The Banking Regulation Review

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Editor
Jan Putnis

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THE BANKING REGULATION REVIEW

THIRTEENTH EDITION

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PREFACE

The past year in banking regulation has been dominated, in most parts of the world, by the severe economic effects of the coronavirus pandemic. Governments and regulators have taken unprecedented steps to support businesses and individuals through the crisis. In financial terms, much of this support has been channelled through banks, and banks have had to work hard to continue to lend and to serve their customers in this difficult period.

Despite the human suffering and long-term economic damage that the pandemic has caused, there has been no significant banking crisis in the past year and, in most countries, no real sign that banks are failing to weather the storm so far. While there are of course exceptions, this is in large part a consequence of the relatively strong capital and liquidity position that banks around the world were in before the pandemic struck, which was itself a position that would not have arisen in many countries without the comprehensive prudential regulatory reforms that followed the global financial crisis of 2007–2009. Indeed, some regulators have commented that the pandemic is proving to be the first real test of those reforms and that, at least so far, the rules and institutional frameworks for banking regulation that were created after the global financial crisis have proven their worth.

As in all ongoing crises, there are causes for both pessimism and optimism. A pessimistic assessment with which it is hard to argue in many parts of the world is that we are still at an early stage in the economic damage that the pandemic has caused. The gradual withdrawal of government support programmes for businesses and the consequent further increases in non-performing loans with which banks have to deal will pose a further severe test for the banking systems of many countries at a time when governments will be relying on banks to support economic recovery. In some countries the strong links between bank viability and the ability of governments to issue sovereign debt at sustainable interest rates may re-emerge as a significant problem.

The optimistic assessment is necessarily a longer-term one given the challenges that the pandemic continues to present. The pandemic has undoubtedly provided the banking sector with an opportunity to show that it can be a force for financial stability and economic renewal at a time of crisis, in marked contrast to the blow to confidence that the sector suffered following the global financial crisis. This opportunity is closely linked to moves by many banks to consider their corporate purpose, the sustainability of their activities in environmental and social terms, and the quality, and in many cases the diversity, of their governance. This somewhat disparate collection of objectives, referred to as ESG (for environmental, social and governance) in many parts of the world, is increasingly dominating discourse between banks and their regulators and investors. Whether this would have happened in quite the way it has without the pandemic is impossible to know, but it does not seem much of an exaggeration

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to suggest that in many countries the banking sector that will emerge from the pandemic will have a series of cultural and business objectives that are quite different from those that existed before.

Regulators have become more assertive on these matters, particularly with regard to environmental objectives, and we will increasingly see a harder edge to the expectations that they are forming of banks' adherence to policies designed to address climate change. The repricing of many risks that is expected to take place as opinion settles on the pace at which transition to a low-carbon economy should take place will have a profound effect on the balance sheets of many banks. Shareholder pressure will force change in some banks, and banks with significant exposure to the petroleum economy will have to consider radical changes to their business models.

On social matters, financial inclusion and fair treatment of vulnerable customers are motivating legal and regulatory reform in many countries. There is a strong link between financial inclusion and the adoption of new technologies and business models, particularly in payment services. Many of the businesses that are contributing to the adoption of these technologies are not banks but rely on banks (or payment systems that are owned or controlled by banks) in order to operate. Allied to this are the increasingly serious and well-resourced attempts by firms using distributed ledger technologies to develop new means of payment, including stablecoins.

Regulators struggle to keep pace with these developments, but they hold back at their peril on addressing the implications for banks. The concept that the same or similar services and activities should be regulated in the same way is proving to be difficult to apply in practice, not least because there is a fundamental difference in financial stability terms between institutions that take deposits and those that do not. But the challenge of how to establish a level playing field on which to supervise banks and non-bank payment firms and lenders is one that must surely be addressed, and addressed soon, by regulators in a coordinated way around the world. The time for regulators to congratulate themselves on the effectiveness of financial sector reform following the global financial crisis has come to an end. It is now time to think hard about where risks lie and how risks will develop in the emerging tech-enabled financial system, and the possible causes of the next financial crisis.

It is perhaps surprising, given all the disruption caused by covid-19, that some countries have managed to push through significant legal and regulatory reforms in banking in the past year. These measures have included significant overhauls of the whole bank regulatory regime in some countries and, in other countries, further moves to implement Basel III standards. We have already seen some important changes of policy and emphasis in the United States under the new Biden administration. Legal and regulatory reform has continued in the European Union, although many initiatives have been delayed by the pandemic. The final departure of the United Kingdom from the European Union single market on 31 December 2020 and the resulting decoupling of London as a major banking centre from the European Union legal framework will continue to have reverberations and structural implications for banks operating in Europe. The long-term implications of Brexit for banks remain hard to predict; in particular, whether it will be a prelude to further fragmentation in banking regulation around the world.

This edition of *The Banking Regulation Review* covers 33 countries and territories in addition to the usual chapters on International Initiatives and the European Union. My thanks go to the authors for continuing to prepare informative chapters in the difficult and

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uncertain conditions in which many of them have been working over the past year. They continue to make this book the useful overview and guide to banking regulation around the world that it is.

Thank you also to the partners and staff of Slaughter and May in London and Hong Kong for continuing to support and contribute to this book, and in particular to Nick Bonsall, Ben Kingsley, Peter Lake, Emily Bradley, Ben Goldstein, Selmin Hakki, David Kasal, Tolek Petch, David Shone, Adrien Yeung and Ada Zhang.

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Jan Putnis
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Chapter 13

HONG KONG

Peter Lake[1]

I INTRODUCTION

Hong Kong has a three-tier system of banking institutions covering licensed banks, restricted licence banks and deposit-taking companies. There are separate licensing regimes, laws and regulations governing money lenders and money brokers. As at 28 February 2022, there were 159 licensed banks (eight of which were virtual banks), 15 restricted licence banks, 12 deposit-taking companies and 39 local representative offices of overseas banks in Hong Kong. The five largest licensed banks in Hong Kong measured by total assets are HSBC, Bank of China (Hong Kong), Standard Chartered Bank (Hong Kong), Hang Seng Bank and the Industrial and Commercial Bank of China (Asia) Limited. The Hong Kong Monetary Authority (HKMA) is the government authority responsible for maintaining monetary and banking stability in Hong Kong.

II THE REGULATORY REGIME APPLICABLE TO BANKS

Companies wishing to carry on banking business or the business of taking deposits in Hong Kong are required under the Banking Ordinance[2] to be authorised by the HKMA. These institutions are referred to in the Banking Ordinance as authorised institutions (AIs).

i The HKMA

The HKMA's functions and policy objectives are:

a maintaining currency stability;
b promoting the stability and integrity of the financial system;
c helping to maintain Hong Kong's status as an international financial centre; and
d managing the Exchange Fund (Hong Kong's official reserves).

The HKMA fulfils some of the functions of a central bank, such as formulating and implementing monetary policy, supervising banks and managing the Exchange Fund. Other functions, notably the issuance of bank notes, are carried out by three banks within Hong Kong's commercial banking sector: Bank of China, HSBC and Standard Chartered.

1 Peter Lake is a partner at Slaughter and May. The author would like to thank his colleagues Lydia Kungsen, Grace Jia and Jaime Wong for their assistance in preparing this chapter.

2 Chapter 155 of the Laws of Hong Kong.

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ii Banking regulation

The Banking Ordinance provides the legal framework for banking regulation, which is supplemented by two publications by the HKMA: the Supervisory Policy Manual and the Guide to Authorization. The Supervisory Policy Manual contains the HKMA's latest supervisory policies and practices. The Guide to Authorization sets out the HKMA's interpretation of the authorisation criteria, the procedures for processing applications for authorisation and the grounds for revocation of licences.

iii Local representative offices

Instead of seeking authorisation to be AIs, overseas banks may, with the approval of the HKMA, establish local representative offices in Hong Kong. Local representative offices are not allowed to engage in any banking or deposit-taking business in Hong Kong. Their role is therefore largely confined to liaison work between the overseas bank and its customers in Hong Kong.

iv AI eligibility criteria

Certain basic criteria must be satisfied to be eligible to become an AI and obtain a banking licence. The HKMA has general discretion to grant or refuse an application for authorisation and, if one or more of the criteria is not fulfilled, the HKMA must refuse the relevant application for authorisation. An AI must be a body corporate. Where the applicant for AI branch authorisation is a bank incorporated outside Hong Kong, the HKMA will confirm with the relevant overseas banking supervisory authority that it has given consent for the applicant to establish a branch in Hong Kong. The authorisation criteria for AIs, which are set out in the Seventh Schedule to the Banking Ordinance, ensure that only fit-and-proper institutions are entrusted with public deposits.

v Securities activities

The banking industry is regulated jointly by the HKMA and the Securities and Futures Commission of Hong Kong (SFC) to the extent that AIs carry on business in one or more regulated activities as defined in the Securities and Futures Ordinance[3] (SFO). Regulated activities include dealing in securities, advising on securities, advising on corporate finance and asset management.

The foundation of the regulatory framework for the securities and futures industry is that carrying on a business in a regulated activity without a licence, and without reasonable excuse, is a criminal offence. AIs that carry on business in one or more regulated activities are defined as 'registered institutions' in the SFO. To become a registered institution, the institution in question must satisfy the SFC that it is a 'fit-and-proper' person.

The SFO sets out a limited number of regulated activities (such as leveraged foreign exchange trading and certain types of securities margin financing) that AIs may carry out without a licence. The SFO includes provisions that have not yet commenced whose effect is to extend 'regulated activities' to advising or dealing in derivatives (or other structured products). AIs will largely be exempted from the derivatives regulated activities but are required under other provisions – and in line with international standards – to comply with mandatory reporting, clearing and margining rules in respect of their derivatives activities.

