

IN-DEPTH

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HONG KONG



LEXOLOGY

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In-Depth: Banking Regulation (formerly The Banking Regulation Review) is an annual survey of the most important developments in banking regulation in the most significant jurisdictions worldwide. It provides high-level insight across the gamut of the legal and regulatory requirements applicable to banks, including prudential regulation, rules governing the conduct of business, funding, control and transfers of banking business and much more.

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Hong Kong

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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 31 January 2024, there were 151 licensed banks (eight of which were virtual banks), 16 restricted licence banks, 12 deposit-taking companies and 31 local representative offices of overseas banks in Hong Kong. The five largest licensed banks in Hong Kong measured by total assets are The Hongkong and Shanghai Banking Corporation Limited (HSBC), Bank of China (Hong Kong) Limited (BOCHK), Standard Chartered Bank (Hong Kong) Limited (SCBHK), Hang Seng Bank Limited (HSB) and the Industrial and Commercial Bank of China (Asia) Limited (ICBCA).

Year in review

i Reform of interest rate benchmarks

The London Interbank Offered Rate (LIBOR) for one-week and two-month US dollar settings and all sterling, euro, Swiss franc and Japanese yen LIBOR settings ceased to be published after 31 December 2021. The remaining US dollar LIBOR settings were discontinued after 30 June 2023.

HIBOR remains in use and there are no plans to discontinue HIBOR, although the Hong Kong Dollar Overnight Index Average (HONIA) has been recognised as an alternative to HIBOR.

ii Updates to the Supervisory Policy Manual

The Hong Kong Monetary Authority (HKMA) continues to update the Supervisory Policy Manual (SPM), including, in particular:

1. Module IC-4 (Complaints Handling and Redress) was updated on 6 January 2023 to align the HKMA's requirements with the latest global best practices in financial consumer protection and complaints handling. Authorised institutions (AIs) are expected to perform the following functions:
 - monitor any issues of concern or control deficiencies that are identified when handling customer complaints; and
 - make use of alternate dispute resolution channels such as the mediation and arbitration services of the Financial Dispute Resolution Centre to resolve complaints involving monetary disputes referred by the HKMA that cannot be resolved through the AIs' internal mechanisms.
2. Module CR-S-4 (New Share Subscription and Share Margin Financing) was updated on 17 November 2023 to reflect changes following the launch of Fast

Interface for New Issuance (a digital platform for initial public offering settlement) and to provide further guidance on risk management of share margin financing.

3. Module AML-2 (Guideline on Anti-Money Laundering and Counter-Financing of Terrorism) was updated on 25 May 2023 (as further described in Section II.ix).
4. Module MR-1 (Market Risk Capital Charge) was published on 3 October 2023 for consultation purposes. It specifies the requirements for implementing the new market risk capital framework in Hong Kong and provides guidance on the approaches to calculation of market risk capital charge (including the standardised (market risk) approach, the internal models approach, the simplified standardised approach) and the requirements related to the boundary between the trading book and banking book.
5. Module MR-2 (CVA Risk Capital Charge) was published on 3 October 2023 for consultation purposes. It stipulates the requirements for implementing the new regulatory credit valuation adjustment (CVA) risk capital framework in Hong Kong and sets out the reduced basic CVA approach, the full basic CVA approach and the standardised CVA approach.
6. Module CG-6 (Competence and Ethical Behaviour) was published on 18 December 2023 for consultation purposes and covers the HKMA's expectations for AIs in ensuring the competence, probity and integrity of their staff. The module includes principles that AIs should consider when establishing and implementing policies and procedures for monitoring, developing and maintaining the competence levels and ethical behaviour of their staff.

iii Implementation of Basel III final reform package

The following rules (the Rules) will come into operation to implement the Basel III final reform package and related updates:

1. the Banking (Capital) (Amendment) Rules 2023 (BCAR) set out the revised capital standards contained in the Basel III final reform package. The revised capital methodologies are used to determine the capital requirements of banks in relation to their exposures to credit risk, operational risk, market risk and CVA risk and the output floor. The BCAR also introduces the option of a positive neutral countercyclical capital buffer;
2. the Banking (Disclosure) (Amendment) Rules 2023 (BDAR) contain updated disclosure requirements as contained in the documents published by BCBS in connection with disclosure requirements relating to Pillar 3, leverage ratio and market risk;
3. the Banking (Exposure Limits) (Amendment) Rules 2023 (BELAR) mainly incorporate consequential amendments arising from the BCAR for implementing the revised capital standards contained in the Basel III final reform package; and
4. the Banking (Liquidity) (Amendment) Rules 2023 (BLAR) introduce consequential amendments arising from the BCAR.

