Alternatives in Hong Kong

Building on the City's Strengths

How Hong Kong can extend its leadership in alternative asset management

July 2022

Contents

Foreword

Hong Kong has risen to become one of the world's pre-eminent international financial centres and helped fuel the growing economies of Asia. Around the world, investors are seeking to diversify and improve returns by allocating more capital to alternative asset classes such as private equity, hedge funds, real estate, private credit, commodities, infrastructure and digital assets. This is stimulating greater interest in allocating that capital to the Asia Pacific region, which continues to be the fastest-growing and most dynamic part of the global economy.

As a gateway to Mainland China and regional connector together with its attractive legal, tax and regulatory settings, deep talent pool, capital markets ecosystem, Hong Kong is a significant centre for alternative asset management, and ownership.

However, Hong Kong is unquestionably facing some of its biggest challenges to date. Some of these challenges are pandemic induced, and represent major current issues that Hong Kong is slowly but surely working its way through. The right lessons must be drawn from this period so that Hong Kong will emerge stronger and more resilient against potential future disruptions posed by any future variants of the Covid virus or other viral outbreaks. Against increasing competition and global challenges, including the pandemic, more should be done to maintain the city's competitive advantages and to build an even brighter and resilient future. It is critical that a delicate balance is struck giving proper recognition to Hong Kong's stature as an international financial centre and broader local public health considerations. The current trajectory provides reason for hope, but challenges remain.

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Looking beyond the pandemic, it is of vital importance and utmost urgency that the Hong Kong Government unequivocally communicate and demonstrate that the financial services sector matters. This paper aims to support this process and highlight clear strategic imperatives for rebuilding Hong Kong's international reputation as a top-tier, world class city in which to work, live, raise families, and prosper.

Reasserting Hong Kong's reputation as an international financial centre is essential to restoring Hong Kong's place on the world stage. This will require high-priority conversations, commitment and conviction of asset managers, wealth managers, investors, policymakers, thought leaders, service providers, and other key stakeholders.

This paper, in collaboration with PwC, provides an overview of Hong Kong's many opportunities and a range of areas where it can focus to further its success in the short, medium, and long term. Notwithstanding the challenges of the pandemic, this paper intends to support a rich dialogue between policymakers, regulators, asset managers, investors, and service providers as we all work together to support the long term growth of the alternatives sector in Hong Kong, and realise the economic and social benefits it provides.

It reflects views from the Alternative Investment Management Association's consultations with alternative asset managers, as well as research and insights gathered by PwC through interviews and roundtables with key stakeholders in the alternative asset management sector.

We hope you find it valuable and thought provoking and would welcome your feedback or questions.

Time is of the essence, and the time for action starts now.

Executive Summary

This paper has been prepared by the Alternative Investment Management Association (AIMA) to highlight the importance of Hong Kong's alternative asset management sector. It also recommends ways that the city can continue to differentiate itself to extend its position as an international financial centre, and remain the preferred destination for alternative asset managers and investors in Asia Pacific and globally.

Hong Kong's commitment to growth, an effective legal system, competitive tax regime, balanced and progressive regulatory environment, sophisticated capital markets, deep and diverse talent pools and bond with Mainland China have enabled the city to become the most comprehensive asset and wealth management centre of choice in Asia Pacific. It is particularly popular among managers focused on alternative assets including private equity, hedge funds, real estate, private credit, commodities, infrastructure, and digital assets.

Hong Kong is the largest Asian hedge fund centre, hosting more than half of the hedge funds located in the region, and is now the second-largest private equity hub in Asia Pacific after Mainland China.

These firms are supported by a deep and sophisticated array of service providers, including fund administrators, prime brokers, custodians, auditors, transfer agents, consultants, and lawyers. Alternative asset managers and investors (in particular institutional investors and family offices) are attracted to the significant opportunities to support Asia Pacific's fast-growing and entrepreneurial businesses in technology, e-commerce, sustainability solutions and other areas. More than 740 alternative investors have established offices in Hong Kong to capitalise on these regional opportunities[1].

Going forward, Hong Kong will need to maintain its tradition of innovation to preserve and extend its enviable position in the face of increasing competition and the transformational changes to the global economic and investment landscapes. With this in mind, AIMA and PwC canvassed market participants – including asset managers, asset owners, thought leaders, investors and service providers – to identify the key attributes they most value about Hong Kong and potential areas for future development.

The review found most alternative asset class participants believe Hong Kong should maintain and grow its position as a leading and comprehensive asset and wealth management centre. They also think the alternatives sector has been well supported by the city's regulatory and commercial environment.

1 Preqin data, November 2021

However, participants also believe Hong Kong must take steps now to protect its status and capitalise on the enormous opportunities presented by Asia Pacific's continued growth and other trends by focusing on:

Upholding the rule of law and judicial independence

Maintaining its simple and competitive tax structure

Ensuring it maintains a transparent and effective regulatory framework

Developing, attracting and retaining high-quality talent, both home grown and international

Capitalising on its proximity to Mainland China through the Greater Bay Area (GBA)[2] and other trading channels

Promoting further depth and breadth in the capital markets system

Making alternative assets more accessible to local and regional investors

Supporting the growth of private credit

Establishing leadership in environmental, social and governance regimes (ESG)

Harnessing the power of, and encouraging, new technology

2 Please see 'Glossary' and 'Opportunities' for details

> "Now is the time for all stakeholders with skin in the game to collaborate on how to strengthen Hong Kong's strategic blueprint in order to attract – and retain - alternative asset managers to ensure Hong Kong continues to be a leading international financial centre in Asia."

Phillip Meyer
Chair, Executive Committee AIMA Hong Kong & General Counsel & Co-Chief Operating Officer, Oasis Management Company Ltd.

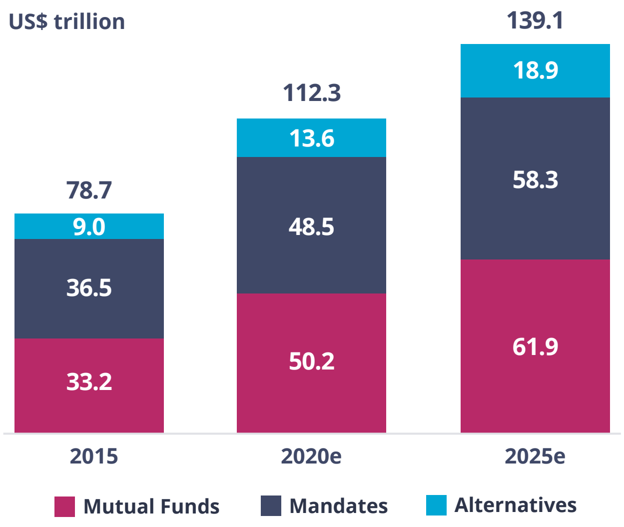
Growth of Alternative Assets

Asia Pacific's alternative asset class is growing faster than anywhere else in the world as institutional investors, wealthy individuals and a wide range of smaller investors seek to diversify their strategies and improve their returns.