3 Chapter 571 of the Laws of Hong Kong.

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vi Insurance distribution

The insurance industry is regulated by the Insurance Authority under the Insurance Ordinance.[4] The starting point is that carrying on an insurance business without a licence is a criminal offence. The Ordinance was expanded with effect from 23 September 2019 to cover the distribution business of insurance products (i.e., the business of insurance agents and insurance brokers). The starting point is that carrying on an insurance distribution business without a licence, and without reasonable excuse, is a criminal offence.

Banks (and their staff) who distribute insurance products will therefore require licensing from the Insurance Authority. As of 23 September 2019, there are some 110,000 insurance intermediaries in Hong Kong.

vii Virtual assets

Registered institutions providing services related to virtual assets (VAs) and VA-related products must comply with the VA guidance issued by the SFC and the HKMA – in particular, the guidance issued in January 2022 regulating the distribution of VA-related investment products, and the provision of VA dealing, advisory and asset management services. The guidance contains a framework for registered institutions and other SFC-licensed intermediaries to provide such services and distribute VA-related products to professional investors (save for a limited category of exchange-traded VA derivatives that may be distributed to retail investors), and requires them to comply with various investor protection safeguards. These safeguards include partnering only with SFC-licensed VA trading platforms, and conducting VA knowledge tests and suitability assessments on clients (with certain exceptions available where they are institutional and qualified corporate professional investors).

viii Cross-border marketing

The Banking Ordinance prohibits marketing that invites members of Hong Kong's public to make deposits. The prohibition catches persons outside Hong Kong who market to persons in Hong Kong. The prohibition is subject to a number of exceptions, including invitations to make deposits with AIs and invitations to make deposits outside Hong Kong, which contain prescribed disclosures.

Hong Kong's securities legislation, under the SFO, similarly prohibits the active marketing of regulated activities to Hong Kong's public if the relevant service provider of the regulated activities has not been granted a licence by the SFC.

A similar prohibition applies to the active marketing of insurance distribution services.

ix HKMA's approach to banks regulated by overseas regulators

The HKMA recognises that the primary authority for supervising overseas banks lies with the supervisory authority of the jurisdiction where the relevant bank is incorporated. Accordingly, not all of the provisions in the Banking Ordinance and the Supervisory Policy Manual are applicable to AIs incorporated outside Hong Kong. Corporate governance and capital adequacy are two areas where the Banking Ordinance and the Supervisory Policy Manual are not applicable to banks incorporated outside Hong Kong, although the Banking Ordinance does set out certain capital thresholds to be met by an institution to become and remain authorised.

4 Chapter 41 of the Laws of Hong Kong.

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However, the HKMA does retain supervising power over most matters of day-to-day conduct of banking affairs for overseas banks authorised in Hong Kong. Rules and guidelines under the Banking Ordinance covering areas such as the appointment of directors responsible for the Hong Kong operations of overseas banks, the code of conduct of their Hong Kong operation, internal risk controls and risk management, liquidity management, trading activities and money laundering are applicable to overseas banks authorised in Hong Kong.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The primary responsibility for the prudent management of an AI rests with the board of directors and management itself. The HKMA issues guidance to AIs through its Supervisory Policy Manual. While the Supervisory Policy Manual does not itself have the force of law, any failure to adhere to any of the guidelines set out in it may call into question whether an AI continues to satisfy the minimum criteria for authorisation under the Banking Ordinance.

Continuous supervision

The HKMA adopts a continuous supervision policy to detect and address problems at an early stage. Various techniques are used by the HKMA to gather information and to monitor the business of each AI, including:

a on-site and off-site examinations;
b prudential meetings with the senior management;
c meetings with the board of directors;
d cooperation with external auditors; and
e sharing information with other supervisors.

Furthermore, regular statutory returns are required to be submitted to the HKMA.

Risk-based approach

The HKMA adopts a risk-based approach to evaluate the safety and soundness of an AI, its risk-management systems and its internal controls. This enables the HKMA to pre-empt any serious threat to the stability of the banking system.

The major types of inherent risks identified by the HKMA are credit, interest rate, market, liquidity, operational, legal, reputational and strategic risks. A risk-management rating is assigned and factored into the management and other relevant components of the CAMEL rating system, which is an internationally recognised framework for assessing capital adequacy, asset quality, management, earnings and liquidity. The output of the CAMEL system is a supervisory rating to reflect the HKMA's view of the overall safety and soundness of the relevant AI.

For a Hong Kong-incorporated AI, the HKMA normally conducts a regular supervisory review once a year. The supervisory review process is a comprehensive assessment of the level of capital that a Hong Kong-incorporated AI should set aside for the major types of inherent risks identified for the purpose of risk-based supervision.

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The HKMA has issued rules under the Banking (Capital) Rules[5] that prescribe in detail how the capital adequacy of locally incorporated AIs should be calculated. These rules incorporate Basel III technical guidance. In addition, the HKMA's Supervisory Policy Manual module CA-G-5 (supervisory review process) sets out details of the changes to the supervisory review process that were necessitated by the implementation of the Basel III capital standards. The Banking (Capital) Rules have been amended in previous years to introduce several capital buffers such as the capital conservation buffer, the countercyclical capital buffer and the higher loss absorbency (HLA) requirement. The capital conservation buffer is an additional layer of Common Equity Tier 1 (CET1) capital above the hard minimum capital requirements that is 2.5 per cent of banks' total risk-weighted assets. The countercyclical capital buffer is a further requirement for CET1 capital ranging from zero to 2.5 per cent of risk-weighted assets for banks' private sector credit exposures in Hong Kong when the HKMA determines there is excess aggregate credit growth associated with a build-up of system-wide risk in Hong Kong. The HLA ratio will apply to domestic banks considered by the HKMA to be systemically important (there are currently no global systemically important banks (G-SIBs) headquartered and incorporated in Hong Kong). They will be obliged to comply with this requirement by maintaining an additional layer of CET1 capital increasing to a range of from 1 per cent to 3.5 per cent of their total risk-weighted assets.

While there are separate regulators for the prudential supervision of securities, insurance, Mandatory Provident Fund schemes and money lending businesses in Hong Kong, the HKMA supervisory review process assesses all the major risks of a banking group, whether arising from banking or non-banking activities.

Climate change risk

On 30 December 2021, the HKMA updated its Supervisory Policy Manual by issuing a new module GS-1 (Climate Risk Management). The module builds on international initiatives (including the Task Force on Climate-related Financial Disclosures) and provides high-level guidance to AIs to build climate resilience by incorporating climate considerations into governance, strategy, risk management and disclosure. It contains helpful historical information and an overview of climate-related issues, including physical and transition risks. The module focuses on governance (responsibilities of board and senior management, oversight of the development and implementation of the AI's climate-related strategy, including setting of goals and actions and risk appetite); climate strategy planning and implementation; incorporation of climate-related risk considerations into the AI's risk management framework (including risk identification and measurement (both at portfolio, counterparty (including clients) and transactional level), monitoring and reporting, control and mitigation); and disclosure.

Module GS-1 envisages the management of climate risk via the existing, traditional framework of risk types (credit risk, market risk, liquidity risk, operational and legal risk, reputational risk and strategic risk).

5 Chapter 155L of the Laws of Hong Kong.

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VA risk

The HKMA issued guidance on 28 January 2022 on how AIs that interface with VAs and VA service providers (whether through proprietary investment or provision of banking services to customers) should approach this from a prudential and risk perspective.

The HKMA clarified that it adopts a risk-based approach based on the principle of 'same risk, same regulation', with banks expected to identify and understand associated risks before engaging in VA activities. Although banks are not currently prohibited from incurring financial exposures to VAs, they are expected to have adequate risk management controls and risk mitigation in place (including setting prudent limits on the institution's overall exposures to VAs) and conduct appropriate due diligence on VAs and VA service providers. AIs planning VA products or services should liaise in advance with the HKMA on the adequacy of their risk-management controls.

Consolidated supervision

The capital adequacy, concentration of exposures and liquidity of a Hong Kong-incorporated AI are supervised on a consolidated basis to enable the HKMA to assess any weaknesses within a banking or financial group that may have an impact on the AI itself, and to take any necessary defensive or remedial actions. When supervising banking groups, the HKMA takes a flexible approach to determining the scope of consolidated supervision. As a general rule, the banking group's local and overseas offices and financial subsidiaries are covered. Non-bank companies are included in the consolidation if they undertake financial business such as hire purchase, credit cards or leasing. Where non-bank companies (e.g., securities firms or insurance companies) are adequately supervised by other supervisors, the HKMA will rely heavily on their cooperation to ensure effective overall supervision of the banking group. The HKMA will also consider contagion risk in relation to an AI's holding and sister companies.

ii Management of banks

One of the authorisation criteria under the Banking Ordinance is that the HKMA must be satisfied that the chief executive and directors of the applicant company are fit and proper persons to hold their respective positions. The HKMA will have regard to the person's experience, knowledge and skills, as well as his or her reputation and character, competence, soundness of judgement and diligence, whether he or she has a record of non-compliance with non-statutory codes or disciplinary records, his or her involvement as a director in any companies wound up by the court, and his or her business record and financial soundness and strength.

The legal and regulatory duties of the management of AIs are detailed in the HKMA's Supervisory Policy Manual modules on corporate governance (CG-1 to CG-7). In particular, Supervisory Policy Manual module CG-1 (Corporate Governance of Locally Incorporated Authorized Institutions) sets out principles adopted by the HKMA in line with the Basel Committee on Banking Supervision's Principles for Enhancing Corporate Governance and Supervisory Policy Manual module CG-6 (Competence and Ethical Behaviour) sets out the latest developments in enhancing training programmes for banking practitioners in Hong Kong.

