Hong Kong Banking and Capital Markets Regulatory Outlook 2022

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Building a better working world

Introduction

Hong Kong's banking and capital markets sector has entered 2022 facing stronger headwinds from COVID-19 than might have been anticipated this time last year. The first quarter has seen the Omicron outbreak sweep through the city and the SAR government impose an extended set of social distancing measures including the continued imposition of restrictions impacting both international and Mainland China travel. The impact of this continued uncertainty on Hong Kong's longer-term role as a financial center remains to be seen and, as we will explore further in this year's report, it creates some more immediate considerations for regulatory risk management as firms respond to the evolving situation. Overall, however, the banking and capital markets sector remains resilient and the regulatory priorities of the HKMA and SFC continue largely in line with the trajectory they have set out in recent months.

Climate change has risen to the forefront of the agenda of regulators worldwide and those of the Hong Kong Monetary Authority (HKMA) and Securities and Futures Commission (SFC) for banks and fund managers respectively.

The HKMA and SFC also continue to be concerned about the impact of technology given its centrality to the operations of financial institutions (FIs). Both the SFC and HKMA have or are about to introduce new operational resilience requirements. The HKMA is also concerned about the ability of banks to restore critical data in the event of critical cyber attacks and the HKMA and SFC both remain concerned about cybersecurity in a more digitized environment with an evolving cyber risk profile. The HKMA is also pushing for a fundamental transformation of the bank's technological capabilities with well-thought-through plans to implement those capabilities. To implement these and meet the increasing regulatory expectations, FIs will need to review their technology change management capabilities, bake compliance and risk controls in from the "get-go" and ensure their data governance and quality are fit for purpose.

The capital markets remain a key strength for Hong Kong and geopolitical tensions have in some respects benefitted them. The SFC is introducing new rules to bring greater transparency to book building for equities and debt capital markets and remains concerned about IPO due diligence and market manipulation. FIs will have to keep an eye on the opportunities and show that they maintain top notch due diligence and market integrity controls to stay in the game. The Hong Kong Investor Identification Regime will also contribute to greater market transparency on trading activity and market abuse.

Wealth Management Connect (WMC) for the Greater Bay Area (GBA) started last year and offers a great opportunity for banks and asset managers to provide a range of products to meet the needs of Guangdong Province investors. New product controls will have to be kept tight and FIs will not be able to afford suitability or complaint handling failures in order to be able to reap the benefits.

Virtual assets will face their day of reckoning in Hong Kong this year. The SFC's virtual asset and virtual assets service provider (VASP) regime should be legislated for this year and the HKMA has issued a discussion paper for stable coin regulation but with a clear preference for regulation. This is the year many forms of virtual assets will be brought within the regulatory perimeter in Hong Kong. The scene is about to become a lot more predictable and maybe dull but a lot easier for incumbent FIs to operate in.

On financial crime, this is a year in which the previous trend of FIs' increasing reliance on technology and regulatory preference for this will continue. Geopolitical tensions arising from Ukraine will add to an increasingly complex sanctions environment.

Last but by no means least, a number of longer-term regulatory reform agendas will continue, and in some cases conclude during 2022. Hong Kong's banks have remained highly resilient and maintained healthy capital and liquidity ratios throughout the pandemic and although recent data shows some potential concerns around asset quality, Basel 3 has provided the HKMA the tools it needs to steer the sector. Banks should expect some additional focus from the regulator on their credit risk management and review frameworks. The final components of the Basel 3 regime must be implemented this year, and along with the last stages of IBOR transition, will continue to place demands on banks' change management bandwidth, particularly in some key areas of data and systems development. Lastly, the HKMA's resolution framework should be a priority for many firms with a focus on the operational continuity in resolution requirements.

Our report explores these regulatory themes and key considerations for banking and capital markets firms in responding to them in 2022.

Top 10

Hong Kong banking and capital markets regulatory themes for 2022

1. Digitization acceleration

The acceleration of digital transformation initiatives, partly as a result of COVID-19, continues, and managing the associated risks remains a high regulatory priority. In 2021, the HKMA set out its strategy for promoting fintech enablement and set a high bar for expectations that Hong Kong's banks must fundamentally transform themselves by the end-to-end digitization of their processes and businesses. The HKMA in June 2021 issued its Tech Baseline Assessment, a concerted push for all banks in Hong Kong to "go FinTech." This required all banks with significant Hong Kong operations to assess their current adoption of fintech and to give a clear roadmap for its adoption in end-to-end processes by the end of 2025. This is a revolution in how Hong Kong banks will organize themselves and will place them on a level playing field with virtual banks that have been licensed and operating for close to 2 years now but have yet to have had a major market impact. This year banks will have to make serious efforts to address the HKMA's aims.