Hong Kong is a significant global centre for the management of alternative assets, which is a broad category that includes private equity, hedge funds, real estate, private credit, commodities, infrastructure, and digital assets. For institutions and high-net-worth (HNW) individuals and families, these asset classes are 'alternative' to listed equities and fixed income investments. They are also widely recognised as an attractive and prudent way to diversify investments and enhance returns.

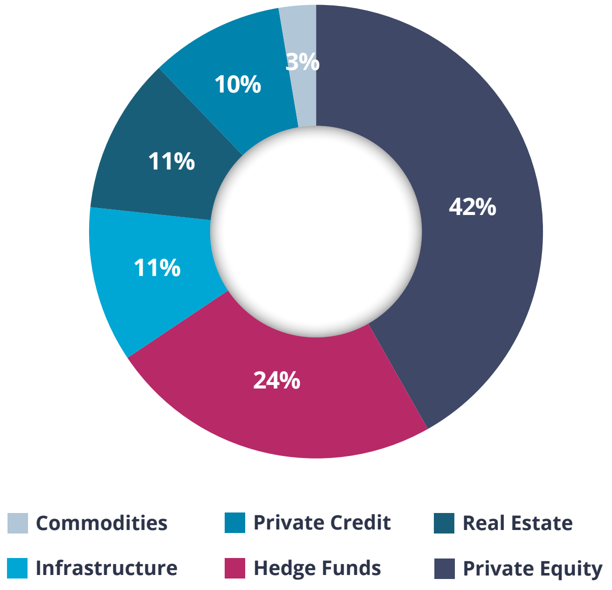
Globally, the alternatives asset class is expected to grow to US$18.9 trillion by 2025 and make up 14% of assets under management (AUM) worldwide. Figures 1 and 2 provide a breakdown of global assets under management today, forecasts for their expected growth and detail on alternatives.

Figure 1:
Global assets under management



Source: PwC

Figure 2:
Breakdown of projected alternative asset classes globally in 2025



Source: PwC

The alternatives investment market in Asia Pacific likewise is set to continue growing strongly in coming years; in a June 2021 report, financial data firm Preqin noted that private capital is playing an increasing role in asset allocations across Asia Pacific and that "Asia-Pacific-focused private capital AUM has already expanded almost sixfold over the past decade".[3] Expectations are that private capital AUM will reach US$6 trillion by 2025 – compared to only US$2 trillion today.

In Hong Kong, alternatives have experienced outstanding growth, and the city manages the lion's share of alternative assets within Asia Pacific. It is also home to more than half of the major hedge funds located in Asia Pacific with more than US$1 billion under management. These 'Billion Dollar Club' funds collectively manage approximately US$220 billion. These assets are managed by a wide range of established multinational asset managers, as well as emerging local and regional boutique fund houses.

This partly reflects its proximity to and the importance of potential investment targets in Asia – especially in Mainland China – but also the desire of investors to invest in themes such as digital and technological innovation, sustainability and climate protection, urbanisation, healthcare and pharmaceuticals, as well as the growth of the Asian middle class, consumer spending and e-commerce across the region.

A further growth opportunity for Hong Kong is the private credit sector. Private credit is already a US$1trillion global asset class and expected to double in size to over US$2trillion by the end of 2025[4]. At present the Asian private credit sector is a nascent segment of the global market, but the region is quickly maturing and emerging as an opportunity for global fund managers and allocators, including those with hubs in Hong Kong.

3 Preqin Markets in Focus: Alternative Assets in Asia-Pacific 2021
4 Preqin estimate

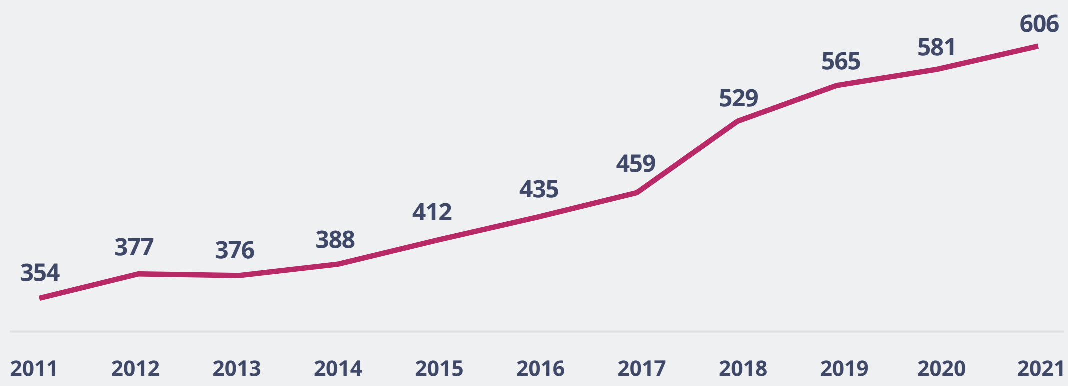
Recent market research illustrates that Asia-focused private credit AUM has already more than doubled from US$27 billion in December 2014 to US$57 billion in June 2019.[5] The growing appeal of the region to private credit managers is validated by AIMA's own research which noted that 39% of private credit managers expect investors to allocate more capital to Asian focused credit strategies over coming years.[6]

The growth of asset management firms in Hong Kong supports this, and the overall growth of the alternative asset management sector. The number of licensed corporations carrying out asset management activities (Type 9 Regulated Activity) in Hong Kong has more than doubled in the past decade to 1,979, as of December 2021[7], with regulators, such as the Securities and Futures Commission (SFC), recognising early on the importance of the sector to the city and the region.

The alternative asset management sector also generates high-value employment in Hong Kong. **The city's financial services sector provides 273,000 jobs**[8]**, of which about 48,000 are directly in the asset management segment**[9]. In addition, the industry supports a wider range of roles across the asset management ecosystem, such as fund administrators, prime brokers, custodians, auditors, transfer agents, consultants and lawyers. This important contribution to the economic and social environment of Hong Kong is currently well supported by the number of asset managers (including private equity and venture capital firms) and Hong Kong's leading position as one of the largest hedge fund hubs (Figure 4).

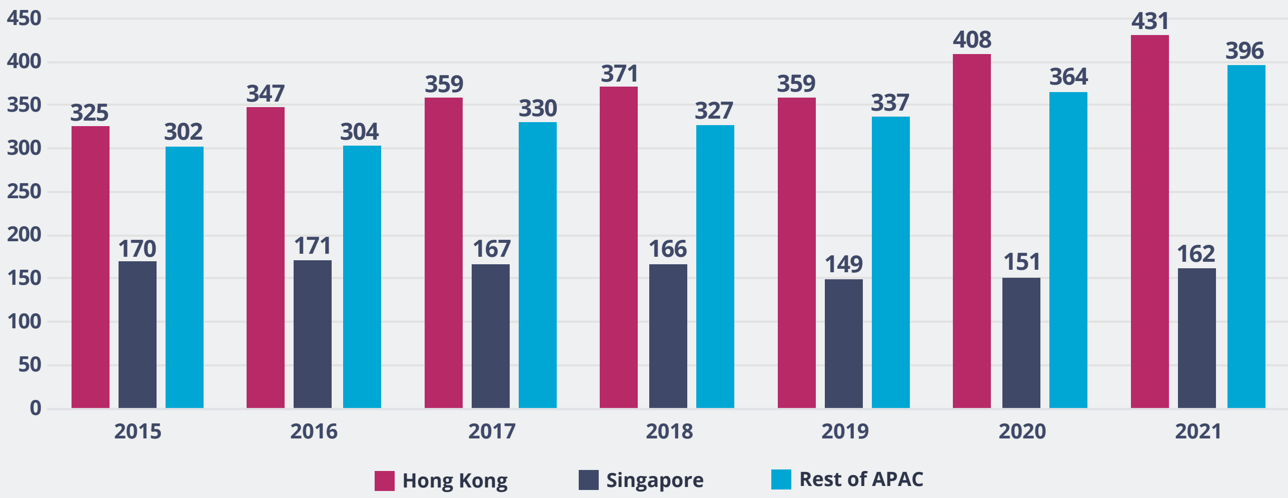
5 Preqin estimate
6 Financing the Economy 2020
7 SFC - Statistics (published by the SFC)
8 HKTDC Research - Financial Services Industry in Hong Kong
9 SFC - Asset and Wealth Management Activities Survey 2020