The board is ultimately responsible for the conduct of an AI's affairs, but the HKMA recognises that it may be beneficial for supervision of major functional areas to be delegated to certain specialised committees such as an executive committee, credit committee, asset and

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liability committee, remuneration committee and audit committee. It is also recognised that key functions and policies of an AI that is a subsidiary of another banking institution may be determined and centralised at the holding company level.

Outsourcing

The Supervisory Policy Manual module SA-2 (Outsourcing) sets out the HKMA's supervisory approach to outsourcing and the major points that the HKMA recommends AIs to address when outsourcing their activities. The HKMA's main concerns are with accountability, risk assessment, the ability of service providers, confidentiality of customer data, the degree of control the AI maintains over outsourced activities, contingency planning and access to outsourced data by the HKMA's examiners and the AI's internal and external auditors.

iii Regulatory capital, loss-absorbing capacity and liquidity

Capital adequacy ratio

The HKMA must be satisfied that an AI has financial resources that are adequate for the inherent risks in its business to reduce the risk of insolvency. All AIs are required under the Banking Ordinance to maintain minimum levels of share capital. As regards Hong Kong-incorporated AIs, the HKMA's framework for capital adequacy is based on Basel III (which was implemented in Hong Kong on 1 January 2013).

A Hong Kong-incorporated AI is required under the Banking (Capital) Rules to maintain a CET1 capital ratio of at least 4.5 per cent, a Tier 1 capital ratio of at least 6 per cent and a total capital ratio of 8 per cent. Branches of foreign banks are not subject to this requirement but, based on the HKMA's past practice of generally requiring any foreign bank that wishes to establish a branch in Hong Kong to maintain a capital adequacy ratio of at least 8 per cent, it is likely that the HKMA will continue to require foreign banks to meet the three minimum risk-weighted capital ratios.

Under the supervisory review process discussed above, the HKMA may require an AI to have a capital buffer to cater for risks and uncertainties that are not already captured by the three minimum risk-weighted capital ratios. The HKMA has the power under the Banking Ordinance to vary any capital requirement rule applicable to an AI.

Leverage ratio

Hong Kong-incorporated AIs must also comply with the minimum leverage ratio set out in the Banking (Capital) Rules. The leverage ratio is a non-risk-based measure of an AI's capital adequacy, introduced as a 'back-stop' to restrict the build-up of excessive leverage in the banking sector and to provide an additional safeguard against model risk and measurement error in the risk-based capital adequacy ratios. The minimum leverage ratio is 3 per cent.

Capital buffers

As mentioned in Section III.i, the HKMA has implemented the following capital buffers: the capital conservation buffer, the countercyclical capital buffer and (for domestic systematically important banks (D-SIBs)) the HLA requirement.

The capital conservation buffer is an additional band of CET1 capital at 2.5 per cent.

The level of the countercyclical capital buffer is an additional band of CET1 capital base that ranges from zero per cent to 2.5 per cent. The level is determined by the HKMA's analysis on whether there is excess aggregate credit growth associated with a build-up of

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system-wide risk in Hong Kong. It is an extension of the capital conservation buffer. On 28 January 2022, the HKMA announced the countercyclical capital buffer would remain unchanged at 1 per cent and noted that economic indicators point to continued recovery in Hong Kong in the last quarter of 2021, but uncertainties about the global and domestic pandemic situations have increased.

The HLA requirement applies only to D-SIBs. It is also an additional band of CET1 capital base that acts an extension of the capital conservation buffer. The HLA range (where applicable) is normally between 1 per cent and 2.5 per cent, although there is a top range of 3.5 per cent. On 24 December 2021, the HKMA announced that the total number of D-SIBs had decreased from six to five compared to the number of D-SIBs published on 30 December 2020. The Bank of East Asia Limited was no longer identified as a D-SIB, considering its systemic importance relative to other institutions. The updated list of D-SIBs is: HSBC, Bank of China (Hong Kong) Limited, Hang Seng Bank Limited, Industrial and Commercial Bank of China (Asia) Limited and Standard Chartered Bank (Hong Kong) Limited. Of the five banks, the HKMA has designated the highest HLA (2.5 per cent for 2022) to HSBC and the lowest HLA (1 per cent for 2021) to Hang Seng Bank Limited and Industrial and Commercial Bank of China (Asia) Limited.

If a Hong Kong-incorporated AI's capital level erodes to a level falling within the capital conservation buffer zone, the countercyclical capital buffer zone, or, for a D-SIB, the HLA buffer zone, restraints will be imposed on that AI's distributions. A Hong Kong-incorporated AI is expected to discuss with the HKMA if it anticipates that any of its capital levels will fall close to the buffer zones.

Loss-absorbing capacity rules

The Financial Institutions (Resolution) Ordinance[6] covers resolution, including bank resolution. On 14 December 2018, the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules were issued and came into operation. The rules enable the HKMA to prescribe loss-absorbing capacity (LAC) requirements for 'within scope' financial institutions that are Hong Kong-incorporated AIs, and for their Hong Kong-incorporated holding companies or Hong Kong-incorporated affiliated operational entities. Not all Hong Kong-incorporated AIs will be classified as 'within scope' – meaning that not all Hong Kong-incorporated AIs will be subject to the LAC requirements. It is worth noting that the LAC consolidation group may differ from the regulatory capital consolidation group. The rules set out how to calculate LAC leverage ratios (both external LAC and internal LAC, and under a solo, solo-consolidated and consolidated basis), capital component ratios and resolution component ratios (which will often be the same as the related capital component ratio). External LAC risk-weighted ratio will, at a minimum, be the sum of an AI's capital component ratio and its resolution component ratio. Internal LAC risk-weighted ratio will be set at a fraction of the external LAC risk-weighted ratio (likely 75 per cent in most cases). There is a requirement for at least a specified portion (likely one-third) of the LAC to be in the form of LAC debt since LAC debt (unlike LAC equity) is not at risk of depletion before bank failure and so provides a fixed quantity of financial resources that can support an orderly resolution. The rules also cover disclosure requirements in relation to LAC and deductions for holding non-capital LAC liabilities.

6 Chapter 628 of the Laws of Hong Kong.

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The Banking (Capital) Rules contain provisions relating to LAC, including a provision that an AI must take into account its minimum LAC requirements, in addition to its minimum regulatory capital requirements, in calculating the CET1 capital remaining available to meet the capital buffer requirement.

Note that capital that counts towards meeting the regulatory capital requirement (i.e., those hard requirements, ignoring the 'softer' capital buffers) will generally count towards meeting a LAC requirement. This means that the new additional burden for a 'within scope' Hong Kong-incorporated AI will likely be the resolution component ratio.

Solo and consolidated capital adequacy ratio

In broad terms, the Banking (Capital) Rules impose capital requirements on Hong Kong-incorporated AIs at two levels: on a solo basis and a consolidated basis.

All Hong Kong-incorporated AIs are required to maintain a capital adequacy ratio on a solo basis, which provides a measure of each institution's (including its local and overseas branches) capital strength. A Hong Kong-incorporated AI may apply to the HKMA to include in its capital base, for the purposes of calculation of its solo capital adequacy requirement, the capital invested in any subsidiary that meets the criteria set out in the Banking (Capital) Rules (effectively requiring the subsidiary to be managed by that parent AI) such that the capital adequacy ratio of that institution will be calculated on a 'solo-consolidated basis'.

Where a Hong Kong-incorporated AI undertakes other banking and financial business through subsidiary companies, the HKMA normally also requires the AI to maintain its capital adequacy ratio on a consolidated basis. This is to ensure that the Hong Kong institution's capital position is maintained at an adequate level taking into account its exposures to risks stemming from such subsidiaries. It is usually the practice of the HKMA to set the same minimum capital adequacy ratio requirement at both the solo and consolidated levels, unless the results of the supervisory review process justify otherwise.

Group supervision may also extend to controllers of the AI, including an assessment of controllers' financial resources to provide continuing support to the AI.

Composition of capital base

Under the Banking Ordinance, the capital base of an AI is the sum of its Tier 1 capital and Tier 2 capital. Tier 1 capital is the sum of an AI's CET1 capital and its additional Tier 1 capital. The key elements of the CET1 capital of an AI are the AI's CET1 capital instruments; the amount standing to the credit of the AI's share premium account (if any) resulting from the issue of the AI's CET1 capital instruments; the AI's retained earnings and other disclosed reserves; and the amount of minority interests arising from the CET1 capital instruments issued by the consolidated bank subsidiaries of the AI and held by third parties. The Banking (Capital) Rules also set out in detail how an AI's additional Tier 1 capital and Tier 2 capital are to be calculated. In respect of each category of capital, the Banking (Capital) Rules also specify which items are to be excluded from the calculation, as well as which deductions are to be made.

Risk-weighted amount

The Banking (Capital) Rules set out approaches that a Hong Kong-incorporated AI can use to calculate its risk-weighted amounts for credit risk, market risk, operational risk and sovereign concentration risk. Each Hong Kong-incorporated AI is expected to choose options for calculating credit risk, market risk and operational risk based on the results of its own

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detailed feasibility study. However, there is a default approach for each of those risks that every Hong Kong-incorporated AI must adopt unless the prior approval of the HKMA has been obtained for using another approach.

Banks in Hong Kong generally have strong capital bases. The consolidated capital adequacy ratio of Hong Kong-incorporated AIs was well above the 8 per cent requirement under the Banking (Capital) Rules (20.4 per cent as at the end of 2021).