Banks should not underestimate the effort and investment required and the challenges likely to be encountered. For large entities with significant Hong Kong operations, it requires a transformational agenda to re-engineer all processes, reboot controls for a digital environment, and assess what impact this will have on the firm's strategy and business model, staffing, and change management processes. For inbound banks, it will pose a challenge given most technology investment decisions are not made in Hong Kong but in head offices overseas and questions will arise as to how to satisfy the HKMA's expectations while remaining aligned with group technology and business model plans. For local banks, the transformation will require a clear, well-planned, and resourced strategy and implementation aligned to that strategy, not just marginal changes to existing IT plans with a surface gloss of addressing the HKMA's headline concerns.

The HKMA wants to see the digitization fundamentally alter the fabric of banks and result in them fully digitizing their operations, front to back. The alternative is that non-digital banks will become increasingly uncompetitive and may face diminishing business. Hence, banks must move away from tactical technology fixes and deliver the fundamental change and future direction the HKMA wants to see.

Banks will have to make digital means of delivery of processes and control of risks and compliance central to their way of doing business. The focus should be on digital interfaces, automation, straight-through-processing and using modern technologies to assist, or make business and risk decisions. This will have to be reflected in accountability and governance structures, team structures, and capacity building (training, recruitment, resource planning, and budget).

The transformation will also change the risk profile of banks as the likelihood and scope for manual operational errors diminish but technology, operational resilience, and cyber resilience risks rise with increased digitization.

However, the change also poses an opportunity to re-evaluate risk and compliance controls for a digital straight-through processing environment and to achieve more efficient risk and compliance outcomes in a more near time environment. This will require a leap to "risk management by design" embedding risk and compliance controls into the business requirements at the earliest stage of the system development life cycle. To do this, Hong Kong banks will have to accelerate the process of risk and compliance upskilling so that the control functions are better equipped to speak to and work with technology change management functions. Bank boards and senior management will also need to upgrade their understanding of digital processes and risk and control functions so that they can oversee the transformation and manage a successful outcome.

The HKMA will be focused on how banks handle this transition project strategically and manage the risk and compliance transformation. FIs' senior management will have to stay on top of that process and how risks are being managed and compliance and risk capabilities being enhanced.

In the meantime, to support this digitization the HKMA may look to support the fintech industry and its evolution in Hong Kong with targeted measures in areas of demand (e.g., Greentech or artificial intelligence). This has already been seen through environmental, social and governance (ESG) working groups and circulars on the use of artificial intelligence (AI). Measures that increase financial inclusion, keep Hong Kong's banking sector stable and support small and medium enterprises (SMEs) will be key priorities.

2. Hong Kong's evolving role as an international financial center

Hong Kong's government and regulators have always consciously sought to regulate Hong Kong to preserve and develop its role as an international financial center. They continue to do that and Hong Kong's role is continuing to evolve. Increasingly, Hong Kong is focusing on being an offshore financial center for Mainland China. That role is intensifying somewhat owing to recent geopolitical and regulatory developments. Some of those developments and the persistent influence of COVID-19 and border health control and public social distancing measures are posing challenges for Hong Kong and its role.

Hong Kong Exchanges and Clearing (HKEX) continues to perform as one of the major sources of IPO funding in the world. Its role has evolved in recent years with changes in HKEX listing rules to accommodate different corporate governance demands that technology companies frequently demand and initially unprofitable biotechnology companies. HKEX's role is continuing to develop as it permits special purpose acquisition company (SPAC) listings and benefits from the US-China geopolitical tensions to offer a sophisticated modern regulatory environment with currency convertibility for Chinese companies seeking to redomicile from the US. We return to these themes later in this piece.

Hong Kong is also strengthening the breadth of the various "connect" initiatives which give it privileged access to Mainland investment opportunities and a privileged opportunity to service the needs of Mainland investors. Hong Kong has already benefitted enormously from the existence of the stock and bond connect initiatives. Under stock connect, Mainland investors can trade stocks listed on HKEX and Hong Kong investors can directly trade stocks listed on the Shanghai and Shenzhen exchanges. Under bond connect, Hong Kong investors can invest in Mainland offered bonds and Mainland investors can invest in Hong Kong offered bonds. To this late last year, WMC has added which though presently limited in size has significant scope for expansion to serve the needs of Mainland Chinese investors for wealth management products beyond the products offered on the Mainland. It offers significant opportunities for Hong Kong-based private banks and asset managers. To these developments, a possible future evolution that could be interesting would be a "green connect" that would permit Hong Kong investors to invest in Mainland Chinese-related sustainable finance products and Mainland investors a chance to invest in Hong Kong offered sustainable finance products.

Hong Kong continues to serve as a base from which multinational corporations can enter China. It provides proximity to Mainland China, staff familiar with the Mainland China market, access to Mainland markets and products via the various connect schemes, and a familiar and predictable legal environment. However, Mainland China is itself becoming an increasingly attractive environment with Mainland joint venture foreign ownership laws being liberalized to permit foreign banks to acquire up to 100% of their Mainland joint ventures. They will however face the challenge of integrating those entities into their global conduct and compliance frameworks. Hong Kong will continue to offer certain benefits until the Mainland offers full currency convertibility and while Hong Kong continues to offer a more predictable environment for the settlement of legal disputes.