Figure 3: Total number of private equity and venture capital firms in Hong Kong



Source: AVCJ Research

Figure 4: Total number of hedge fund managers by regional headquarters



Source: Preqin

Figure 5: 10 biggest hedge fund hubs

Location	Number of Billion Dollar Club firms	AUM (US$bn)
New York metropolitan area*	228	1,562
London, UK	101	539
Hong Kong	**44**	**184**
Singapore	13	27
Paris, France	13	70
Luxembourg	8	11
Stockholm, Sweden	7	19
Sydney, Australia	7	41
Rio de Janeiro, Brazil	6	26
Geneva, Switzerland	6	29

**New York, Connecticut and New Jersey, combined*
Source: HFM database (as of 31 Mar 2022)

Strengths and Opportunities: Hong Kong's Six Pillars

Hong Kong's unique strengths and geographic advantages have made it the centre of choice for investors and service providers. Going forward, the growth of Greater China, the rapid expansion in wealth across the region and the need for retirement and private credit solutions are all expected to provide the impetus for significant further growth.

Strengths

In recent decades, Hong Kong has striven to be an all-encompassing asset and wealth management centre of choice in Asia Pacific that serves a wide investor base and accommodates the investment requirements of local, regional and global entities.

The city has positioned itself very well with a strong infrastructure that includes asset managers as well as an advanced and robust service provider ecosystem. This ecosystem is facilitated by many of the world's leading providers, as noted above. Moreover, the financial services industry is well represented through industry associations, such as AIMA, who have established good working relationships with regulators and policymakers, including the SFC, the Hong Kong Monetary Authority (HKMA), the Inland Revenue Department (IRD), the Financial Services and the Treasury Bureau (FSTB) and the Financial Services Development Council, to ensure that the industry's views are heard and considered.

Hong Kong's successful development has been driven by the city's effective legal system, competitive tax regime, balanced regulatory environment and sophisticated capital markets, deep and diverse talent pools, and close relationship with Mainland China, whilst also connecting with the other regional markets.

The six pillars that set Hong Kong apart

Rule of law

- Judicial independence
- Common law heritage
- Dispute resolution (including arbitration)

Tax system

- Low, simple taxation
- Tax neutrality
- Effective tax treaties

Regulatory environment

- Flexible, independent, transparent and commercial
- Investor protection
- Rising regulatory tech

Talent pool

- Professional support
- Acquisition and retention
- Tech-savvy population

Capital markets

- Equity and debt markets
- Resilient financial system
- Listing and fundraising

Proximity to Mainland China

- Gateway to Chinese wealth
- Greater Bay Area
- Market access channels

These six pillars are critical features of Hong Kong's past success and must be supported -- and encouraged to evolve -- in order for Hong Kong to retain its place as a leading international finance centre in Asia, and major contributor to the alternative asset management industry.

Opportunities

Looking forward, Hong Kong has a range of opportunities to reassert and grow its status as an international financial centre with a strong capability in alternative asset management. We discuss some key opportunities below and expand on these themes in the next section.

A gateway to and from Mainland China

An important and widely recognised attribute is Hong Kong's ongoing role as a gateway into and from Mainland China.

In our consultation with asset management stakeholders to help shape this report, the overwhelming majority of respondents agreed or strongly agreed "Hong Kong will continue to play the gateway role for Mainland China in the coming years, enabling international institutions to access Mainland China and helping Mainland China access the rest of the world".

In this role, Hong Kong is uniquely positioned to benefit from international asset managers and institutions interested in allocating funds to investments in Mainland China, as well as Chinese asset managers and owners looking to gain international exposure.

Figure 6 details the number of recent initiatives that have expanded opportunities for Chinese investors to invest overseas.

Figure 6: Current access routes for Chinese investors to invest overseas

Date	Initiative[10]	Investment type(s)
2006	Qualified Domestic Institutional Investor (QDII)	Equities and Bonds
2012	Qualified Domestic Limited Partnership (QDLP)	Traditional and alternative investments
2014	Shanghai-Hong Kong Stock Connect (Southbound)	Equities
2015	Mutual Recognition of Funds (MRF)	Mutual funds
2016	Shenzhen-Hong Kong Stock Connect (Southbound)	Equities
2016	China Interbank Bond Market Direct Scheme	Bonds
2021	Wealth Management Connect	Bank deposits and low-risk mutual funds
2021	Bond Connect (Southbound)	Bonds

10 Please see 'Glossary' for Initiative details

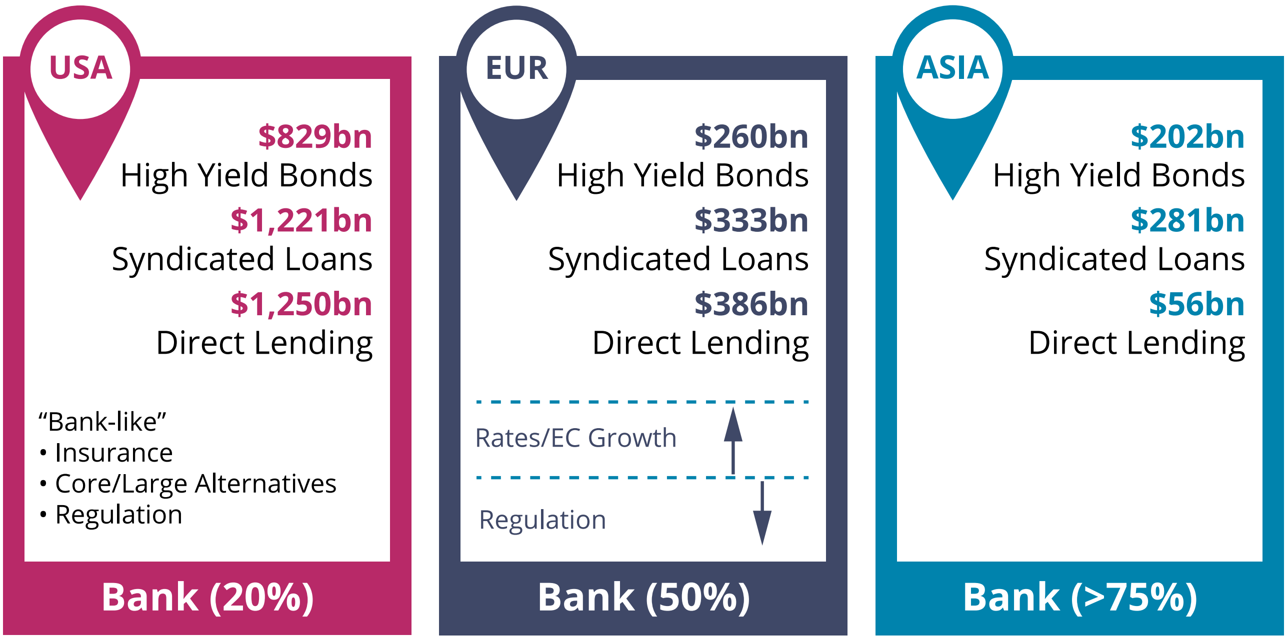
The opportunities presented by the development of these initiatives have made significant contributions to the growth of the asset management industry. However, it will be imperative that trading platforms continue to evolve to provide appropriate and relevant investment opportunities for alternative asset managers and investors, in particular institutional and family office investors. Furthermore, while there are many opportunities for Chinese investors to access non-renminbi (RMB) denominated assets, there is not currently an efficient and effective channel for these investors to access the alternatives asset class in Hong Kong. Introducing appropriate access routes to such asset classes via Hong Kong will be important especially at a time where there is significant wealth accumulation in Mainland China.