The Rules will come into operation on the following dates:

1. 1 April 2024 regarding:
 - the provisions unrelated to the Basel III final reform package in the BCAR (including the introduction of the option of a positive neutral countercyclical capital buffer); and
 - the provisions in the BELAR that are considered significant to ensuring the effective operation of the Rules; and
2. a date to be appointed by the HKMA (which is currently expected to be 1 January 2025) regarding:
 - the other provisions in the BCAR and the BELAR; and
 - the BDAR and BLAR.

The HKMA requires Hong Kong-incorporated AIs to comply with the reporting requirements for the new standards on market risk and CVA risk from 1 July 2024.

iv Trust business

The HKMA published a circular on 2 May 2023 to outline the reporting requirements in relation to the regulation and supervision of trust business. The requirements apply to the following:

1. AIs;
2. subsidiaries of Hong Kong-incorporated AIs (AI subsidiaries); and
3. holding companies, subsidiaries (for AIs incorporated outside Hong Kong) and affiliates of AIs (associated AIs), that carry on trust business in Hong Kong as a trustee.

AIs were required to report to the HKMA by 15 May 2023 whether they themselves or any of their AI subsidiaries, or both, carry on trust business in Hong Kong as a trustee and the particulars of the AI's managers or the particulars of the AI subsidiaries, or both.

AIs and AI subsidiaries that carry out trust business in Hong Kong as a trustee are subject to an ongoing obligation to notify the HKMA within a stipulated time of:

1. any new appointments, cessation of existing appointments and changes in the responsibilities of the managers (with respect to AIs) and responsible officers (with respect to AI subsidiaries); and
2. any changes to the trust business (with respect to AIs).

Associated AIs that carry out trust business in Hong Kong as a trustee and that wish to be included on the HKMA's list of trustees are required to notify the HKMA of changes to their initial and annual declarations on compliance with the Code of Practice for Trust Business (including suspension or cessation of trust business in Hong Kong).

Under the SPM module TB-1 (Regulation and Supervision of Trust Business), AIs are required to submit an incident reporting form in relation to any material non-compliance with any legal or regulatory requirements, any major incident and any other matter that may have material impact on the fitness or propriety of the trustee.

v Regtech

As part of the HKMA's initiative to promote Regtech adoption in Hong Kong, the HKMA publishes a series of Regtech Adoption Practice Guides (the Regtech Guide) to provide guidance on industry challenges and explanations on how the use of technology can enhance the efficiency of risk management and regulatory compliance.

On 10 May 2023, the HKMA published the ninth issue of the Regtech Guide, which focuses on Regtech solutions for customer data and privacy. It offers guidance on the implementation and advice on how banks can use Regtech solutions to address challenges across the customer data lifecycle.

vi Climate change

Following its pilot climate risk stress test in 2021 to assess the climate resilience of the banking sector, the HKMA issued, on 21 April 2023, a set of guidelines to give more information on its second round of the climate risk stress test (conducted from June 2023 to June 2024). The test involves scenarios with different assessment horizons: a short-term scenario combining climate and macroeconomic shocks and three long-term scenarios developed based on a subset of scenarios from the Network of Central Banks and Supervisors for Greening the Financial System. AIs participating in the test should follow a specified approach in segmenting their exposures to produce a more consistent sectoral impact analysis and should assume a static balance sheet to detect their weaknesses in terms of the latest business profiles and strategies. The reporting standards have also been enhanced to include more metrics in terms of risk factors, business sectors and geographical locations.

On 29 August 2023, the HKMA published high-level principles to assist AIs in planning for a net-zero transition and announced that it will conduct a survey on AIs' practices in transition planning with a view to sharing with the industry a range of practices based on the survey results. These high-level principles include setting clear objectives and targets, setting up a robust governance framework and embedding transition considerations into internal processes, devising appropriate initiatives and actions to achieve the objectives, engaging with clients, performing reviews and updates, and maintaining transparency.

vii Green and sustainable finance

On 30 May 2023, the HKMA published a discussion paper on the development of a green taxonomy for Hong Kong and issued a prototype green taxonomy that covers the following sectors:

1. electricity, gas, steam and air conditioning supply;
2. transportation and storage;

3. water supply, sewerage, waste management and remediation; and
4. construction.

The HKMA asked for feedback and plans to fine-tune and expand on the prototype.