Liquidity risk

The risk-based supervisory approach includes the continuous supervision of each AI's liquidity risk. Central to this is an assessment of an AI's ability to maintain adequate liquidity in the event of a liquidity crisis. The HKMA considers the amount of high-quality liquid assets that an AI can readily dispose of or pledge for funding; the results of stress tests on its cash-flow and liquidity positions; and the stability of the AI's funding sources and its contingency measures for dealing with crisis situations.

The Banking (Liquidity) Rules[7] implement the Basel III liquidity coverage ratio (LCR) and seek to promote banks' resilience to short-term liquidity risks by ensuring they have sufficient high-quality liquid assets to meet their obligations for at least 30 days under an acute stress scenario.

The LCR applies only to AIs designated by the HKMA as 'category 1 institutions' under the liquidity rules. Category 1 institutions are those internationally active AIs or larger or more sophisticated AIs that are significant to the general stability of the local Hong Kong banking system or those AIs that have material liquidity risk. Since 1 January 2019, all category 1 institutions must maintain at all times an LCR of at least 100 per cent. Other AIs not designated as category 1 institutions (category 2 institutions) will be subject to the liquidity maintenance ratio (LMR), which is a modified version of the pre-existing liquidity ratio. Since 1 January 2019, all category 2 institutions must maintain on average in each calendar month an LMR of at least 25 per cent.

On 1 January 2018, a new net stable funding ratio (NSFR) and a new local core funding ratio (CFR) were brought into force. These apply to different categories of AI to ensure their assets are financed with sufficiently stable sources of funding. Since 1 January 2019, all category 1 institutions must maintain at all times an NSFR of at least 100 per cent unless certain exemptions apply and certain category 2 institutions (which are designated by the HKMA as category 2A institutions) must maintain on average in each calendar month a CFR of at least 75 per cent.

Whether incorporated in or outside Hong Kong, the LCR, LMR, NSFR or CFR (as applicable) will apply only to an AI's business in Hong Kong and its local branches (i.e., excluding any subsidiaries or overseas branches of the AI). For a Hong Kong-incorporated AI, the HKMA may require the LCR, LMR, NSFR or CFR (as applicable) to be calculated on a consolidated basis instead of on an unconsolidated basis, or on both a consolidated and an unconsolidated basis.

7 Chapter 155Q of the Laws of Hong Kong.

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Liquidity of Hong Kong banks

Hong Kong banks' balance sheets have remained liquid in the aftermath of the global financial crisis, notwithstanding persistent challenges arising from the covid-19 pandemic. The consolidated quarterly average LCR of category 1 institutions in Hong Kong stood at 157.3 per cent (September 2018), 153 per cent (September 2019), 156.8 per cent (September 2020) and 155.5 per cent (September 2021). The average LCR of category 1 institutions was 155.5 per cent in the third quarter of 2021 – well above the statutory minimum of 100 per cent. The consolidated quarterly average LMR of category 2 institutions in Hong Kong stood at 52 per cent (September 2018), 54.5 per cent (September 2019), 55.8 per cent (September 2020) and 58.2 per cent (September 2021). The average LMR of category 2 institutions was 58.2 per cent in the third quarter of 2020, well above the statutory minimum of 25 per cent on average in each calendar month.

iv Recovery and resolution

The HKMA is a member of the Financial Stability Board (FSB) and has committed in principle to improving the effectiveness of its own resolution regime in light of the FSB policy paper, Key Attributes of Effective Resolution Regimes, published in October 2011 and updated in October 2014. The Financial Institutions (Resolution) Ordinance,[8] which is the primary legislation setting out Hong Kong's resolution regime, came into operation on 7 July 2017. The Ordinance establishes a cross-sector resolution regime for relevant financial institutions (including all AIs) with a view to avoid or mitigate the risks otherwise posed by their non-viability to the stability of Hong Kong's financial system.

The HKMA is contributing to the process of drawing up international resolution and recovery plans as a member of the crisis management groups of several G-SIBs.

In addition to the powers given under that Ordinance, the HKMA may also exercise a number of powers under the Banking Ordinance if, inter alia, an AI informs the HKMA that it is likely to become unable to meet its obligations, or that it is insolvent or about to suspend payment. The HKMA may also take such action unilaterally. In these circumstances, the HKMA, after consultation with the Financial Secretary of Hong Kong, may give directions to the AI in relation to its affairs, business and property.

The Supervisory Policy Manual contains a guideline on recovery planning, RE-1, which informs AIs of the key elements of effective recovery planning and sets out the HKMA's approach and expectations in respect of its review of recovery plans. The Banking Ordinance was amended on 2 February 2018 to give explicit statutory backing to recovery planning. The legislation covers the powers of the HKMA to:

a require the preparation and maintenance of a recovery plan;
b impose requirements on an AI to ensure the recovery plan is fit for purpose;
c impose requirements on an AI to revise its recovery plan;
d give directions to implement recovery plan measures under specific conditions;
e require AIs to notify certain trigger events; and
f extend recovery powers to an AI's locally incorporated holding company.

On 7 July 2017, the HKMA issued three codes of practice: Resolution Planning – Core information Requirements (CI-1); Operational Independence of the Monetary Authority as

8 Chapter 628 of the Laws of Hong Kong.

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Resolution Authority (RA-1) and The HKMA's Approach to Resolution Planning (RA-2). On 20 March 2019, the HKMA issued the Resolution Planning – LAC Requirements (LAC-1) code of practice.

On 27 August 2021, the Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules came into effect. These Rules require Hong Kong-incorporated AIs (and certain group companies or Hong Kong-incorporated holding companies) to include terms in certain non-Hong Kong law governed contracts to ensure those non-Hong Kong law contracts will be subject to the HKMA's power to require stays on termination rights. The Rules also contain record-keeping requirements. On 22 December 2021, the HKMA issued the code of practice Resolution Planning – Contractual Recognition of Suspension of Termination Rights (ST-1), which provides guidance on how to comply with those rules.

On 5 November 2021, the HKMA issued the code of practice Resolution Planning – Operational Continuity in Resolution (OCIR-1). The code of practice sets out the HKMA's expectations on how an AI should put in place arrangements now to secure continuity (were the AI subject to resolution) of services essential to critical financial functions.

v Over-the-counter derivatives

Mandatory reporting of over-the-counter (OTC) derivatives came into effect on 10 July 2015 (although licensed banks were previously reporting OTC derivatives under simplified interim reporting requirements introduced in 2013). The scope of mandatory reporting was expanded on 1 July 2017 and currently covers certain interest rate swaps, non-deliverable forwards, FX derivatives, equity derivatives, credit derivatives and commodity derivatives.

Mandatory clearing (and related record-keeping requirements) of OTC derivatives commenced on 1 September 2016. This first phase of mandatory clearing focused on certain standardised interest rate swaps denominated in US dollars, euros, sterling, Japanese yen or Hong Kong dollars and entered into between 'major dealers' (i.e., AIs, approved money brokers and licensed corporations) or between a major dealer and a 'financial services provider' specified on a list prepared by the SFC and approved by the HKMA. An AI that exceeds the relevant average three-month clearing threshold (currently US$20 billion, which is determined in respect of all outstanding OTC derivatives (other than certain deliverable FX forwards and deliverable FX swaps)) will, if its counterparty is a major dealer that also exceeds the clearing threshold, or if its counterparty is a designated financial services provider, be subject to mandatory clearing and related record-keeping obligations in respect of the relevant interest rate swaps. However, in respect of an AI incorporated outside Hong Kong, the obligations only apply to transactions that are recorded in the Hong Kong books of that AI.

On 11 September 2020, the HKMA revised the Supervisory Policy Manual module (CR-G-14) on margin and other risk mitigation standards for non-centrally cleared OTC derivatives. The margin provisions apply to an AI in respect of certain non-centrally cleared derivatives it enters into with a 'covered entity' (although in respect of an AI incorporated outside Hong Kong, the obligations only apply to the transactions that are recorded in the Hong Kong books of that AI). A covered entity means:

a a financial counterparty, meaning (broadly) a licensed or regulated entity that has, or whose group has, an average aggregate notional amount of non-centrally cleared derivatives for the relevant annual testing period (AANA) exceeding HK$15 billion; or

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b a significant non-financial counterparty, meaning a non-financial counterparty that has, or whose group has, an AANA exceeding HK$60 billion.

The requirement to exchange variation margin started from 1 March 2017. The requirement to exchange initial margin has been phased in from that date, with a current AANA threshold for both the AI and its covered entity counterparty of HK$6 trillion, reducing to HK$375 billion with effect from 1 September 2021 and then HK$60 billion with effect from 1 September 2022. This delay follows the deferrals announced by the Basel Committee and IOSCO.

vi Bank culture

On 2 March 2017, the HKMA issued a circular seeking to promote sound corporate culture for banks. The circular concentrates on governance (emphasising the importance of senior management setting an appropriate tone from the top and leading by example), incentive systems (to avoid incentivising short-term business performance at the expense of the interests of customers and the safety and soundness of a bank) and assessment and feedback mechanisms (to monitor adherence to banks' cultures and behavioural standards, and to set out escalation steps, including whistle-blowing mechanisms). Necessary enhancement measures were required to be implemented by 2 March 2018.

On 19 December 2018, the HKMA announced further measures to gauge the progress of bank culture reform in Hong Kong, stating that it will implement a number of supervisory measures. These include:

a AI self-assessments being extended to cover the banking culture;
b the HKMA, via site visits and off-site reviews, assessing and benchmarking AIs' practices; and
c the HKMA meeting with senior management and board members of AIs to gather insights and any lessons they have learnt.