Hong Kong as a hub for private credit in Asia

Growth in the global private credit market accelerated following the global financial crisis (GFC) when increased regulations forced banks to reduce their lending to some market segments. This provided an opportunity for credit fund managers to deploy capital to and fill the gap left by the retrenchment of these traditional lenders. The global private credit sector is currently a US$1trillion asset class that is expected to exceed US$2trillion by the end of 2025[11].

Currently, non-bank lending to the private non-financial sector exceeds bank lending in advanced economies (see Figure 7). Strong growth in the private credit market globally and demand amongst Asia SMEs for growth capital has made this type of financing a significant opportunity for the alternatives sector in Hong Kong.

Figure 7. Non-bank lending to the private non-financial sector



Source: StepStone Private Debt, COVID-19 Market Survey May 2020; Reuters, Credit Suisse, Bloomberg, Barclays, Asia High Yield Index

11 Preqin

Mainland China's current non-bank lending or private credit segment has strong growth potential, especially as policymakers actively encourage a more diverse and resilient financing mix across the economy. This will provide opportunities for alternative asset managers in the private credit space, including refinancing, establishing partnerships with traditional lenders, or establishing themselves as new sources of finance.

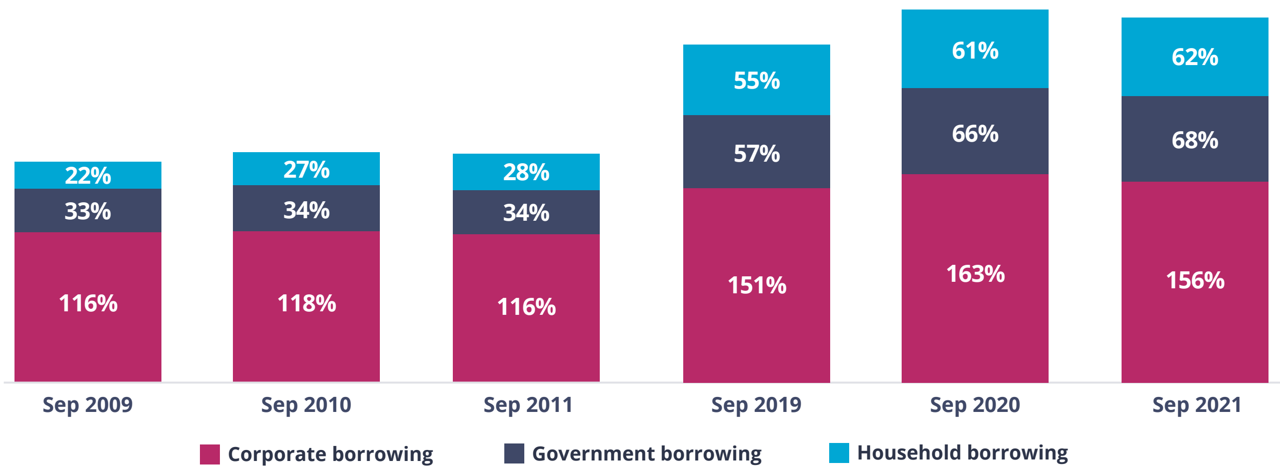
While Hong Kong itself offers some opportunities for investment in private credit, the city's proximity to Mainland China makes it a natural gateway and conduit for market participants to source and evaluate the significant and growing credit needs of businesses based in the Mainland. Corporate lending, especially to private companies, presents the most compelling opportunities for private credit operators.

Further Hong Kong has both geographic and strategic advantages that allows it to not only be a gateway to Mainland China but also be a regional connector for market participants to access and contribute to the growing credit needs elsewhere in the Asia Pacific region.

Growth of private equity

Private equity is vital to financing growth, and is achieved through an active value creation approach – helping companies to realise their full potential. In addition to providing capital for portfolio companies, both through co-mingled funds and managed co-investment vehicles, and generating returns for investors, private equity firms offer significant indirect upskilling opportunities as talent is built and nurtured within portfolio companies.

Figure 8: Credit to the non-financial sector in Mainland China (as a percentage of GDP)



Source: Bank for International Settlements (BIS) and PwC analysis

Greater wealth and sophistication

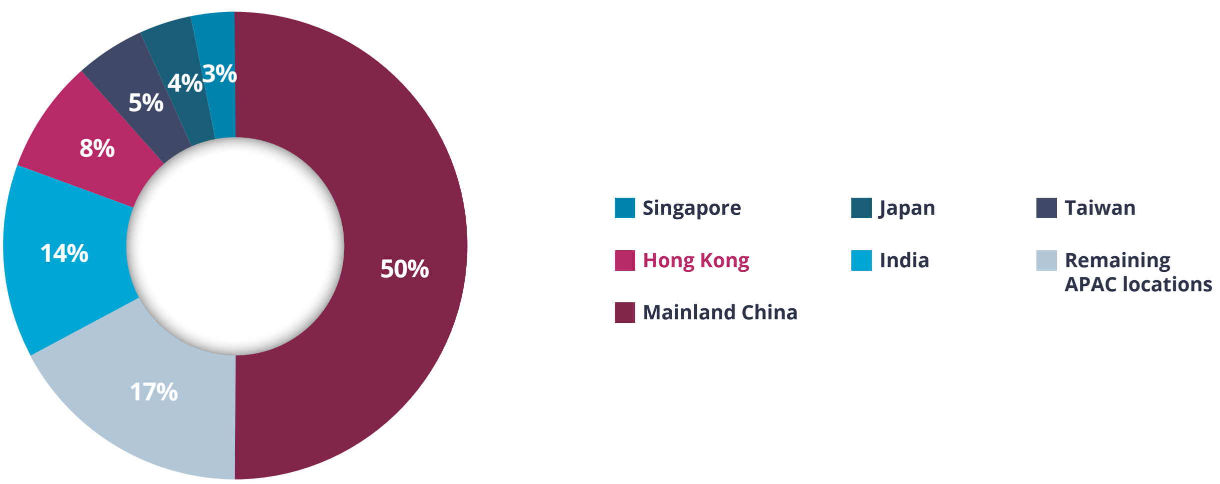
Another tailwind for Hong Kong is the enormous growth in wealth in Mainland China, where total billionaire wealth saw exponential growth between 2009 and 2020 (Figure 9). Over the period, Mainland China's billionaire wealth had grown by almost thirteen times, compared with twice in the United States. Asia Pacific is home to 38% of billionaires globally, worth a collective US$3.3trillion, with half of Asia-Pacific's billionaires based in Mainland China and 8% in Hong Kong (Figure 10).