There are certain challenges that have emerged in the last two years. The first is the sanctions environment which has become complex for foreign entities in Hong Kong to navigate with the rise of conflicting Chinese and US sanctions environments owing to geopolitical tensions. The other is the increasingly tight data transfer environment between Mainland China and other jurisdictions including Hong Kong. Mainland China has asserted greater control over access to and transfer of private and sensitive data. While this may be justified, it will cause greater difficulties in accessing stored in Mainland China, using data on a group-wide basis, and the compliance costs of doing so.

Lastly, there are some broader operational challenges for international firms operating in Hong Kong that are driven by the persistence of COVID-19 and the strict social distancing and border health controls. While these issues have affected the world, Hong Kong has adopted particularly strong controls. Though the Hong Kong government has recently indicated it will progressively liberalize some of these controls, particularly flight bans and a long quarantine period, the attention of international firms will be focused on whether these controls will indeed be liberalized. The controls have made travel in and out of Hong Kong to manage regional Asia-Pacific operations very difficult and have been a disincentive for foreign staff to move to Hong Kong or remain in Hong Kong. Some firms with split regional headquarters between Hong Kong and Singapore have been considering their longer term operating model between the two financial centers. Given some of these challenges, the unique role that Hong Kong continues to play as the gateway to the Mainland China market is increasingly significant in maintaining its edge as a global financial center and we expect the regulatory environment to continue to support this position.

3. Green finance

a. ESG risk management

In 2021, the SFC finalized their climate risk management requirements for fund managers and the HKMA consulted on and finalized their climate risk management requirements for banks. SFC-regulated fund managers have until late 2022 to comply and HKMA regulated banks until the very end of 2022. As a result, the two most critical sectors of banking and capital markets now have clear regulatory imperatives to manage their climate risk exposures, both for themselves as FIs and for their counterparties or customers.

We understand that the SFC presently has no intention of regulating climate risk management for other licensed corporations.

Climate risk is a transformative change for the financial industry. It affects all aspects of the business strategy and model and operations of FIs. It requires FIs to understand complex ecological and climate processes that previously they would not have thought highly relevant, identify the sources of information needed to support this, and develop the necessary skills, expertise, and technology, and embed processes to incorporate this in their decision-making.

We see FIs struggling to turn their ESG strategy into a reality embedded within the firm, dealing with the potential problems of climate risk strategy integration, and dealing with elevated stakeholder demand for greater transparency.

Firms should start implementation now. They should start:

- Incorporating climate risk and broader sustainable finance objectives into the risk identification and assessment frameworks. While assessing the climate impacts of credit risk will be at the forefront for most banks, firms must also pay particular focus to non-financial and control frameworks including product governance, transaction execution and sales processes.
- Systematically incorporating sustainable finance and climate risk into the operating model for compliance
- Embedding a prioritized action plan to address gaps identified between current practices and the SFC and HKMA requirements to target implementation with the 2022 commencement dates
- Understanding their climate risk data needs in terms of granularity, and the sources from which the data can be obtained, and how to turn that into usable, standardized, metrics that will measure risks and assist decision making.

b. Product risk and greenwashing

As ESG regulation is evolving across the region and in Hong Kong, one of the most immediate areas of risk for FIs is product risk and greenwashing, which refers to intentionally or mistakenly making false or misleading environmental claims in relation to banking and investment products. Product risk and greenwashing also embrace the obligations of FIs to sell suitable products to their customers. Market demand for products that withstand ESG risk better or that help meet climate risk transition needs and product supply to meet that demand has run ahead of regulation and, in some cases, FIs' control and risk functions' understanding or capabilities.

At present, there has been little evolution in regulation to guard against greenwashing. Last year, the SFC introduced rules for funds that make ESG claims and that are distributed to retail investors. Those rules are operative since the start of 2022 and require fund names to be not misleading and to make various disclosures about its features as an ESG fund: their focus, investment strategy, asset allocation, any reference benchmark, and related ESG risks. The funds also must periodically assess whether they have reached their ESG objectives and when applying for authorization self-certify compliance with the rules or give a third-party certification.

There is presently no sign that there will be wider anti-greenwashing regulations in Hong Kong. But the Cross-Agency Steering Group is exploring the creation of a green taxonomy that will refer to the work of the Common Ground Taxonomy of the International Platform on Sustainable Finance. The creation of taxonomy will assist FIs in assessing whether a project to be funded by a product or specific purpose facility (e.g., a green bond) can legitimately be claimed to be green.

Specific new regulations aside, greenwashing is a polite euphemism for what is more traditionally regarded as securities fraud. FIs should already have controls in place to govern regulatory and legal risks arising from flawed product disclosures. The difference between green products and greenwashing risk will be whether firms have the skills and experience to evaluate green claims, the data and metrics to measure claims and processes to engage in ongoing monitoring of green products that will often have an ongoing lifespan during which FIs will have to supervise the ongoing use of product funds.

FIs will have to ensure resources given to green disclosure control programs match the volume and risks of products they issue.