The HKMA launched the first phase of AI self-assessment on culture in early 2019, requiring 30 AIs (including major retail banks in Hong Kong and selected foreign bank branches with substantive operations in Hong Kong) to submit their self-assessment outcomes within six months. The HKMA published its initial observations from the AI self-assessment exercise on 14 January 2020. Going forward, the HKMA plans to further progress its culture supervisory measures, including:

a sharing more observations from its review of AI self-assessments;
b commencing focused deep-dive reviews into certain key areas of banking culture, such as incentive systems of front offices in specific business streams of retail banks; and
c continuing its culture dialogues with AIs.

On 22 May 2020, the HKMA issued the Report on Review of Self-assessments on Bank Culture, which covered a range of practices, including governance, incentive systems and assessment and feedback mechanisms. Common themes identified in the Report include:

a further work is needed to ensure incentive systems are designed to promote sound culture and prevent incidents of misconduct;
b stronger links are required to connect Hong Kong operations with the culture efforts of their headquarters or upstream entities as well as their downstream operations, as appropriate;

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c deeper analysis is expected to benchmark AIs against the findings from the reviews of major overseas misconduct incidents;

d more focus is needed to facilitate the undertaking by relevant staff of the continuous professional development under the Enhanced Competency Framework issued by the HKMA or by other professional bodies to complement the effort of promoting sound culture;

e more effort is needed to tackle the key challenge of culture assessment to identify the gaps between current progress and desired culture;

f more work is needed in promoting an environment that provides 'psychological safety' to encourage staff to speak up without fear of adverse consequences; and

g sustained effort is required in driving cultural changes and AIs should be mindful of 'culture fatigue'.

As part of the ongoing supervisory work to promote sound culture in the banking sector, the HKMA commenced, in March 2021, a focused review on the incentive systems of front offices in the sale and distribution of banking, investment and insurance products of 20 retail banks. On 23 November 2021, HKMA Published the Interim Report on Incentive Systems of Front Offices in Retail Banks, which provides an interim update on the focused review and shares the initial observations based on data gathered from the activities undertaken. The HKMA is advancing to the next phase of the focused review and expects to explore and identify further themes and practices in its initiative to promote sound bank culture.

IV CONDUCT OF BUSINESS

i Conduct of business rules

The HKMA requires AIs to establish a code of conduct setting out the standards of behaviour expected of their management and employees. The code of conduct should discourage conflicts of interest, the granting and receiving of credit by members of staff to themselves or their relatives, bribery, personal investments when in possession of price-sensitive information and outside employment. It should also encourage staff to handle personal data carefully, and to contribute to the good reputation of the AI by reporting any illegal activities. The HKMA requires the effectiveness of the code of conduct and related systems to be audited regularly.

Furthermore, IC-1 (risk management framework) of the HKMA's Supervisory Policy Manual provides guidance on establishing an effective risk management framework (such as delineating responsibilities of the board and different committees of AIs), monitoring risk-taking activities and the risk management process and maintaining procedures to facilitate firm-wide risk.

ii The Code of Banking Practice

The Code of Banking Practice (the Code), issued jointly by the Hong Kong Association of Banks and the Deposit-taking Companies Association and endorsed by the HKMA, gives wider protection to customers and promotes good banking practices by aligning with international standards on financial consumer protection. The Code is issued on a voluntary basis, although the HKMA expects all AIs to comply with it and the HKMA monitors compliance. It covers areas such as terms and conditions, fees and charges, use of customer information, residential mortgage financing, card services and electronic banking services.

On 10 December 2021, updates made to the Code concerned the following:

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a requirements related to the provision of terms and conditions of using electronic devices (and, where electronic devices are used in branches or other face-to-face situations, to providing alternative means of review upon request);
b marketing published via third parties (and third-party websites);
c requirement for channels for the public to verify the authenticity of marketing and promotional activities;
d inclusion of community needs as a factor to consider when closing branches or changing services;
e requirement to issue warning messages to customers as soon as practicable on relevant customer security risk events such as cyber threats, frauds, scams, bogus marketing and promotional communications;
f provision of reasonable opportunity for customers to review relevant documentation before applying for a product or executing a transaction;
g requirement for certain non-paper-based information to be downloadable (for a reasonable specified time frame) and storable by the customers;
h requirement for customer access to non-paper-based statements for a minimum period of seven years;
i requirement for card issuers to make available application forms for error or dispute resolution, and to provide information on the chargeback mechanism of card associations;
j requirement for card issuers to disclose fees and charges for transactions in Hong Kong dollars incurred outside Hong Kong, and to remind customers in the fee schedule about arrangements for settling foreign currency transactions in Hong Kong dollars. Card issuers' statements should contain information on the applicable all-inclusive exchange rate for each foreign exchange transaction, as well as charges imposed on transactions in Hong Kong dollars incurred outside Hong Kong;
k in respect of outgoing payments, require disclosure upon request, to the extent the information is held, on timing, fees and charges and identity of intermediary and correspondent banks (and their fees and processing time) and, where an outgoing payment instruction cannot be completed, the time required for the amount to be transferred back to the customer; and
l reference made to the Hong Kong association of Banks and the DTC Association guidelines when handling reports from customers in relation to funds mistakenly transferred to a wrong recipient within Hong Kong.

iii Banking confidentiality

Under common law, a term imposing a duty of confidentiality may be implied in contracts between a bank and its customer. The duty of confidentiality applies to information arising directly from the customer's account, and other information obtained through the relationship between the bank and the customer or in coming to decisions about the bank's treatment of its customers. For the purpose of this duty, where a banking group is structured through subsidiary companies, each subsidiary is considered as a separate entity. Therefore, restrictions on disclosure apply equally to transfers of information within a banking group as to transfers to a third party. In contrast, branches of a single corporate entity are considered to form part of the same entity. Therefore, information may be transferred freely between them subject to any applicable data protection laws.

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There are four heads of acceptable disclosure of a customer's confidential information by a bank:

a compulsion of law;
b duty to the public;
c interests of the bank; and
d express or implied consent of the customer.

Head (c) is only applicable where disclosure is needed to protect the bank and not simply where it would be commercially advantageous.

Personal data are regulated in Hong Kong by the Personal Data (Privacy) Ordinance[9] (PDPO). The purpose of the PDPO is to protect the privacy interests of living individuals in relation to personal data. It applies to any person (a data user) who controls the collection, holding, processing or use of personal data in Hong Kong. A 'person' for the purposes of identifying a data user includes 'any public body, any body of persons, corporate or unincorporated'. Branches as well as subsidiary companies may constitute separate data users, and transfers between them should be in accordance with the PDPO. A third party to whom data are outsourced (e.g., for the completion of IT tasks) will not be a data user for the purposes of the PDPO in relation to data it 'holds, processes or uses solely on behalf of another person' if it does not hold, process or use that data for any of its own purposes. This exemption is not available where the third party is involved in the collection of data.

According to the Code, AIs should treat their customers' (and former customers') banking affairs as private and confidential, and should at all times comply with the PDPO and any relevant codes of practice issued or approved by the Privacy Commissioner in the collection, use and holding of customer information.

In October 2014, the Office of the Privacy Commissioner for Personal Data, Hong Kong (PCPD), published a guidance note entitled, Guidance on the Proper Handling of Customers' Personal Data for the Banking Industry, which explains for the benefit of banks the PDPO requirements in relation to the collection, holding, processing and use of customer data. The guidance note contains a number of useful case studies that are based on matters that have been considered by the Privacy Commissioner. In October 2015, the PCPD published a revised edition of its frequently asked questions on Understanding the Code of Practice on Consumer Credit Data in relation to the Sharing of Mortgage Data for Credit Assessment Purpose. The publication addresses common questions regarding the regulations on the sharing of mortgage data by credit providers through a credit reference agency under the Code of Practice on Consumer Credit Data.

On 19 November 2021, the HKMA issued guidance on sharing customer data by AIs for direct marketing by third parties. The HKMA considers that the banking industry should aspire to higher standards in this regard, given the special trust relationship between AIs and their customers.

The PDPO contains: specific requirements and offences relating to using data for direct marketing purposes; and (as from 8 October 2021) offences aimed at deterring doxing, being the disclosure of personal data without consent where the discloser intends or is reckless as to whether specified harm (such as harassment, threat, intimidation, harm or damage) would be caused.

9 Chapter 486 of the Laws of Hong Kong.

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iv Potential sources of liability

The Supervisory Policy Manual reminds directors of AIs to be aware of their legal obligations under all applicable laws and regulations, including but not limited to the Banking Ordinance, the Companies Ordinance,[10] the SFO, the PDPO, the Financial Institutions (Resolution) Ordinance, the Drug Trafficking (Recovery or Proceeds) Ordinance,[11] the Organised and Serious Crimes Ordinance,[12] the Anti-Money Laundering and Counter-Terrorist Financing Ordinance[13] and the Prevention of Bribery Ordinance.[14]

The SFO contains provisions on market misconduct (insider dealing, market manipulation, disclosure of false or misleading information, etc.). The SFO also contains several key provisions applicable to AIs that are registered with the SFC to carry on a business in one or more regulated activities. In general, AIs are subject to the provisions of the SFO in the same way as licensed corporations (i.e., institutions that are licensed by the SFC) in respect of their regulated activities. The major areas of difference, arising from the need to avoid regulatory overlap with the Banking Ordinance, are capital requirements and the handling of client money.

Directors may be held personally liable for non-compliance with many of the requirements under the Banking Ordinance and the SFO. In certain circumstances, such as under some offences in the Theft Ordinance,[15] directors may be held criminally liable for offences committed by companies of which they are a director.