Figure 9: Growth of top 10 markets according to billionaire wealth 2009–2020

Market	Wealth 2009 (US$ bn)	Wealth 2020 (US$ bn)	Relative change
United States	1,338.7	3,608.6	2.7x
Mainland China	**134.9**	**1,680.9**	**12.5x**
Germany	216.1	594.9	2.8x
Russia	260.2	467.6	1.8x
France	82.2	442.9	5.4x
India	222.1	422.9	1.9x
Hong Kong	**115.6**	**356.1**	**3.1x**
United Kingdom	76.7	205.9	2.7x
Canada	52.8	178.5	3.4x
Brazil	88.6	176.1	2.0x
	2,587.9	**8,134.4**	**3.1x**

Source: UBS and PwC

Figure 10: Proportion of Asia Pacific billionaires by location



Source: UBS and PwC

Asia Pacific is also expected to see the fastest growth in ultra-high-net-worth individuals (UHNWIs) over the next five years. By 2025, Asia is expected to be home to 24% of UHNWIs worldwide – up from 17% a decade earlier.[12]

Estimates suggest that there are already more than 115,000 UHNWIs in Asia Pacific who could each be candidates to set up family investment management offices in Hong Kong.[13] The city offers several unique advantages for family offices to operate and grow, such as the ability to provide one-stop services, and these offices are expected to seek to increase their exposure to alternative assets.

The rise of wealthy individuals in Mainland China, in particular, has been remarkable and can be expected to drive growth in the region's wealth and asset management sectors for years to come. The nation's citizens currently hold approximately US$28 trillion of savings in bank deposits,[14] but are moving away from such conventional saving and towards investing.

To date, this investment has generally taken the form of wealth management products (WMPs) with implicit guarantees offered by banks and insurance products, and to some extent, asset management products such as public funds and private funds. However, there is a shift away from WMPs as the 'Super Guidance' regulations issued in Mainland China in 2017 have led to vast changes across the industry, including redirecting capital from WMPs to market-driven investment products.

The growth in the range of available domestic fund investment vehicles, such as limited partnership funds, provides additional capital raising structures and opportunities for the asset management industry. Developed and implemented appropriately over time, these should contribute to Hong Kong's competitiveness on an international stage.

In addition, the soaring wealth accumulation in Mainland China is outgrowing the capacity of the onshore investment universe. This is creating a clear need for Chinese investors to access a wider range of investment opportunities, which creates further opportunities for alternative managers, and the need for investment in appropriate access routes via Hong Kong.

Funding retirement

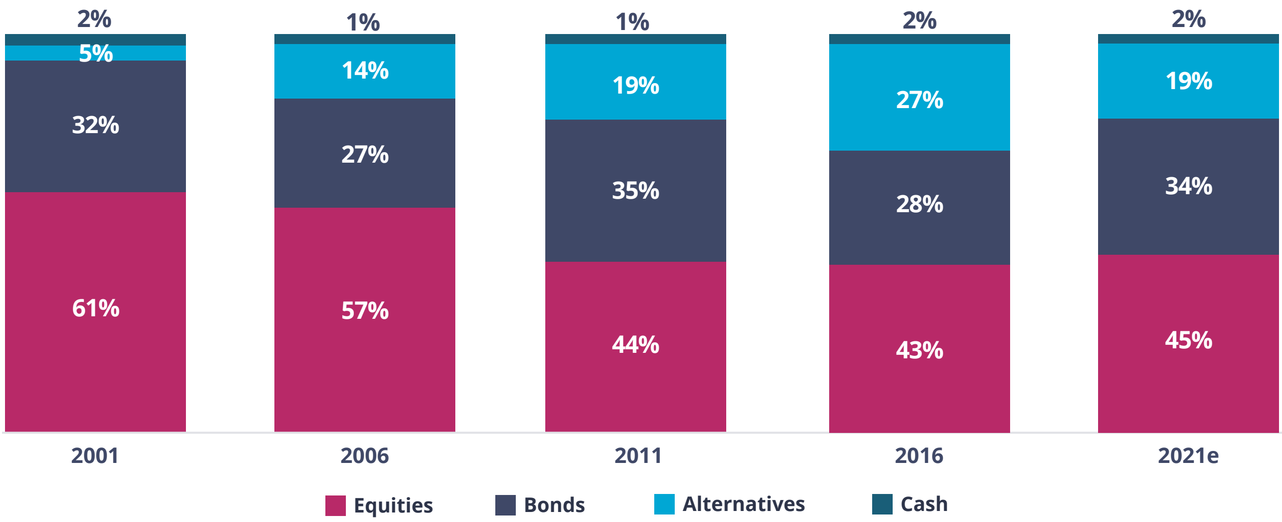
The gap between the need for lifetime financial security and the means to provide it is expected to mushroom to approximately US$15.8 trillion globally by 2050[15], driven primarily by people living longer and lower fertility rates, which will increase dependency ratios. Given this, the alternative asset management sector has the potential to play an important role in providing adequate financial security for retirees.

Asset managers can help bridge these escalating pension gaps by providing appropriate investment products and financial knowledge. Alternatives have an integral role to play because turning to less-liquid assets can enable investors to find new sources of long-term returns, whilst diversifying some assets out of potentially volatile and sometimes underperforming public markets.

12 Knight Frank - The Wealth Report 2021
13 Knight Frank - The Wealth Report 2021
14 World Economic Forum Insight Report - China Asset Management at an Inflection Point
15 Group of Thirty - Fixing the Pensions Crisis: Ensuring Lifetime Financial Security

As shown in Figure 11, large pension funds in key markets around the world have already grown their exposure to alternative asset classes as they look to meet actuarial targets for future funding.