Further, there is no express ESG linked suitability obligations in Hong Kong yet. But, the existing suitability obligations still require consideration of it as a risk, return, and investor preference matter. FIs must consider how to incorporate ESG risks and investor preferences into product and customer due diligence and the product suitability matching process.

c. Data and reporting/disclosures

One of the critical issues FIs faces in getting to grips with climate change risk management is access to the right data to manage those risks and how to measure climate risk exposures for internal purposes and for disclosure externally.

Transparent, reliable, and comparable data is needed and traditionally FIs have not needed to obtain it. Climate risk is a complicated area involving listed and unlisted corporate data, supply chain participant data, weather and other environmental information, industry, economic and demographic information. Much of this data is not traditionally required to be disclosed or gathered. Some of it is government data. Much of it is traditionally not publicly available. For some of it, proxy data is used, e.g., geospatial data from satellites, etc. The data also has to cover longer periods of data both backward and forward-looking which poses collection and prediction difficulties.

The government and regulators are thinking about these issues and are looking to address some. The Cross-Agency Steering Group set up to include the HKMA, SFC, Insurance Authority, the HKEX, the Financial Services and Treasury Bureau (FSTB) and Environment Bureau has formed working committees to focus on two issues: enhancing access to and availability of relevant data and data analytic tools, and filling in the data gaps identified by market participants. It will also provide information portals for relevant data and resources and is looking to standardize information needs in certain areas.

To help FIs meet their data needs, a plethora of ESG data providers and rating agencies have sprung up in the last few years. They are of variable quality. Issues of the reliability, consistency, and transparency of data provided by such entities and complexity in what rating measure, how they are compiled and how they should be used can pose difficulties for FIs seeking to use them.

The International Organization of Securities Commissions (IOSCO) examined the issue of ESG data providers and rating agencies recently and reported late last year. IOSCO makes recommendations for the content of regulations its member regulators are expected to implement. IOSCO suggested that regulators focus more on ESG data providers and rating agencies. Most of the recommendations focused on the self-regulation of data providers and rating agencies to instill confidence in the sources of their data, methodologies, to avoid and manage conflicts of interest, disclosures, and so forth. The SFC will no doubt act on the report, particularly as it chairs the IOSCO Board. But the recommendations seem relatively mild being focused on self-regulation and it could be wondered if they are going to solve the issues in relation to data and ratings. So we expect to see SFC consultation on implementing these IOSCO recommendations.

In the interim, entities that negligently or intentionally issue false or misleading information, including data providers and rating agencies, would still be covered by securities fraud regulations in the Securities and Futures Ordinance and SFC Code of Conduct.

To avoid unintended liability from relying on inaccurate or misleading data or ratings from third-party providers, FIs should follow the IOSCO recommendation to conduct due diligence on ESG data and rating providers that they use in their internal processes. SFC product disclosure regulations impose the same obligations and breaches could lead to regulatory and civil liabilities for consequentially misleading disclosures. FIs should understand their data needs, how they can best use ratings, and the limitations on both data and ratings arising from their quality, methodologies, and purposes and conduct a targeted vendor scan to see who is best placed among the universe of data providers and rating agencies to assist them. FIs should also extend robust third-party risk management and data governance frameworks to ensure the reliability of ESG data and ratings and that they are used appropriately.

4. Resilience

a. Operational resilience

The last couple of years has elevated the importance of operational resilience as a strategic priority for FIs. COVID-19, plus an increasingly complex range of man-made disruptions affecting IT (e.g., cyber attacks, outages, change management issues) and wider operational impacts of terrorist threats, supply chain shortages, civil disturbances, third-party dependencies, and the growing physical effects of climate change (e.g., storms, flooding, wildfires) have challenged continuity of operations and client service. In response, FIs are prioritizing the implementation of a dynamic, robust, and sustainable operational resiliency framework across their organizations. Achieving resilience as an outcome has also been elevated to the top of regulatory priorities internationally, as interconnectivities and dependencies are exposed, and international supply chains and data sharing are disrupted. With the international regulatory focus on operational resilience and the practical pandemic-driven focus, operational resilience will be a regulatory priority for Hong Kong's regulators this year.

In Hong Kong, the HKMA issued a consultation for its Supervisory Policy Manual (SPM) Module on Operational Resilience[2] in December 2021. Similarly, regulatory expectations have emerged from the SFC for operational resilience and governing remote working arrangements that became common during COVID-19 and have become normalized in hybrid office-remote working environments in the future.

The integral components of a resilient FI long pre-date COVID-19, albeit within organizational silos, are covered in operational risk, third-party risk management, information security, business continuity management, and recovery and resolution plans.

However, end-to-end recoverability and resumption of entire business services have seldom previously been the focus of FIs or regulators. The cross-regional disruptions inflicted by the COVID-19 pandemic have been a "call to action" for the industry to broaden the scope and duration of severe yet plausible scenarios.

As more activities are conducted off-premises and front-to-back digitization accelerates, elevated resiliency threats coupled with heightened regulatory expectations to protect customers and markets emerge from these increasing organizational complexities and dependencies.