V FUNDING

Customer deposits are the most important source of funding for retail banks in Hong Kong. As at the end of June 2021, they accounted for 57.2 per cent of all AI's total liabilities. The high level of customer deposits also contributes to the low rate of interest offered on Hong Kong dollar loans by licensed banks in the Hong Kong interbank market (HIBOR): the one-month HIBOR fixing averaged approximately 0.09 per cent quarterly (June 2021). The three-month HIBOR saw a mild reduction of 18 basis points during the first half to 0.17 per cent at the end of June 2021.

i Stable funding requirement

The HKMA introduced a stable funding requirement in October 2013, which requires AIs with significant loan growth to ensure they have adequate stable funding to support their lending business.

ii Provision of liquidity assistance by the HKMA

On 26 August 2019, the HKMA announced an updated liquidity facilities framework for AIs, to include a new resolution facility. The full liquidity facilities framework comprises: (1) settlement facilities (intraday repo and discount window); (2) standby liquidity facilities

10 Chapter 622 of the Laws of Hong Kong.
11 Chapter 405 of the Laws of Hong Kong.
12 Chapter 455 of the Laws of Hong Kong.
13 Chapter 615 of the Laws of Hong Kong.
14 Chapter 201 of the Laws of Hong Kong.
15 Chapter 210 of the Laws of Hong Kong.

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(including term repos and FX swaps) to make term liquidity available; (3) a contingent term facility, as a last-resort support arrangement available at the discretion of the HKMA, which will take into account contagion and systemic risks; and (4) a resolution facility, to ensure that an AI that has gone into resolution has sufficient liquidity.

On 3 April 2020, the HKMA issued a circular further clarifying some operational parameters of the standby liquidity facilities, which is part of the liquidity framework.

Deposit protection scheme

Depositors receive credit protection for certain deposits (and subject to specified limits) under the deposit protection scheme (DPS), which was launched in 2006 under the Deposit Protection Scheme Ordinance[16] (DPSO) under which eligible deposits are protected. Eligible deposits exclude:

a structured deposits;
b bearer instruments;
c term deposits with a maturity exceeding five years;
d deposits where the repayments are secured on the assets of the member of the DPS;
e offshore deposits;
f deposits held for the account of the Exchange Fund;
g deposits held by an excluded person under the DPSO; and
h financial products other than deposits.

The HKMA acts as an executive arm of the Hong Kong Deposit Protection Board in administering the DPS.

Only licensed banks are required and eligible to participate in the DPS. This is consistent with the aim of the DPS, which is to protect small depositors. A small number of licensed banks, which are branches of overseas-incorporated banks that are already covered by appropriate overseas deposit protection schemes, are exempted from the DPS.

The DPS is pre-funded by contributions from each member of the scheme. Further, the Deposit Protection Board has secured a credit facility from the Exchange Fund. The size of the credit facility is sufficient to cope with the simultaneous failures of two medium-sized banks.

Compensation will be paid to depositors when the court issues a winding-up order; or the HKMA, after consultation with the Financial Secretary, instructs the Deposit Protection Board to pay compensation. Under the DPS, each depositor (whether an individual or a corporate) who is not an excluded person under the DPSO is entitled to a maximum of HK$500,000 of compensation for each failed scheme member with which it places deposits.

To allow affected depositors to gain quicker access to the payout, the DPSO was amended in 2016 to adopt a gross payout approach for the determination of compensation. This enhanced protection for depositors so that any compensation paid to depositors is determined on the basis of their aggregate protected deposits held with a failed bank (up to HK$500,000 per depositor) without deducting the amount of liabilities owed by those depositors to the same bank.

16 Chapter 581 of the Laws of Hong Kong.

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VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Control of Hong Kong-incorporated AIs

The Banking Ordinance provides that no person shall become a controller of a Hong Kong-incorporated AI without the prior approval of the HKMA. A controller includes the following:

a an indirect controller: a person in accordance with whose directions or instructions the directors of the institution are accustomed to act;

b a majority shareholder controller: a person who controls over 50 per cent of the voting rights of the institution; and

c a minority shareholder controller: a person who controls between 10 per cent and 50 per cent of the voting rights of the institution.

Note-issuing banks

Pursuant to Section 3(5) of the Legal Tender Notes Issue Ordinance,[17] the Financial Secretary may amend any terms and conditions on which the authorisation to issue bank notes was granted. Shortly after Temasek Holdings, a Singapore state investment company, acquired a stake in Standard Chartered in 2006, the Financial Secretary of Hong Kong approved an additional policy requirement relating to the continuing authorisation of banks to be note-issuing banks. This provided that a note-issuing bank shall not have any close association with any foreign government or foreign government-controlled entity that either alone or with associates is entitled to control 20 per cent or more of the voting power of the note-issuing bank or its holding company. In effect, the policy requirement is a barrier to controlling 20 per cent or more of the voting power of any of the three note-issuing banks in Hong Kong (although a determined bidder may not view the note-issuing status as a fundamental issue).

Overseas-incorporated AIs

While the acquisition of shareholdings and control in AIs incorporated outside Hong Kong do not need to be approved by the HKMA, the HKMA still needs to be satisfied that a person who is to be a controller of an AI is a fit and proper person to hold such a position. In doing so, the HKMA will rely heavily on the views of the home supervisor of the overseas-incorporated AI.

ii Approval process for controllers of Hong Kong-incorporated AIs

Application

A person seeking to become a controller of a Hong Kong-incorporated AI must first serve on the HKMA a written notice of intention. The written notice must be submitted together with any supporting documents requested by the HKMA.

Subject to the below, it is generally the policy of the HKMA that a person who intends to hold 50 per cent or more of the share capital of a Hong Kong-incorporated AI should be a well-established bank or other supervised financial institution in good standing in the financial community and have appropriate experience. If a prospective majority controller does not fulfil this requirement, the HKMA's primary concern will be to ensure that any

17 Chapter 65 of the Laws of Hong Kong.

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risks posed to the AI by the controller and the group to which the controller belongs are understood and well contained. To achieve this, the HKMA may impose conditions on the controller. If the controller is incorporated outside of Hong Kong, or is not a financial holding company nor a subsidiary of a financial holding company, the controller will generally be asked to establish a Hong Kong-incorporated holding company whose sole purpose will be to hold the shares of the AI. This holding company will be subject to conditions such as capital adequacy, liquidity, large exposures, intra-group exposures and charges over assets, group structure, activities undertaken, risk management, fitness and proprietary of directors and senior management and submission of financial and other information. The HKMA has encouraged the establishment of virtual banks and stated in its Guideline on Authorization of Virtual Banks (reissued on 8 June 2018) that these conditions (on the establishment and supervision of a Hong Kong holding company) mean that non-financial firms (including technology companies) may be eligible to own and operate a virtual bank in Hong Kong.

Timing

The Banking Ordinance does not specify when written notice needs to be submitted to the HKMA. However, the HKMA's preference is to be approached at the earliest appropriate opportunity, and experience has indicated that the HKMA expects to be approached for an approval in principle before the formal application process begins. This includes an expectation to pre-vet any proposed announcement of the sale of an AI (regardless of whether or not the AI is incorporated in Hong Kong).

The HKMA then has up to three months from the date of service of the notice to serve a notice of consent, and the HKMA may need the full three months, particularly if the proposed controller is not an established bank or financial institution. In other, more straightforward cases, this period is normally six weeks to two months. The HKMA will be taken to have consented to a person becoming a controller of a Hong Kong-incorporated AI if it does not serve on him or her a notice of objection within the three-month period.

Considerations

In granting the notice of consent, the HKMA:

a must be satisfied that the person is a fit and proper person to become a controller of the Hong Kong-incorporated AI;

b must be satisfied that the interests of depositors and potential depositors of that Hong Kong-incorporated AI would not be threatened by that person becoming a controller;

c takes into account the person's likely influence on that Hong Kong-incorporated AI if he or she were to become a controller; and

d takes into account the financial position, reputation or conduct of the applicant to determine whether such person, if a controller of the Hong Kong-incorporated AI, could potentially damage the Hong Kong-incorporated AI through contagion.

In granting the notice of consent, the HKMA may specify such conditions as it thinks proper to safeguard the interests of depositors and potential depositors.

Although not explicitly set out in the legislation, the HKMA will take similar considerations into account when considering controllers of non-Hong Kong-incorporated AIs, which it will review in the context of whether an AI remains fit and proper.

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Approval

If the HKMA has served a notice of consent to the applicant, that person must become a controller within 12 months of the date on which he or she was served the notice of consent.

Controller financial support

Where a minority or majority shareholding in a Hong Kong-incorporated AI is being acquired, the HKMA will generally require the acquiring shareholder controller to provide a letter of comfort committing to provide capital support, liquidity support or both to the AI, if necessary. The form of the letter of comfort is set out in the HKMA's Guide to Authorization.

Transfers of banking business

While other common law jurisdictions have a court-sanctioned scheme process to effect the transfer of banking business without the consent of the depositors or other counterparties, Hong Kong does not have an equivalent process.

Notification to the HKMA

A Hong Kong-incorporated AI cannot make any arrangement, or enter into any agreement for the sale or disposal of all or any part of its banking business or its business of taking deposits, without the prior written approval of the HKMA.

Private member's bill

In a business or asset transfer in Hong Kong, private legislation is the only alternative to obtaining individual customer consent.

A private member's bill is a special type of legislation intended to affect or benefit some particular person, association or corporate body. It may be used to transfer all or part of a company's business to another company or to extinguish the rights of any creditor of the company, or both. The private member's bill procedure has been used for a number of bank mergers with a Hong Kong element (e.g., Citibank, Dao Heng Bank, Standard Chartered and Bank of Communications), although this procedure is rare and is not currently favoured by the HKMA.

The customer consent route is the usual form of transfer.