Figure 11: Aggregate asset allocation for P7 markets (Australia, Canada, Japan, Netherlands, Switzerland, the UK and the US)



Source: Thinking Ahead Institute

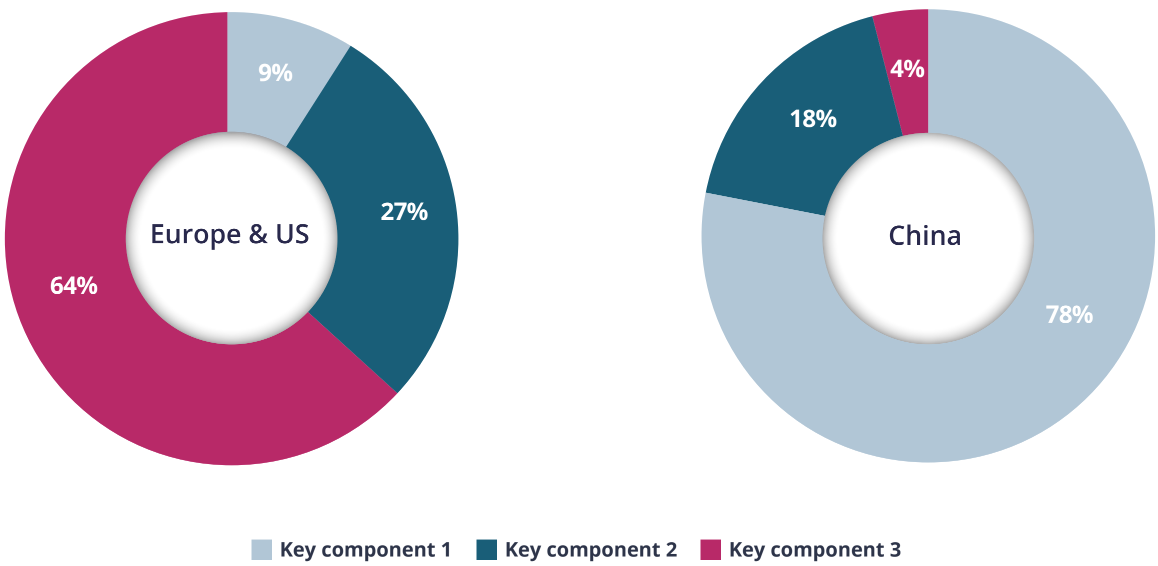
In Asia Pacific, pension asset allocators are expected to increase their exposure to alternative investments as traditional investments fail to offer the returns many pension funds require to cover their members' future needs. For example, the Government Pension Investment Fund (GPIF) in Japan, which is the world's largest pension fund, currently has a low allocation to alternative investments. However, in recent years, the GPIF has regularly awarded mandates to boost its alternative investments exposure and has hired third parties to manage foreign alternatives. More than 50% of Japanese pension funds now allocate some of their assets in alternatives, compared to 12.8% in 2014.[16]

In Hong Kong, the privately managed Mandatory Provident Fund (MPF) system is yet to allocate funds to the alternatives class, so any positive change could have a significant impact. It can be argued that the maturity level and development of the MPF system has yet to reach a critical mass to invest in alternative asset classes. Policymakers should seriously consider how to bring the asset class into play at some point in the near future.

16 PwC and Association of the Luxembourg Fund Industry (ALFI) - Beyond their Borders: Evolution of foreign investments by pension funds 2020 Edition

Figure 12 also highlights the massive untapped growth potential of Mainland China's pension system; Key component 1 (state pension provided by the government) and key component 3 (commercial pension provided by insurers, banks and asset managers) offer especially compelling opportunities for alternative asset managers and for Hong Kong as a leading location for such solutions.

Figure 12: The three key components of Mainland China's pension system



Source: International Finance News

Mainland China's key components

Key component 1: State pension provided by the government

Component:
Public Pension Fund, National Council Social Security Fund

AUM:
RMB8.1 trillion

Coverage:
~960 million participants

Key component 2: Corporate annuity provided by insurers

Component:
Enterprise Annuity (EA), Occupational Annuity

AUM:
RMB2.0 trillion

Coverage:
57.57% of EA cover state-owned enterprises

Key component 3: Commercial pension provided by insurers, banks and asset managers

Component:
Individual plans, tax-deferred insurance products

AUM:
Negligible

Coverage:
Almost 50,000 participants in tax-deferred pension

Vision for Hong Kong's Future

By focusing on the right issues, Hong Kong is well placed to realise its full potential as a leader in alternative asset management in Asia Pacific and globally.

Hong Kong has numerous strengths and has been successful in becoming a comprehensive global financial centre, and in fostering a thriving alternative asset management sector. This momentum should only grow as Asia Pacific continues to develop, as institutional and private investors seek a wider range of investment opportunities in the region, and as people in Asia Pacific look to invest globally.

However, the city will need to maintain its tradition of agility, innovation, internationalism and inclusivity to capitalise on the significant opportunities that lie before it and to ensure it remains relevant in the face of the major technological and social changes reshaping the Asian and global economies. These include rapid advances in financial and regulatory technology, new currencies and payment types, and a greater focus on ESG issues among investors globally – in particular climate change and financing the transition – and social mobility.

Against this backdrop, it is important for asset managers, investors, policymakers, regulators, service providers and other stakeholders to engage in dialogue to help shape the Hong Kong of tomorrow and make it more attractive, competitive and resilient.

As noted previously, the six pillars of Hong Kong's success – Rule of Law and Judicial Independence, Flexible and Transparency Regulatory Environment, Simple and Competitive Tax Regime, Strong Talent Pool, Robust Capital Markets, and its proximity to Mainland China – are features that must be preserved and encouraged to flourish and evolve.

This section outlines areas that should be covered in these discussions, with some of AIMA's views on potential approaches.

1. Upholding the rule of law and judicial independence

A distinctive and highly valued attribute of Hong Kong among local and international asset managers – and investors – is the city's strong rule of law and independent judicial system.

A majority of fund managers consulted identified the rule of law as the most important reason they chose to establish or locate in Hong Kong.

Upholding the rule of law will be paramount in ensuring Hong Kong remains one of the freest economies in the world and one of the leading international centres for funds management and capital raising activities.

2. Maintaining a simple and competitive tax structure

Hong Kong's low tax rates and its simple tax system – which is territorial in nature – offer clarity and certainty to those operating in the city. This solid foundation ensures Hong Kong is competitive in attracting leading and renowned international businesses as well as emerging market players.

Hong Kong's policymakers have also been sensitive to the needs of alternative asset managers. AIMA and the industry as a whole have had proactive engagement from the FSTB, the IRD and the regulators, HKMA and SFC, to address the industry's concerns around tax and the city's competitiveness with other jurisdictions. This led to the profits tax exemption for offshore funds in 2006, the introduction of the Unified Fund Exemption regime in 2018, and the recent introduction of tax concessions for carried interest.

Policymakers should continue to adopt a proactive approach and further their working relationships with market participants to ensure Hong Kong remains competitive and fit for the future, including continual review of tax arrangements to ensure that all sectors of the market (including, for example, alternative lenders and debt purchasers) are able to avail themselves of industry wide exemptions and incentives.

> **"The Government of the Hong Kong SAR, supported by the alternative investment industry, has been proactive in implementing tax policies to attract and retain alternative investment activities in Hong Kong. Going forward policy should be implemented in such a way as to be accessible to the industry, and to maintain and enhance the competitiveness of Hong Kong."**
>
> James Ford, Partner, Co-Head of APAC Funds Practice, Allen & Overy

3. Ensuring an independent, transparent and effective regulatory framework

One of the attributes that makes Hong Kong attractive as an international financial centre is its independent, transparent and effective regulatory framework and regulatory bodies.

