th anniversary of Hong Kong's sovereignty being transferred to Chinese rule. This event was marked by an official ceremony with President Xi Jinping visiting. The media coverage of the event ignores the repression of Hong Kong citizens. The League of Social Democrats who were planning for public protests were intimidated by the National Security police to abandon the plans and have kept Avery Ng, the group's former chairman, under arbitrary house arrest. The police set up a barricade to keep any sign of dissent away from the President's eyes. Further, the authorities have also barred some media outlets from covering the ceremony.
- The issue of Hong Kong has long been an international issue and other

countries have tried to corner China on the same. Further, the convergence of the event with the 25th anniversary of Hong Kong's sovereignty being transferred to China could have led to criticism at the international stage once again. Therefore, the authorities are making sure of suppressing any negative reportage of the event.

- In such a situation, calling the ETF Connect program a "gift package" suggests that China is trying to avoid any criticism from the international community. All public statements regarding the program have highlighted how equally beneficial ETF Connect is for both regions. By calling it a gift package, China is also trying to demonstrate that the citizens of Hong Kong keep no dissent at all against the issue of their sovereignty and are in total agreement with the Chinese government.
- Further it must be noted that while the program promises equal opportunity for growth, the imbalance of eligible ETFs between Mainland China and Hong Kong has allowed only the Chinese side to enjoy the benefits. In summation, calling ETF Connect a "gift package" would be incorrect.