VII THE YEAR IN REVIEW

i LIBOR

On 25 March 2021, the HKMA issued a circular informing AIs that they should cease to issue new LIBOR contracts (regardless of tenor) after 31 December 2021.

ii Updates to the Supervisory Policy Manual

The HKMA continues to update the Supervisory Policy Manual, including, in particular:

a Module CA-B-2 (Systemically Important Banks) on 23 April 2021, to update it to: (1) improve the assessment of AIs' complexity in the HKMA's identification process of D-SIBs; and (2) reflect recent developments;

b Module IB-1 (Supervision of Insurance Intermediary Business of Authorized Institutions) on 25 June 2021, which is a new module outlining the HKMA's supervisory and enforcement approach in respect of insurance regulated activities

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of AIs. These powers arise by reason of the Insurance Authority having delegated to the HKMA its inspection and investigation powers in relation to insurance regulated activities carried on by AIs;

c Module CS-1 (Group-wide Approach to Supervision of Locally Incorporated Authorized Institutions) on 20 July 2021, to update it to reflect the HKMA's current supervisory approach and practices; incorporate relevant international standards concerning the supervision of financial conglomerates; and cater for consequential changes arising from amendments to the Banking Ordinance. The module clarifies the HKMA's policy where there is a financial services group (containing a Hong Kong-incorporated AI) headed by an unregulated holding company. Typically, the Hong Kong-incorporated AI (which has an unregulated ultimate holding company) must be directly held by a Hong Kong-incorporated holding company (IHC), which itself will be subject to prudential limits on capital adequacy, liquidity, large exposures, intra-group exposures and charges over assets; and be subject to consultation requirements, risk system and control requirements and fitness and proprietary requirements. In addition, the unregulated ultimate holding company heading the group (and, to a slightly lesser extent, any intermediate holding companies in the chain) are required to: support the AI's capital adequacy; limit intragroup exposures of the IHC group to other group companies; submit periodic independent review reports on its financial condition (capital adequacy, leverage position, liquidity position, intra-group exposures), ability to provide capital or liquidity support to the IHC and the AI, group risks that may impact the IHC and the AI and how those risk are managed and controlled; ensure its (and its related parties') representation on the board of directors of the IHC and of the AI is limited to specified limits; and submit specified financial and other information;

d Module CG-5 (Guideline on a Sound Remuneration System) on 29 July 2021, to update it to incorporate the most recent guidance issued by the FSB; strengthen board oversight; give guidance for group remuneration policies, including for foreign bank branches; and align the module with the remuneration disclosure requirements in the Banking (Disclosure) Rules;[18]

e Module GS-1 (Climate Risk Management) on 30 December 2021, to issue new high-level guidance to AIs to build climate resilience by incorporating climate considerations into governance, strategy, risk management and disclosure. Further details on Module GS-1 can be found in Section III.i. 'Climate change risk');

f Module TA-2 (Foreign Exchange Risk Management) on 18 January 2022, to incorporate the Basel Committee on Banking Supervision's Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions[19]; and

g proposed new Module TB-1 (Regulation and Supervision of Trust Business), issued as a consultation draft on 4 November 2021, to regulate AIs in the context of trust business (which catches setting up trusts, acting as trustee, arranging for others to act as a trustee, managing trust assets, administration services and transfer of assets to beneficiaries). The purpose of the proposed module is to promote treating customers fairly and customer-centric culture in trust business, and to better align with

18 Chapter 155M of the Laws of Hong Kong.

19 https://www.bis.org/publ/bcbs241.pdf.

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international standards and practices. The proposed module would apply to all AIs as well as subsidiaries of Hong Kong-incorporated AIs. The general principles for trust business contained in the proposed module include:

- fairness, honesty and integrity (including on disclosure of information and fees and charges);
- due skill, care and diligence;
- due care in understanding, managing and controlling trust assets;
- establishment of corporate governance structure and internal controls (including on delegation, outsourcing and complaint handling);
- compliance with legal and regulatory requirements; and
- cooperation with regulators;

iii Updates to the resolution regime

As mentioned above, on 27 August 2021, the Financial Institutions (Resolution) Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules came into effect. These rules require Hong Kong-incorporated AIs (and certain group companies or Hong Kong-incorporated holding companies) to include terms in certain non-Hong Kong law governed contracts to ensure those non-Hong Kong law contracts will be subject to the HKMA's power to require stays on termination rights. The rules also contain requirements on systems of control and on the keeping of records. Industry associations are preparing or have prepared template language to assist AIs in satisfying their obligations under the rules to include the new required terms. For example, on 24 September 2021, ISDA published a Hong Kong Jurisdictional Module to the ISDA Resolution Stay Jurisdictional Modular Protocol.

On 5 November 2021, the HKMA issued OCIR-1 (Resolution Planning – Operational Continuity in Resolution), which sets out the HKMA's expectations regarding arrangements AIs should put in place to secure the continuity in resolution of services that are essential to the continued performance of critical financial services. The arrangements should also support post-stabilization restructuring in a timely manner. If an AI does not meet the HKMA's expectations, the HKMA may conclude that a significant impediment exists to orderly resolution and therefore direct the AI to take steps to remove or mitigate the effect of the impediment. The HKMA, following the same approach as for resolution planning, will prioritise implementation of the continuity arrangements by AIs which are DSIBs or Hong Kong-incorporated AIs with total consolidated assets of more than HK$150 billion.

On 22 December 2021, the HKMA, as a resolution authority in relation to banking sector entities, issued Module ST-1 (Resolution Planning – Contractual Recognition of Suspension of Termination Rights), which provides guidance on how to comply with the rules.

iv Regtech

In March 2021, the HKMA issued its sixth edition of *Regtech Watch*. The publication highlights how technology applications can help AIs manage risks associated with treasury activities (such as operational risk, legal risk, liquidity risk and market risk) and how regtech may strengthen risk management controls in treasury operations that involve a large volume of trading data over multiple systems. Treasury activities traditionally involve a number of manual processes and the management of treasury risk often requires collation and analyses of large volumes of data maintained at different systems of the bank. The publication highlighted:

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a the use of big data analytics and artificial intelligence solutions to manage rogue trading risk and identify and collate information on suspicious transactions;

b the use of third-party data software to standardise digital representations of derivative products and enhance consistency between banks of trade information recorded (and how trade information is recorded). DLT may be applied to create a single source of truth; and

c use of cloud-based data management solutions to improve efficiency of banks' liquidity risk monitoring and prediction modelling. Using the cloud enhances capacity (including capacity associated with seasonal data surges) that may be constrained using servers and other on-site hardware.

In June 2021, the HKMA issued its seventh (and final) edition of *Regtech Watch*. The publication highlights the HKMA's three-year road map to integrate supervisory technology into its processes. This involves proof-of-concepts for developing a central platform so all information about AIs is contained in a single location, and then building a knowledge management system. A proof-of-concept will be conducted to automate standardised tasks. A speech-to-text proof-of-concept will be conducted to transcribe audio recordings into timestamped machine-readable text and identify specific keywords, tone and sentiment. At a later stage, a proof-of-concept will be conducted to show entity relationships in the form of network diagrams to increase transparency and assist the HKMA in detecting early warning signals. Also at a later stage, a proof-of-concept will be conducted to categorise or assign scores to large quantities of news related to AIs, which will help gauge exposures to conduct risk. Towards the end of the HKMA's road map, the HKMA will investigate methods to make policy assimilation and dissemination more accessible, such as by the use of an open API framework and enabling HKMA policy change to be incorporated into AIs' internal policies and procedures with minimal human participation.

In June 2021, the HKMA published the first issue of the *Regtech Adoption Practice Guide* (the *Guide*), focusing on cloud-based regtech solutions. Benefits of cloud technology include timely offsite support and faster implementation and scalability of solutions. The publication provides practical implementation guidance on adoption of cloud regtech (and highlights key risks) and shares use cases.

On 18 June 2021, the HKMA requested each AI to participate in a tech baseline assessment to provide data on current and planned fintech adoption. This assessment is used to collect data as part of the HKMA's focus that under 'Fintech 2025' all AIs should be encouraged to fully digitalise their operations from front end to back end.

On 26 July 2021, the HKMA published the second issue of the *Guide*, focusing on AML/CTF efforts in the ongoing monitoring of customers. The publication notes the challenges caused by manual processes in collating relevant, complete and up-to-date information in relation to customers and their transactions and shares information on how AIs have successfully adopted AML/CTF solutions. The paper also provides practical implementation guidelines to AIs on the adoption of AML/CTF regtech solutions.

On 27 September 2021, the HKMA published the third issue of the *Guide*, focusing on regtech solutions in the space of governance, risk and compliance. This involves the interaction of people, processes and technologies to gather and aggregate risk information across an organisation to enable timely management attention and action. The paper

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reiterated a previous theme, being the future introduction of machine-readable regulations (designed for ingestion by machines to enable regulations to be automatically incorporated into an AI's obligations registers and governance, risk and compliance systems).

On 26 November 2021, the HKMA published the fourth issue of the *Guide*, focusing on regtech solutions designed for regulatory reporting and stress testing. As regulators increase the frequency and granularity of regulatory reporting requirements, and require more specific stress test scenarios, regtech solutions may be used to alleviate some of the pain points.

On 25 January 2021, the HKMA published the fifth issue of the *Guide*, focusing on the implementation of controls and technical capabilities to protect bank data, systems and business activities from cyberattacks.

v Climate change

As mentioned above, on 30 December 2021, the HKMA updated its Supervisory Policy Manual by issuing a new module GS-1 (Climate Risk Management).