To date, the HKMA and the SFC have proven effective in balancing the provision of robust regulatory oversight to protect investors and maintain financial stability, while encouraging market and product development and innovation.

Looking ahead, regulators should focus on ensuring their teams and market participants have the right skills and international exposure to respond to the digital and technological advancements occurring in global financial markets. The city should also adopt international standards in a thoughtful and appropriate manner consistent with market developments.

> **"A thriving Hong Kong can only be sustained if innovation and regulations work in tandem."**
>
> Lisa Tsui, Partner, PwC Hong Kong

A further measure to ensure Hong Kong's regulatory regime remains fit for purpose should be to ensure the city maintains a licensing regime that acts as an appropriate gatekeeper, while retaining the flexibility to apply the regime to different types of businesses within the alternative asset ecosystem, and attract (and maintain) the best talent. Effective training, exams and setting competency requirements, for example, contributes to this.

Continued proactive and regular engagement by the SFC, HKMA, Insurance Authority, FSTB and IRD (to name a few) with the industry and industry associations, such as AIMA, is welcomed, and encouraged. It is recognized that there exists a good working relationship and that this is important to maintain and develop, as necessary. The need for healthy dialogue and engagement between regulators and policymakers is to ensure that the regulatory framework of the future is independent, effective, transparent, and in the interests of the city and the industry (as part of a regional and global industry).

> **"Hong Kong's transparent and effective regulatory framework has been central to the success of the growth of the asset management industry. Moving forward, regulators, managers and other stakeholders should work together to ensure the regulatory environment evolves in the best interests of the alternative asset management industry and Hong Kong, as an international financial centre."**
>
> Charlotte Robins, Partner, Head of Hong Kong Financial Services Regulatory, Allen & Overy

4. Developing, retaining and attracting a high-quality international talent pool

> **"To further promote capital market development, Hong Kong must ensure it can attract and retain exceptional talent."**
>
> Rex Ho, Asia Pacific Financial Services Tax Leader, PwC Hong Kong

People are the lifeblood of any city's financial services industry. Hong Kong is no exception, and its ability to develop, attract and integrate international talent to the city has seen it become a leading international financial centre. However, the city faces significant competition and challenges in attracting and retaining skilled and diverse talent.

While Hong Kong has consistently ranked highly for liveability and a strong track record for making it relatively easy for overseas professionals to work, it is imperative that the city and its financial services sector look to become more agile.

These might include ensuring that financial services professionals can move freely between Hong Kong, Mainland China and the rest of the world, and ensuring that the education, training, experience and qualities expected of regulated persons is commensurate with their business focus, including the need to achieve appropriate and effective corporate governance and being consistent with what is expected internationally. Incentives should be considered to support the city's capacity to serve and operate competitively, both as a regional hub and as a global financial centre.

5. Capitalising on Hong Kong's proximity to Mainland China through the GBA and other trading channels

During our consultation, more than half of respondents felt that the current channels and programmes for private managers to tap into the growing wealth in China were inadequate.

Hong Kong has a range of opportunities to capitalise on its proximity to Mainland China while maintaining the unique attributes that have made it a successful international financial centre. These include its participation in the Mainland's GBA initiative.

The GBA is an important economic development strategy for Mainland China that will drive a higher level of integration between Hong Kong and neighbouring regions of Guangdong and Macao. A key initiative to support the plan is Wealth Management Connect (WMC), which was launched in September 2021 and is designed to promote financial and investment cross-border flows with the GBA region.

WMC could provide the infrastructure for alternative asset managers, playing the role of product manufacturers, to tap into the opportunities in the GBA region. Currently, this opportunity is limited to banking institutions and traditional asset managers that offer deposits and mutual funds respectively. But the wealth management industry continues to rapidly change, with a new generation of sophisticated investors demanding a wider suite of products and greater convenience. The evolution of the WMC should look to include alternative asset classes.

This could occur once the WMC has more of a track record, and as Mainland policymakers become more comfortable with the nature and size of investor flows and the WMC's impact on capital controls.

There is also potential for the GBA to allow for more connections between private equity funds and venture capital funds in Hong Kong, and the capital-hungry start-ups throughout the new region. This would enable foreign investors to invest in emerging enterprises in the GBA, bringing both international funding and expertise to the table.

The GBA region is home to many of Mainland China's technology leaders, and there are opportunities for alternative asset managers to help foster the development of these innovative companies.

> **"The alternative asset management industry in Hong Kong can reach new heights by capturing the unique opportunities in Mainland China."**
>
> Marie-Anne Kong, Asset and Wealth Management Leader, PwC Hong Kong

6. Promoting further depth and breadth in the capital markets system

Hong Kong's alternative asset management sector is only part of the city's asset management and capital markets system. This means that measures to enhance the depth and sophistication of the industry and capital markets overall play an important role in supporting the alternatives sector, by increasing the availability of related funds, infrastructure, talent and expertise.

Hong Kong's capital markets are deep and have withstood numerous challenges and emerged stronger and more resilient. Such challenges include the Asian Financial Crisis in 1998, the SARS epidemic in 2002, the GFC in 2008 and now the COVID-19 pandemic.

Factors that contribute to the resilience of Hong Kong's capital markets include its ample foreign reserves, strong capital and liquidity ratios, tried and tested exchange rate system, and professional support network. Due to these strong foundations, the city's capital markets have enjoyed stellar growth since their inception despite the speed bumps along the way, driven primarily by the continued introduction and enhancement of products and services.

> "To further strengthen capital markets in Hong Kong, broader product ranges could be permitted to increase the depth and diversity of the city's investor base."
>
> **Kendall Johnson, Chief Operating Officer, Torq Capital Management (HK) Limited**

However, there remains potential to add more depth and sophistication – which would in turn improve liquidity – to Hong Kong's capital markets to enable investors to broaden their portfolios. For Hong Kong to remain ahead of the curve and be renowned as an international financial centre, the city should look to give international asset managers and institutions a broader array of options that allow participants to build portfolios consistent with their needs and objectives.

Other important initiatives

Making alternative assets more accessible

With innovation in technology, increasing receptiveness from regulators and more interest from traditional market players in offering alternatives in a format accessible by a broader group of investors, alternatives are expected to become less 'alternative'. This trend can already be seen globally in a blurring of the boundaries between traditional and alternative asset classes.

However, alternative assets and related products are currently mainly accessible only to institutional investors and accredited investors. High minimum investments and illiquid product structures often also act as a barrier to investors accessing the alternative asset class.

For Hong Kong to position itself as a leading jurisdiction for alternative products and the go-to destination for alternative fund managers, there is merit in broadening the base of investor groups who can access the alternative class. This would also enable investors to diversify their investments and enhance returns, as many are seeking to do.

One key area to focus could be retirement funds. As discussed on page 20 earlier in the paper, there is scope for Hong Kong's MPF system to allocate funds to alternatives to potentially improve returns for Hong Kong residents.

In addition, it will be important for Hong Kong to ensure such alternative products can access the necessary (and growing) asset classes in order to provide the benefit and returns to its investors. To this end, Hong Kong should look to ensure appropriate legal and regulatory frameworks going forward, for example to further support safe investment in digital assets, and to maintain the city's status as an international financial centre which provides a diverse breadth of asset investment opportunities.