The HKMA issued a circular on 29 November 2023 to outline the expected standards and examples of good practice regarding the sale and distribution of green and sustainable investment products by registered institutions, including in relation to product due diligence, disclosure, governance and controls, staff training and bookbuilding activities. Registered institutions that market or classify investment products as green and sustainable (except those on bookbuilding) should comply with the expected standards no later than 12 months from the date of the circular.

Hong Kong's Green and Sustainable Finance Cross-Agency Steering Group (CASG) (co-chaired by the HKMA and the Securities and Futures Commission of Hong Kong (SFC)) was established to promote the green and sustainable finance market in Hong Kong, strengthen talent and address data gaps. The CASG announced on 7 August 2023 that it is developing, for the financial sector in Hong Kong, a roadmap on the appropriate adoption of the international sustainability disclosure standards issued by the International Sustainability Standards Board (ISSB), as well as a data portal to increase the availability and accessibility of climate-related data.

viii Enhancing the security of electronic banking services

Given the increasing prevalence of fraudulent electronic banking (e-banking) transactions, the HKMA has formulated a set of e-banking security enhancements in collaboration with the HKAB and the Hong Kong Police Force. AIs are required to implement various measures, including using ambush authentication, requesting for additional confirmations for suspicious high-risk transactions, notifying unusual e-banking activities, maintaining the capability to implement multiple authentication methods, restricting concurrent login sessions and maintaining a 24/7 customer reporting channel. AIs are required to implement these measures no later than 31 March 2024 (although the HKMA may permit implementation at a later stage if an AI experiences practical difficulties in meeting this deadline).

The HKMA will also revise SPM module TM-E-1 (Risk management of E-banking) and launch an industry consultation on the proposed amendments in due course.

ix Anti-money laundering and counter-terrorist financing

The Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO)^[2] was amended on 1 June 2023.

The key changes are to:

1. amend the definition of 'politically exposed person' to align with the international standards set by the Financial Action Task Force;
2. enable a risk-based approach to be adopted to determine the degree of customer due diligence (CDD) that former 'politically exposed persons' are subject to;

3. clarify that recognised digital identification systems can be used for CDD and identification purposes; and
4. specify that the beneficial owner of a trust includes the trustee of the trust, a beneficiary and a class of beneficiaries of the trust entitled to a vested interest in the trust.

The AMLO also introduced a licensing regime for virtual asset (VA) service providers.

Under the new licensing regime, the carrying on of a business of operating a VA exchange will require an SFC licence. For this purpose, operating a VA exchange means providing services through electronic services:

1. to offer to sell or purchase VAs regularly or in a way that forms a binding transaction or to introduce persons to other persons to negotiate or conclude sales or purchases of VAs in a way that forms a binding transaction; and
2. to come into direct or indirect possession of client money or client VAs.

The SFC will only grant licences to Hong Kong-incorporated companies with a permanent place of business in Hong Kong or registered non-Hong Kong companies. Relevant persons must satisfy a fit and proper test and comply with anti-money laundering and counterterrorist financing measures (such as record-keeping) and other regulatory requirements (such as having adequate financial resources, knowledge and experience, and proper reporting and disclosure procedures).

The Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (for Authorised Institutions) and the Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (for Stored Value Facility Licensees) were both amended on 25 May 2023 to provide further guidance on the AMLO amendments.

On 9 February 2023, the HKMA issued an updated Guidance Paper on Transaction Monitoring, Screening and Suspicious Transaction Reporting (Guidance Paper), which provides further guidance and clarification on how AIs and stored value facility licensees should implement internal systems to monitor and report financial crime. In particular, the Guidance Paper encourages the use of technology to generate targeted alerts and the use of external information from Commercial Data Interchange, the HKMA's data sharing initiative.

x Fintech

The HKMA, SFC and Insurance Authority (IA) jointly published a new Fintech Promotion Roadmap on 25 August 2023, which outlines the initiatives to be undertaken by the three regulators in the 12 months from the date of publication to promote the adoption of fintech in the financial services sector. This will include regular fintech showcase events, roundtables, seminars, training sessions, practical guidelines, promotional videos and a new fintech knowledge hub.

xi Resolution planning

The HKMA published a new chapter to the Financial Institutions (Resolution) Ordinance (FIRO)^[3] Code of Practice on 15 February 2024 on resolution planning and the continuity of access (CoA) to financial market infrastructure (FMI) services. The chapter outlines the HKMA's expectations in relation to the ex ante arrangements that AIs should implement, in a resolution scenario, to maintain CoA to critical FMI services. AIs are expected to:

1. identify providers of critical FMI services and maintain related information;
2. assess the requirements and conditions for maintaining CoA critical to FMI services; and
3. develop measures, including the preparation of a contingency plan, for maintaining CoA critical to FMI services.

xii Sale and distribution of tokenised products

Tokenised products are the digital representation of real-world assets using distributed ledger or similar technology. Noting AIs' initiatives on tokenisation, the HKMA published a circular on 20 February 2024 to provide guidance on the sale and distribution of tokenised products that are not regulated under the Securities and Futures Ordinance (SFO)^[4] and governed by the requirements of the SFC and the HKMA.

The regulations and consumer or investor protection measures for the sale and distribution of a product also apply to the product's tokenised form because the tokenised form has the same characteristics (including risks) as the underlying product. For example, the regulations and investor protection measures set forth by the HKMA with respect to the sale of a non-SFO regulated structured investment product will apply to the distribution of the tokenised form of the non-SFO regulated structured investment product. AIs should assess the applicable legal and regulatory requirements when selling and distributing tokenised products and establish relevant systems and controls.

AIs should ensure that there are adequate due diligence, disclosure and risk management consumer or investor protection measures with respect to the sale and distribution of tokenised products.

xiii Custodial services for digital assets

In light of the growing interest in digital asset-related activities, the HMKA published a circular on 20 February 2024 to establish standards on the provision of custodial services for digital assets that depend primarily on cryptography and distributed ledger or similar technology (e.g., VAs as defined under the AMLO, tokenised securities and other tokenised assets) except for limited purpose tokens as defined under the AMLO. The standards apply to AIs and subsidiaries of Hong Kong-incorporated AIs that conduct digital asset custodial services and cover governance and risk management, segregation of client digital assets, safeguarding of client digital assets, delegation and outsourcing, disclosure, record keeping and reconciliation of client digital assets, anti-money laundering and counter-financing of terrorism and ongoing monitoring.

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 (BO)^[5] to be authorised by the HKMA. These institutions are referred to in the BO as AIs.

i The HKMA

The HKMA is the government authority responsible for maintaining monetary and banking stability in Hong Kong.

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 (Hong Kong's official reserves). Other functions, notably the issuance of bank notes, are carried out by three banks within Hong Kong's commercial banking sector: BOCHK, HSBC and SCBHK.

ii Banking regulation

The BO provides the legal framework for banking regulation, which is supplemented by two publications by the HKMA: the SPM and the Guide to Authorization. The SPM 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 BO, 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 SFC to the extent that AIs carry on business in one or more regulated activities as defined in the 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 derivative activities.

vi Insurance distribution

The insurance industry is regulated by the IA under the Insurance Ordinance.^[6] The starting point is that carrying on an insurance business without a licence is a criminal offence. The licensing regime also covers the distribution business of insurance products (i.e., the business of insurance agents and insurance brokers).

Banks (and their staff) who distribute insurance products will therefore require licensing from the IA. As of 31 January 2024, there are 114,891 insurance intermediaries in Hong Kong.

vii VAs

Registered institutions providing services related to VAs and VA-related products must comply with the VA guidance issued by the SFC and the HKMA in December 2023, which regulates 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 distribute VA-related products and to provide VA dealing services, asset management services in respect of VAs and VA advisory services. In particular, the guidance sets out the requirements applicable to intermediaries when distributing VA-related products and the standards of conducts expected of intermediaries when distributing VA funds authorised by the SFC. The investor protection 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). Since 1 June 2023, VA service providers have been subject to a licensing regime (as further described in Section II.ix).

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 SPM. While the SPM 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 BO.

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. The HKMA also recognises that are emerging risk types. Climate risk, which includes the impacts of climate and weather-related events and long-term progressive shifts of climate and the financial risk related to the process of adjustment towards climate initiatives, may impact the exposure of an AI to the other inherent risks. The HKMA has, since 30 June 2022, been developing a two-year plan to incorporate climate risk considerations into its supervisory processes.

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.

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.