Practical implementation steps are recommended for FIs to elevate their resilience by focusing on these key priorities:

- An orientation to end-to-end business services recoverability, not system resiliency
- Setting of impact tolerances for disruption and recovery
- Responding cohesively to a broader range of disruption scenarios
- Integrated testing to ensure delivery through disruption, by breaking silos and aligning capabilities, across existing departments including operational risk, business continuity planning, recovery and resolution, cyber and third-party risk management
- An elevated role of the board and senior management to ensure accountability

b. Cybersecurity

Cybersecurity risk arises from multiple sources including opportunistic hacking, organized crime, terrorist groups, and state-sponsored hacking particularly with current heightened geopolitical tensions turning cyber attack into a means of pursuing "hybrid" war. Cybersecurity is also assuming greater importance with the increasing digitization of financial services and the effect of COVID-19 in accelerating this. Over the last two years, the move to dispersed remote working and customer-firm interactions has heightened FIs' vulnerability to cyber attack. Dispersed networks are more open to attack and customers and staff can be more vulnerable to cyber attack owing to poor cybersecurity habits in their online personal habits and more vulnerable to social engineering when they spend more time online in a more casual home environment. In this environment, cybersecurity remains a continuing regulatory focus both internationally and in Hong Kong.

In October 2021, the SFC issued its Report on Operational Resilience and Remote Working Arrangements. The guidance noted that cybersecurity was the main element of ensuring operational resilience. One of the main elements of the Report was the recommendation that identified senior management should assume responsibility for operational resilience including cybersecurity and that they should have sufficient information to enable them to continue and in a timely way monitor the FI's operational resilience. The Report noted the increased vulnerability FIs' networks face from remote access, the greater vulnerability of staff working from home to phishing and social engineering, and the need for firms to reassess the cyber threat landscape. In relation to remote working, the Report specifically suggested

FIs: review the cybersecurity risks of remote working; regularly review cybersecurity implications of relying on third parties performing business or operational functions considering their strategies for disruptive events; and regularly train staff on cybersecurity risks associated with remote working. The lessons from the Report will continue to be relevant as remote working remains popular with staff and a continuing means of ensuring business continuity.

The HKMA has been focusing on the reconstruction of firms' data in the event of a highly disruptive cyberattack. Working with the Hong Kong Association of Banks (HKAB), HKMA is requiring banks to design, implement and operate a Secure Tertiary Database (STDB) by identifying critical data, ensuring its quality, designing and implementing controls throughout the data life-cycle to protect it, encrypt it, ensure it archived in a secure repository, develop plans for its restoration and recovery and test those plans. Firms had to submit their assessments of their capability to do so by the end of November 2021. The HKMA will be reviewing and commenting on those self-assessments this year.

The HKMA has also been continuing with Cyber Resilience Assessment Framework (C-RAF) 2.0 which it issued late in 2020. C-RAF is a risk-based framework for banks to assess their own risk profiles and benchmark the required level of cybersecurity and resilience. Banks have been conducting and submitting their risk and maturity assessments in risk-based tiers with the less risky submitting them in the middle of this year and the least risky by mid-2023. Banks are also continuing their Intelligence-led Cyber Attack Simulation Testing (iCAST) in the same 3 risk tiers with the highest priority starting in the middle of this year.

The HKMA's efforts on cybersecurity will also have to be viewed in a harmonized way with their Tech Baseline Assessment urging banks to have plans to digitize end-to-end processes by the end of 2025, the focus on operational resilience discussed above, and similar remote working expectations to those expressed by the SFC.

The HKMA has also demonstrated specific concerns in relation to the reconstruction of data in response to severe cyber attacks as mentioned above in relation to the STDB.

Further, in the context of section 59(2) Banking Ordinance reviews of banks, the HKMA is known to express concern about data governance and data quality. Perhaps most importantly, the HKMA's FinTech Baseline Assessment and the push to digitize all operational processes will require banks to have robust data governance and processes in place across the whole institution as a foundational matter for sound business, risk management, and compliance.

Banks will have to continue to assess the evolving cyber attack threat environment, their altering risk profile and how they maintain acceptable levels of cybersecurity, and their ability to protect and reconstruct critical data.

c. Data strategy

Hong Kong regulators have not focused as explicitly on data regulation as some other regional regulators have such as the Australian Prudential Regulatory Authority (APRA) with Prudential Practice Guide CPG235-Managing Data Risk. HKMA and SFC do demonstrate an implicit supervisory concern about data, but they have not issued such generic data governance and strategy-related regulations.

The HKMA started to focus more explicitly on data issues in the context of its Granular Data Repository (GDR). The GDR pilot was finalized in 2020 and heralded more detailed transaction reporting for banks in relation to residential mortgages and corporate loans. The HKMA is using the GDR to replace statistical surveys on these issues.

The experience of FIs suggests that while it has been possible to provide the granular data required, there have been challenges in reconciling all the data to existing submissions and in providing data in a timely manner. Data ownership for submissions, between business lines and finance, is also a potential cause of data quality issues.