Supporting the growth of private credit

The growth of private credit globally presents a significant opportunity for Hong Kong. While Asia accounts for around one third of global GDP, the Asian share of global private credit AUM is only 7% and the estimated finance gap for Asian SMEs stands at $4.1trillion[17]. These gaps will close as investors and private credit managers increase their presence in Asia Pacific and it is essential that Hong Kong establishes itself as the hub for managers investing in the region.

The benefits of the asset class are increasingly valued by borrowers, investors and policymakers across the world. Private credit provides borrowers with a much-needed alternative to traditional lenders, while also offering investors the opportunity to invest in assets with differentiated risk-return profiles. The sector also supports policymakers' efforts to foster a resilient economy by increasing the diversity of finance providers and improving the allocation of risk among investors.

Policymakers should maintain an open dialogue with investors and investment managers on how to support the sustainable growth of private credit in Asia Pacific and make Hong Kong the centre of the regions burgeoning private credit market.

17 Private credit in Asia

Establishing leadership in ESG

In the face of climate change and the need to finance the transition, the consideration of ESG criteria has become a fundamental priority for investors around the world. Many asset managers have in turn started to embed ESG into their strategies (for example increased appetite for sustainable finance products), operating models, and financial reporting processes.

Alternative asset managers have been the vanguard of this shift since they predominantly serve institutional investors such as pension funds, sovereign wealth funds and endowments, which typically understand the potentially greater role sustainable finance and management of environmental as well as social issues can play in risks and returns, whilst also demanding corporate governance that is capable of providing the necessary stewardship.

According to Preqin, 40% of the AUM in the alternatives industry is now managed by ESG-committed firms (managers that either have an ESG policy or belong to a relevant association), and this figure is expected to grow. Further, 31% of the largest institutional investors globally say climate change would have the biggest impact on the way they invest in the next three to five years[18].

The opportunity for Hong Kong is to become a leader within Asia Pacific – and globally –for supporting ESG-focused investment. The SFC, following consultation with the public and specifically the asset management industry, has introduced regulatory requirements (via amendments to the Fund Manager Code of Conduct) in the furtherance of the management and disclosure of climate related risks.

However, there is scope to substantially increase the city's focus in this area. For example, carbon credits are fast emerging as an alternative asset class, and there could be policies set out to nurture private managers in this space and promote their participation in carbon credits transactions. Further, the city should seek to apply global ESG-related standards or otherwise avoid creating inconsistencies between Hong Kong and other jurisdictions. This would help to make compliance and reporting familiar and straightforward for asset managers and institutions, and avoid fragmentation. To this end, the city should consider nurturing ESG data providers to ensure that both the asset management industry (and corporates) can support and deliver on their and global ESG commitments, especially in relation to climate risk, and encouraging the necessary technology and talent in this regard.

18 MSCI Investment Insights 2021 - Global institutional investor survey

Harnessing technology

The vast majority of respondents believe that more can be done to encourage innovation and product development while maintaining an adequate regulatory environment.

Alternative asset managers are increasingly turning to technology to address regulatory compliance and drive efficiencies. As technology becomes more widely used in the industry, and in the face of the continuous technological advancements, regulators need to support an evolving environment that is fit for purpose and encourages adoption by managers and service providers. Regulators establishing an open dialogue with industry participants and service providers, and utilising technologies for their own use, will be crucial to ensure Hong Kong's competitiveness in a fast-growing sector.

> **"To spur market development and innovation, policymakers and regulators can help unlock the potential of technology while safeguarding investors."**
>
> Jenny Tian, Managing Partner & Chief Executive Officer, Springs Capital Limited

Conclusion

Hong Kong's successful development has been driven by the city's effective legal system, competitive tax regime, balanced regulatory environment and sophisticated capital markets, deep and diverse talent pools, and close relationship to Mainland China. These six pillars are critical features of Hong Kong's success and must be supported -- and encouraged to evolve -- in order for Hong Kong to maintain and extend its leadership in the alternative asset management industry in Asia Pacific.

AIMA remains committed to – and optimistic – about Hong Kong's long-term future as an international alternative asset management centre, but it requires focus, conviction and commitment from policymakers, regulators and market participants, working together.

Further Information

About AIMA

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than US$2.5 trillion in hedge fund and private credit assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage US$600 billion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For more information, please go to www.aima.org.

About PwC

PwC is the leading global professional services network, with firms in 156 countries and more than 295,000 people committed to delivering quality in assurance, tax and advisory services. PwC has around 22,675 Asset & Wealth Management (AWM) professionals globally.

As a leading AWM practice, PwC is committed to playing an active role in shaping and supporting the industry for the betterment of the financial services ecosystem and broader society, in addition to spearheading the development of the burgeoning industry. This resonates with the firm's overall purpose in building trust in society and solving important problems working with government bodies, industry associations, industry leaders and regulators.

Glossary

Bond Connect (Southbound) is an arrangement that enables Mainland institutional investors to invest in the Hong Kong bond market through connection between the Mainland and Hong Kong financial infrastructure services institutions.

China Interbank Bond Market Direct Scheme (CIBM) is an arrangement that enables foreign investors to trade onshore bonds in the China interbank bond market directly through banks.

Greater Bay Area (GBA), also known as the Guangdong-Hong Kong-Macao Greater Bay Area, consists of the Hong Kong Special Administrative Region, the Macao Special Administrative Region as well as the municipalities of Guangzhou, Shenzhen, Zhuhai, Foshan, Huizhou, Dongguan, Zhongshan, Jiangmen and Zhaoqing in Guangdong Province.

Mutual Recognition of Funds (MRF) is an arrangement that allows Mainland and Hong Kong funds that meet certain eligibility requirements to follow streamlined procedures to obtain authorization or approval for offering to retail investors in each other's market.

Qualified Domestic Institutional Investor (QDII) is a scheme which allows domestic institutional investors in China to invest in offshore securities markets via fund management institutions, insurance companies, securities companies and other asset management institutions which have been approved by Chinese regulators.

Qualified Domestic Limited Partnership (QDLP) is a pilot scheme launched by Chinese local governments which provides qualified Mainland investors, such as institutional investors and high net-worth individuals, access to trade in overseas markets.

Shanghai-Hong Kong Stock Connect (Southbound) is an arrangement that allows eligible mainland China investors to, through Mainland securities firms and a securities trading service company established by the Shanghai Stock Exchange, place orders to trade eligible shares listed on the Stock Exchange of Hong Kong (SEHK) by routing orders to SEHK.

Shenzhen-Hong Kong Stock Connect (Southbound) is an arrangement that allows investors to, through their appointed Mainland securities firms and a securities trading service company established by the Shenzhen Stock Exchange in Hong Kong, trade eligible shares under Shenzhen-Hong Kong Stock Connect listed on SEHK by routing orders to SEHK.

Wealth Management Connect (WMC) is an arrangement under which individual residents in the Greater Bay Area can carry out cross-boundary investment in wealth management products distributed by banks in the Greater Bay Area.

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