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 in determining the scope of consolidated supervision. The HKMA considers an AI's banking group to include its immediate holding company, offices, subsidiaries, affiliates and joint ventures, both domestic and foreign. If the AI is the parent company of several subsidiary operations, the

HKMA will assess on a solo basis and assess the risks and strengths of the subsidiary operations and practice 'consolidated supervision' for the banking group. If an AI is a subsidiary of a wider group and with a holding company, then the HKMA will conduct solo and consolidated supervision and review the holding company and other companies in the wider group and apply a 'controller group review' approach. Where an AI or its subsidiaries is also engaged in other financial operations such as insurance and securities businesses, the HKMA will work with the other supervisors (i.e., SFC and IA) to ensure effective overall supervision of the banking group. The HKMA will also rely on and cooperate with host banking supervisors to supervise overseas branches and subsidiaries of AIs. Notwithstanding the HKMA's group-wide approach to supervision, the HKMA's role is to supervise the AI as part of the banking group rather than to supervise all the companies falling within the banking group.

ii Management of banks

One of the authorisation criteria under the BO 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 financial status or solvency, education, other qualifications or experience, ability to carry on the regulated activity competently, honestly and fairly, as well as his or her reputation, character, reliability and financial integrity.

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 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.

The legal and regulatory duties of management of AIs are detailed in the SPM modules on corporate governance (CG-1 to CG-7).

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 BO to maintain minimum levels of share capital. The HKMA has issued rules under the Banking (Capital) Rules^[7] that prescribe in detail how the capital adequacy of Hong Kong-incorporated AIs should be calculated. These rules incorporate Basel III technical guidance. In addition, the SPM 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.

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 at least 8 per cent. Branches of foreign banks are not subject to this requirement as primary reasonability lies with the home supervisor but the HKMA

will generally require any foreign bank that wishes to establish a branch in Hong Kong to maintain capital levels consistent with the latest applicable capital standards issued by the Basel Committee on Banking Supervision (BCBS).

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 AI 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 these 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.

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

The HKMA has implemented the following capital buffers: the capital conservation buffer, the countercyclical capital buffer and (for domestic systemically important banks (D-SIBs) and globally systemically important banks (G-SIBs)) the higher loss absorbency (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 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 system-wide risk in Hong Kong. It is an extension of the capital conservation buffer. On 20 February 2024, the HKMA announced that the countercyclical capital buffer would remain unchanged at 1 per cent.

The HLA requirement applies to Hong Kong-incorporated AIs that are designated as D-SIBs and G-SIBs. It is also an additional band of CET1 capital base that acts as an extension of the capital conservation buffer. The HLA range (where applicable) is normally

between 1 and 2.5 per cent, although there is a top range of 3.5 per cent. On 29 December 2023, the HKMA announced that the total number of D-SIBs remains unchanged at five compared to 30 December 2022. The list of D-SIBs is HSBC, BOCHK, HSB, ICBCA and SCB. Of the five banks, the HKMA has designated the highest HLA (2.5 per cent for 2024) to HSBC and the lowest HLA (1 per cent for 2024) to HSB and ICBC. There is currently no Hong Kong-incorporated AI that has been designated a G-SIB.

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 FIRO covers resolution, including bank resolution. The Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules^[8] 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. 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 be, at a minimum, 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 because 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 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 capital requirements, in calculating the CET1 capital remaining available to meet the capital buffer requirement.

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 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 (20.9 per cent as at the end of September 2023).

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^[9] implement the Basel III liquidity coverage ratio (LCR) and seek to promote banks' resilience to short-term liquidity risks by ensuring that 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.

A net stable funding ratio (NSFR) and a local core funding ratio (CFR) 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.

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 average LCR of Category 1 institutions was 174.5 per cent in the third quarter of 2023, well above the statutory minimum of 100 per cent. The average LMR of Category 2 institutions was 64.1 per cent in the third quarter of 2023, well above the statutory minimum of 25 per cent on average in each calendar month.

iv Recovery and resolution

FIRO, which is the primary legislation setting out Hong Kong's resolution regime, establishes a cross-sector resolution regime for relevant financial institutions (including all

Als) 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.

The BO sets out the powers of the HKMA to require Als to prepare and maintain a recovery plan (including ensuring that the recovery plan is fit for purpose), to give directions to Als to implement recovery plan measures under specific conditions, to require Als to notify it of certain trigger events and to extend recovery powers to an AI's Hong Kong incorporated holding company. The SPM module RE-1 (Recovery planning) also provides guidance on the key elements of effective recovery planning and sets out the HKMA's approach and expectations in respect of its recovery plans.

The HKMA may exercise a number of powers under the BO 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 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.