The SFC by contrast has been more muted on the subject of data governance, though data quality and governance has been at the heart of a number of its regulatory reporting enforcement actions for many years (e.g., substantial shareholding, short position, and large open position reporting). As it starts to use more of the capabilities it is building under its own SupTech program internally, the SFC may be expected to focus more on the quality and governance of data kept by FIs. In this vein, more recently, the SFC has been using its Data Standards for Order Life-Cycles (DSOL) heavily in inspections focused on equities trading misconduct and controls. The SFC has been using the DSOL data protocols for the first time to help it analyze trading data to look for control flaws and misconduct.

The experience of some FIs suggests some teething problems with the implementation of DSOL in particular in relation to the accuracy of data mapping that will require re-examination. We understand that the SFC is looking to clarify some of its concerns with the industry. FIs should review the accuracy of how they have mapped DSOL required data fields to items in their data libraries.

For both regulators, the long-term direction, of increased data submissions that are both more granular and nearer to real time, is clear.

Hence, there are some issues firms should manage for themselves. They should evaluate whether they have the right data governance and quality processes and ensure that their chief data officer's role is clear and they have the skills, influence, and authority to procure the necessary changes. Firms may also need to review the ability of their finance and technology systems to produce the right data, at the right level of granularity in a timely manner. They will also need to ensure consistency between submissions for different regulatory purposes, as regulators look for increased depth of data to be provided more quickly.

In some instances, e.g., lack of clarity in data reporting requirements or difficulties in providing granular data, firms may wish to pool their concerns under relevant industry associations in order to achieve clarity from the regulators.

5. Capital markets regulation

Hong Kong's capital markets continue to grow strongly. Listings have bounced back on the HKEX and the market continues to diversify away from traditional Hong Kong industries with substantial Mainland China tech and biotech sectors now listed. Geopolitical tensions between China and the US have aided this with several corporations choosing to list in Hong Kong rather than the US. Further entities that had been already listed in the US are also seeking secondary listings in Hong Kong. Both phenomena have widened the range of corporations listed in Hong Kong and have deepened the liquidity of the Hong Kong exchange.

HKEX listing rules to permit special purpose acquisition companies (SPACs) have been consulted have broadened the range of listing options but are subject to tight requirements to ensure experienced and reputable SPAC promoters. Having said that the fervor overseas for SPAC listings is abating with growing skepticism creeping in over some more questionable aspects of SPAC listings and promoter behavior. Nevertheless, there is already a range of applicants for SPAC listings. Their ability to make astute acquisitions is yet to be demonstrated.

The focus for FIs assisting SPAC listings will be on the quality of the promoter, the promoter's compensation, and the proportion of funds returned to investors upon failure to make an acquisition within a fixed time versus compensation to promoters and costs in those circumstances.

The SFC has also finalized its new rules to regulate equity capital market book building procedures more tightly and regulate debt capital market book building procedures for the first time. The new rules will be operative by August 2022. They seek to introduce greater order and fairness into book building procedures, reduce conflicts of interest and enhance market integrity by limiting aspects of book building behavior that may be conducive to falsely inflated demand and rigged public floats that can contribute to post listing manipulation. Some ECM participants will find the rules difficult to adjust to. Others welcome them. DCM participants are likely to find the rules more difficult as DCM book building has traditionally been very lightly. DCM FIs are starting to consider how to adapt. We understand that industry negotiation with the SFC on how some aspects will work in practice is continuing. FIs should seek to assess their book-building processes now as the SFC rules reflect a significant new regulatory intervention that will require a substantial upgrade in policies and procedures. There remain only 5 months until the regime takes effect.

Lastly, the SFC continues its frontloaded regulatory approach to commenting aggressively on draft prospectuses, refusing listings that appear questionable at an early stage, and investigating suspected pump and dump manipulations of newly listed companies, often in conjunction with other law enforcement agencies such as the Police and ICAC. Sponsors remain in the spotlight with a number of recent SFC disciplinary actions against sponsors indicating that poor IPO due diligence practices remain in the SFC's sights. In this environment, firms should pay close attention to their annual IPO sponsor self-assessment required under the Code of Conduct but also consider a deeper health check of their IPO due diligence practices.

The SFC's recent moves to introduce investor identification will improve its market surveillance capacity to act more rapidly against suspected insider dealing and market manipulation. To cope with the implementation of investor identification, firms should:

- Identify the scope of affected clients and systems
- Contact clients to obtain consent to reporting of their identities to the regulators and validate reportable client data
- Assess existing data, system, and reporting architecture to identify the required system build effort and readiness to participate in market rehearsals later this year
- Perform an assurance review of existing Stock Connect infrastructure to apply "lessons learned" to future state investor identification architecture
- Establish internal governance to respond, track and review reporting exceptions under the new regime

Tied with this was the recent successful SFC Market Misconduct Tribunal action for false or misleading disclosure against Tianhe Chemicals Group Limited and the criminal convictions secured by the ICAC against directors of Convoy Global Holdings Limited for conspiracy to draft the company, its board, and the HKEX over placement of bonds by the company. The SFC still has a compensation action outstanding in civil court against Tianhe and its former director and substantial shareholder.