Separately, on 8 December 2021, the HKMA shared sound practices adopted by certain banks to support the transition to carbon neutrality. The practices are grouped into the following areas:

a reducing greenhouse gas emissions of own operations;
b reducing financed emissions through portfolio alignment;
c assisting clients to transition; and
d promoting collective efforts to assist the economy to net zero transition.

vi Insurance

On 25 June 2021, the HKMA issued a new module to the Supervisory Policy Manual, Module IB-1 (Supervision of Insurance Intermediary Business of Authorized Institutions), which outlines the HKMA's supervisory and enforcement approach in respect of insurance-regulated activities of AIs. These powers arise by reason of the Insurance Authority having delegated to the HKMA its inspection and investigation powers in relation to insurance-regulated activities carried on by AIs. The module summarises the major regulatory requirements for AIs distributing insurance products – including those arising under the Insurance Ordinance, the Anti-Money Laundering and Counter-Financing of Terrorism and related guidelines and those originating from the HKMA in light of the special relationship of trust that customers have with AIs.

On 24 September 2021, the HKMA provided guidance to AIs on providing investment and insurance services to customers through non-face-to-face channels. The guidance covers the assessment and treatment of vulnerable customers; suitability assessments (including for those products where a financial needs analysis is not required) and whether transactions are 'unsolicited' or 'execution-only' (in the case of non-complex products).

In October 2021, the Insurance Authority issued an Explanatory Note on 'Regulated Activity' under the Insurance Ordinance, which provides guidance on what actions would fall within the meaning of 'regulated activity' and hence require a licence under the Insurance Ordinance. In particular, the note explains the Insurance Authority's views on conduct that constitutes 'negotiating' or 'arranging' a contract of insurance, or 'attempting to invite or induce' a person to enter into (or make a material decision about) a contract of insurance. The note goes on to give practical examples in the context of:

a an insurer or regulated entity using an unregulated person's website or app to promote or offer insurance products to the unregulated person's customers;

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b an unregulated person having an arrangement with a regulated entity to pass on clients;
c price comparison websites; and
d referral schemes to incentivise existing policyholders to refer friends and relatives to the insurer. (Clerical and administrative tasks (such as sending on forms, passing on messages and data-transfer) fall outside the insurance licensing requirement.)

vii Covid-19 outbreak

On 6 February 2020, the HKMA published the 'Measures to relieve impact of the novel coronavirus' circular, in which it welcomed initiatives taken by some AIs to roll out temporary relief measures for their customers during this difficult time. Measures considered included a principal repayment moratorium for residential and commercial mortgages, fee reduction for credit card borrowing and restructuring of repayment schedules for corporate loans. The HKMA encouraged other AIs to consider taking similar action and indicated that a proactive response by the banking industry will help mitigate the financial consequences of the outbreak. The HKMA has extended the pre-approved principal repayment holiday scheme for small and medium corporates, most recently on 23 February 2022, to include principal debt otherwise due to be repaid on or before 31 October 2022. The pre-approved principal repayment holiday scheme also contains an option for customers to resume partial repayments over a period of one year.

In April 2020, the government introduced a concessionary low-interest loan under the SME Financing Guarantee Scheme, in which a 100 per cent loan guarantee is provided by the government to the lending AIs. While it is a time-limited special relief measure, originally meant to run for one year and end in April 2021, the loan scheme has already been enhanced twice since its launch to ensure it could meet the needs of SMEs during the economic downturn. On 15 September 2020, the total guarantee commitment was raised from HK$50 billion to HK$70 billion. The application period is currently set to expire on 30 June 2022.

On 26 March 2021, the Finance Committee of the Legislative Council approved a HK$15 billion government commitment for the introduction of the 100 per cent Personal Loan Guarantee Scheme. Under the scheme, AIs will carry out the customer due diligence and eligibility to participate in concessionary low-interest loans. After drawdowns, the loans will be sold to The Hong Kong Mortgage Corporation Limited without recourse (with Government providing the funding to The Hong Kong Mortgage Corporation Limited)

On 1 June 2021, the HKMA required all AIs to strongly encourage staff performing client-facing roles or critical support functions to be vaccinated. Those not vaccinated should be tested for covid-19 every two weeks. AIs were required to submit a breakdown of designated staff expected to be vaccinated.

On 18 February 2022, the HKMA strongly encouraged AIs to implement arrangements similar to the vaccine pass arrangement implemented by government and financial regulators for staff entering the workplace. Under the arrangements, staff should be required to present proof of vaccination for at least the first dose of covid-19 vaccine before entering the workplace (with exemptions for those who are unfit for vaccination due to medical conditions).

viii iAM Smart

On 29 December 2020, the Office of the Government Chief Information Officer (OGCIO) launched the initiative of iAM Smart. In a circular of the same date, the HKMA encouraged AIs and Stored Value Facility licensees to actively consider the adoption of iAM Smart.

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iAM Smart provides all Hong Kong residents with a single digital identity and authentication to conduct government and commercial transactions online. Users can make use of the biometrics in their personal mobile devices to authenticate their identities, which will have been verified against their Hong Kong ID cards during the iAM Smart registration process. This means that users can enjoy convenient access to various online services without the need to manage different groups of usernames and passwords or carry multiple security tokens. It is also possible (by attending in person for registration) for iAM Smart to support digital signing with legal backing under the Electronic Transactions Ordinance[20] (legal backing means that it can be used to sign statutory forms and contracts with government).

iAM Smart may be used to store personal data. This avoids users filling in the same date when making different online applications. Users may also consent to their personal data being provided to other entities for different online services. iAM Smart is expected to facilitate remote onboarding of customers.

The HKMA regards the introduction of iAM Smart as a key milestone in the development of Hong Kong's fintech ecosystem.

On 24 May 2021, the HKMA notified AIs that FAQs on AML/CFT had been updated to help AIs understand how iAM Smart can be used to comply with AML/CFT requirements.

iAM Smart has been widely adopted since the launch. On 15 November 2021, the OGCIO announced that more than one million users had registered for iAM Smart and over 160 commonly used government, public and private online services were accessible through the platform.

ix Commercial Data Interchange

On 23 December 2021, the HKMA called for AIs to participate in the Commercial Data Interchange (CDI), which is a next-generation financial data infrastructure to promote efficient financial intermediation in the banking system. This will enable AIs to quickly access the business data of corporates and connect with new data providers with minimal effort. The HKMA believes the CDI will shortly become an indispensable tool for risk management, in particular in relation to SMEs.

x Credit Reference Platform

On 17 December 2021, the HKMA reminded AIs to prepare to participate in the new Credit Reference Platform (CRP), which is scheduled for launch by the end of 2022. The CRP will enable there to be more than one credit reference agency (CRA) for consumer credit data, with the view to enhancing the service quality of CRAs and reducing the operational risk of single point of failure. The HKMA supports the CRP initiative as being in line with creating next-generation data infrastructure and driving fintech development in Hong Kong.

xi Enhanced Competency Framework on Fintech

On 3 December 2021, the HKMA announced the launch of the Enhanced Competency Framework on Fintech. The Framework establishes a set of common and transparent competency standards for developing a strong fintech (including regtech) talent pipeline and enhancing the professional competence of existing banking practitioners in this area.

20 Chapter 553 of the Laws of Hong Kong.

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AIs are encouraged to adopt the Framework as part of their overall efforts in supporting relevant employees' ongoing professional development. The Framework is not, however, a mandatory licensing regime.

Looking back, the HKMA has previously launched seven enhanced competency framework modules, covering:

a private wealth management (updated on 14 July 2021);
b AML and CFT;
c cybersecurity;
d treasury management;
e retail wealth management;
f credit risk management; and
g operational risk management.

xii VAs

As mentioned above, the HKMA issued guidance in January 2022 on how licensed intermediaries may conduct certain activities in relation to VAs and VA-related products, as well as on AIs' interface with VAs and VA service providers (whether on a proprietary basis or as part of their banking services).

In January 2022, the HKMA also issued a Discussion Paper on Crypto-assets and Stablecoins, setting out its thinking on the regulatory approach for stablecoins. It proposed a non-exhaustive list of stablecoin-related activities that will require licensing by the HKMA – for example, issuing, creating or destroying stablecoins and executing transactions in stablecoins. Its initial focus will be on stablecoins that are asset-linked (e.g., linked to a fiat currency). Various prudential and fit-and-proper requirements are likely to apply. The HKMA is seeking feedback from the market and aims to introduce the regime in 2023–2024.

xiii Greater Bay Area

Hong Kong's financial services will benefit greatly from the integration and cross-development of the cities of the Guangdong-Hong Kong-Macao Greater Bay Area (GBA). On 10 September 2021, the HKMA issued a circular on the establishment of a cross-boundary wealth management connect scheme in the GBA (Cross-boundary WMC). Under the scheme, eligible residents in the mainland cities in the GBA and Hong Kong, through a closed-loop funds flow channel established between the banking systems of the two jurisdictions, may invest in wealth management products distributed by banks in each other's market. The Southbound Scheme is where eligible residents in the mainland cities in the GBA invest in wealth management products distributed by Hong Kong banks via designated channels. The Northbound Scheme is where eligible residents in Hong Kong invest in wealth management products distributed by mainland banks via designated channels. Implementation arrangements for a pilot scheme have been established. The implementation arrangements for Hong Kong banks are set out in the circular.

In October 2021, the HKMA and the People's Bank of China (PBoC) signed a memorandum of understanding agreeing to link up the PBoC's Fintech Innovation Regulatory Facility with the HKMA's Fintech Supervisory Sandbox. The objective is to provide a one-stop platform to allow FIs and technology firms to pilot test their cross-boundary fintech initiatives. On 18 February 2022, the HKMA announced that the HKMA and PBoC are ready to accept applications for this cross-boundary fintech sandbox.

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VIII OUTLOOK AND CONCLUSIONS

We anticipate the following areas of focus or development in the next 12 months:

a further focus on regtech solutions, including for KYC operations and procedures;

b continuing focus on progressing the issuance of green finance in the Hong Kong markets; and

c the creation of new market opportunities under the Greater Bay Area initiatives.

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Appendix 1

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