Conduct of business

i Conduct of business rules

The HKMA requires Als 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. The relevant requirements are contained in the SPM module CG-3 (Code of Conduct).

ii The Code of Banking Practice

The Code of Banking Practice (the Code), issued jointly by the Hong Kong Association of Banks (HKAB) 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 Als 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 7 December 2023, the HKMA amended the Code to further enhance consumer protection in digital banking services, empower customers on financial management,

ensure fair treatment of customers and promote international good banking practices in Hong Kong. Specific enhancement measures include:

1. enhancing the customers' understanding of the relevant risks and protection measures of digital banking services;
2. providing enriched information on the risk and potential repayment obligations of loan products from the revised key facts statements (i.e., interest rate risks and impact of related changes on repayment);
3. extending the advance notice period to customers from the existing 30 days to at least 60 days for significant changes to the terms and conditions of loan products (i.e., increase in interest rate);
4. advising customers with potential financial difficulties of possible options (i.e., debt restructuring) to avoid further worsening of their financial situation); and
5. introducing recent updates of the G20/OECD High-Level Principles on Financial Consumer Protection to align with the latest international practice.

Funding

i Customer deposits and interest rates

Customer deposits are the most important source of funding for retail banks in Hong Kong. As at 30 June 2023, they accounted for 57.2 per cent of all AI's total liabilities. The continued US interest rate increases have contributed to a rise in overall funding costs and a higher Hong Kong Interbank Offered Rate (HIBOR): the one-month HIBOR fixing averaged approximately 3.98 per cent quarterly (June 2023) up from 0.31 per cent quarterly (June 2022). The three-month HIBOR fixing average saw an increase from 0.88 per cent quarterly (June 2022) to 4.28 per cent quarterly (June 2023).

ii Deposit protection scheme

Depositors receive credit protection for certain deposits (and subject to specified limits) under the Deposit Protection Scheme (DPS), which is governed by the Deposit Protection Scheme Ordinance (DPSO).^[10]

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.

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.

Control of banks and transfers of banking business

i Control regime

Hong Kong-incorporated AIs

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

1. an indirect controller: a person in accordance with whose directions or instructions the directors of the institution are accustomed to act;
2. a majority shareholder controller: a person who controls over 50 per cent of the voting rights of the institution; and
3. a minority shareholder controller: a person who controls between 10 and 50 per cent of the voting rights of the institution.

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 HKMA may request the applicant to submit information as it may reasonably require.

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 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 neither 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 propriety of directors and senior management and submission of financial and other information. The HKMA encourages the establishment of virtual banks and has stated in its Guideline on Authorization of Virtual Banks (reissued on 23 March 2022) that these conditions (on the establishment and supervision of a Hong Kong-incorporated 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 BO 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. 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:

1. must be satisfied that the person is a fit and proper person to become a controller of the Hong Kong-incorporated AI;
2. 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; and
3. takes into account the person's likely influence on that Hong Kong-incorporated AI if he or she were to become a controller.

The HKMA may specify such conditions as it thinks proper to safeguard the interests of depositors and potential depositors.

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.

iii 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.

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.

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., Wing Hang Bank Limited, Citibank (Hong Kong) Limited, ICBCA and Bank of Communications (Hong Kong) Limited), although this procedure is relatively rare and not currently favoured by the HKMA.

The customer consent route is the usual form of transfer.

Outlook and conclusions

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

1. improving investor and consumer protection measures with respect to VAs and tokenisation;
2. concentrating on preventing and reducing digital fraud;
3. monitoring the implementation of the Basel III final reform package; and
4. continuing focus on promoting green and sustainable finance in the Hong Kong market (particularly on the disclosure and supervision of climate risks, taxonomy and transition finance).

Endnotes

- 1 Vincent Chan is a partner, and Jocelyn Poon and Adrien Yeung are associates at Slaughter and May. The authors would like to thank Lydia Kungsen for her contribution to this chapter. [^ Back to section](#)
- 2 Chapter 615 of the Laws of Hong Kong. [^ Back to section](#)
- 3 Chapter 628 of the Laws of Hong Kong. [^ Back to section](#)
- 4 Chapter 571 of the Laws of Hong Kong. [^ Back to section](#)
- 5 Chapter 155 of the Laws of Hong Kong. [^ Back to section](#)
- 6 Chapter 41 of the Laws of Hong Kong. [^ Back to section](#)
- 7 Chapter 155L of the Laws of Hong Kong. [^ Back to section](#)
- 8 Chapter 628B of the Laws of Hong Kong. [^ Back to section](#)
- 9 Chapter 155Q of the Laws of Hong Kong. [^ Back to section](#)
- 10 Chapter 581 of the Law of Hong Kong. [^ Back to section](#)

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