We expect that, when the book building reforms take effect, the SFC and HKEX will also use their greater insight into book building demand for offerings to intervene earlier in dubious market behavior.

All indicate that, for FIs, the stakes remain high on Hong Kong's capital markets and the need for exacting controls in relation to due diligence and capital markets behavior will continue.

6. GBA and Wealth Management Connect

The long-awaited WMC scheme was officially launched in September 2021. The aim of the WMC is to facilitate cross-boundary wealth management within the GBA. Twenty-three and nineteen retail banks are participating in the Southbound and Northbound Schemes respectively. The scheme will offer further opportunities in the future.

Phase one of the scheme is confined to the retail sector and involves the execution of low and medium-risk products only. Under the Northbound scheme, eligible products include low- to medium-risk public funds and public fixed income wealth management products, and equity wealth management products. Under the Southbound scheme, eligible wealth management products include simple deposits, Hong Kong domiciled funds authorized by the SFC, and bonds which are assessed as low- to medium-risk and non-complex.

Fund flows are conducted and managed in a "closed-loop" system, i.e., investors' funds in their investment accounts can only be used for the purchase of eligible wealth management products and they must be remitted to the investors' remittance accounts via the same path upon investment exit. Investors are prohibited from withdrawing cash from their investment accounts or remitting these funds to any accounts other than their remittance accounts.

Challenges need to be overcome such as the need for Hong Kong investors to be physically present in Mainland China to open a bank account which is difficult during the pandemic as the border with the Mainland is closed. Banks will have to wait for the regulators to resolve this. Also, it appears that customers under the Southbound scheme are highly risk-averse and mainly interested in fixed-term deposits and savings insurance plans.

Private banks and asset managers should continue to lobby for the scheme to be expanded to other more sophisticated customer segments, to increase the range of products and to include advisory-based private banking to tap the opportunities to serve high net worth households in the GBA.

Banks will need to ensure that their customer due diligence, cross border, product disclosure and anti-money laundering controls are flawless as the CBIRC, CSRC, HKMA, and SFC will be cooperating closely to ensure that the WMC operates without material instances of non-compliance that may damage investor confidence in the cross-border scheme.

7. Virtual assets

Hong Kong has been a very active market for the trading of virtual assets. After Mainland China outlawed any activity in virtual assets the Hong Kong virtual asset scene boomed even more. The SFC and HKMA have to date been quite cautious about virtual assets. They are aware of the scale of activity in Hong Kong and have also paid close attention to IOSCO, Basel Committee on Banking Supervision (BCBS), and Financial Action Task Force (FATF) warnings on aspects of virtual assets including investor protection risks, possible cybersecurity risks, a growing exposure of the traditional financial sector to virtual assets and the significant risk of money laundering via virtual assets. Nevertheless, trading in pure virtual assets that are not securities, deposits, or insurance contracts has remained unregulated.

Reflecting this, ads for virtual asset service providers abound on outdoor advertising, on public transport, and on social media. Recent developments suggest that 2022 and the coming years will see this ending as the regulators seek to bring nearly all aspects of virtual asset trading under control.

In 2021, the FSTB issued the consultation conclusions for the regulation of virtual assets and virtual asset service providers (VASPs). The paper recommended that trading in virtual assets become an activity regulated by the SFC and that virtual asset exchanges (VASPs) require an SFC license which would be granted if the VASP can satisfy the SFC that they are fit and proper to hold such a license.

Licensed VASPs would be subject to anti-money laundering requirements under the existing laws and requirements to promote market integrity and investor protection. FIs will need to ensure they have the necessary policy, procedures, and controls to manage and mitigate the ML/TF risks of customers engaging in VA-related activities and banking relationships with VSAPs. In particular, virtual assets would not be able to be offered to retail investors. The regime extends the SFC's opt-in licensing regime to all virtual assets and VASPs. Draft legislation is being prepared to implement these consultation conclusions and will be introduced into the Legislative Council either this or more likely next year.

More recently, HKMA issued a discussion paper containing proposals to regulate stable coins, i.e., cryptocurrencies backed (at least notionally) by fiat currency reserves or algorithms governing their reserves into which they can be freely converted. While the paper was titled a discussion paper, it signaled an HKMA intention to regulate stable coins. HKMA proposed a risk-based approach under which asset-linked stable coins would be regulated with the flexibility to cover algorithm-based stable coins in the future. Anyone offering services including issuing, creating, storing stable coins, managing their reserve assets, validating transactions and records, storing private keys giving access to stable coins, facilitating their redemption, transmitting funds for settlement, and executing stable coin transactions for others would potentially have to be licensed under the laws governing payments services and stored value facilities. Grant of a license would be subject to a fit and proper test, prudential requirements, regulations governing maintenance and management of reserve assets, governance and risk management, anti-money laundering, redemption, financial reporting and disclosure, safety and security requirements, and finality of settlement. The regulatory regime would be modeled on that for payment systems and stored value facilities. The HKMA hopes that a regulatory system will be implemented no later than 2023–24.

Lastly, the HKMA, SFC, and Insurance Authority (IA) have each issued regulatory guidance for FIs that they respectively regulate on how they should approach their offering of virtual asset services and interact with VASPs. The regulators each permit their regulated FIs to engage in virtual asset activity, but each expects to be notified that FIs do so subject to prudential, risk management, and investor protection requirements. The SFC in particular expects their regulated FIs to only deal with regulated VASPs and has allowed a 6 months transitional period for the new rules to come into force. The HKMA and IA appear to expect immediate compliance.

The overall picture that emerges is one of the Hong Kong regulators and government concertedly seeking to eliminate the riskier elements of the virtual asset industry and ensure that is fully brought within the regulatory perimeter. The industry that remains is likely to be less colorful but also more predictable. The less conventional elements of the industry will have to adapt or exit Hong Kong. Those VASPs who adopted a strategy of seeking regulation for consumer trust will now be repaid. For incumbent FIs, the risks associated with participating in the virtual asset markets will be significantly tamed leaving it open for far more risk-averse entities to consider the market entry.

8. Workforce skills and capacity

Since 2019 there has been a shortage of talent and in recent months the shortage has been acute and is limiting banks' expansion in three key growth areas – fintech, green finance, and GBA initiatives. The HKMA had anticipated this and remarked last year that one of the biggest challenges facing banks is the shortage of talent. The issue not only relates to gaps in skill sets but also a lack of personnel. Banks are experiencing a brain drain of their staff due to various existing issues, to which certain related to COVID-19 have now been added. The HKMA in 2020 asked the banks to take stock of potential talent gaps during 2021 to 2025 in its "Capacity building for a future banking" exercise. The study revealed a notable skills gap in fintech and green finance. This shortage is not unique to Hong Kong. But it is exacerbated here by external factors. Banks in the future will need to adopt a more sustainable strategy of developing the relevant talent pool locally.

For its part, the regulator is focused on attracting graduates to the banking industry by doing outreach and offering undergraduates and graduates various skills-building programs in collaboration with the banking industry, academia and other stakeholders, internships, and various opportunities. Banks should make full use of these schemes to identify and develop talent locally but it will take some time to groom these individuals.

In the meantime, the regulator introduced last year a fintech module to its Enhanced Competency Framework (ECF) and there are plans to issue an ECF for Green and Sustainable Finance this year as a means of enhancing the skills of practitioners in these two growth areas. Practitioners will obtain professional certification and are required to undergo ongoing training.

Banks should assess their staff who fall within the scope of various ECF modules, assess if they have the relevant competencies and qualifications and what staff development must be offered, and what skills should be acquired externally.

The shortage of talent is not confined to the banking industry, the different stakeholders and agencies are working together in forums such as Fintech Cross-Agency Coordination Group and Centre for Green and Sustainable Finance are collaborating to address the shortage of talent among other issues.

More broadly, FIs should take stock of their manpower, skills, and experience, what their future needs will be across a host of areas including operational resilience, technology change, sustainable finance, and the Mainland China operating and regulatory environment. FIs need to identify what the gaps are and what strategies they will use to bridge those gaps.

9. Continued evolution of financial crime compliance

AML and CFT remain consistently high priorities for the HKMA and SFC in 2022. The HKMA, in particular, has placed specific emphasis on the progress of bank's use of technology and data capabilities for monitoring of AML risks, most notably transaction monitoring and name screening and the use of new technologies such as machine learning, natural language processing, and data analytics to increase the speed, quality and efficiency of AML/CFT measures within these frameworks. Further specific areas of HKMA focus in 2022 include:

- Proposals to amend the definition of politically exposed persons (PEPs) and to allow for use of digital identification systems in non-face-to-face situations. Both of these will offer greater consistency and ease the onboarding of customers remotely.
- Heightened enforcement — last year, the HKMA imposed record fines on a range of banks for legacy cases under the AML laws and the SFC imposed even higher fines. Both regulators will continue enforcement, especially in relation to transaction monitoring which was the subject of a thematic review and consultation by the HKMA.
- Recent months have seen a surge in online fraud and associated mule account networks and these will attract more attention in 2022. To combat online fraud and promote network analytics the HKMA will share observations and good practices of its thematic review of progress by Fraud and Money Laundering Taskforce (FMLIT) banks. Public-private intelligence sharing is gaining traction worldwide and we expect that the number FMLIT banks grows and the subjects of intelligence sharing will expand beyond fraud-related money laundering.

Broadly, the private banking sector has seen notable focus from regulators across the region in 2021 and we can expect this to be a key aspect of supervisory focus for private banking businesses in Hong Kong in 2022. Continued growth strategies for private banks in the region are driving high numbers of client acquisitions including those in private banking markets such as Mainland China. Together with some noted weaknesses in legacy processes that have come to the attention of regulators, we can expect a significant focus for private banks' onboarding practices regarding CDD and source of wealth in particular. Approaches to plausibility assessment, verification requirements, and broader oversight and governance of approvals by relationship managers are all key areas of attention and represent opportunities for RegTech solutions.

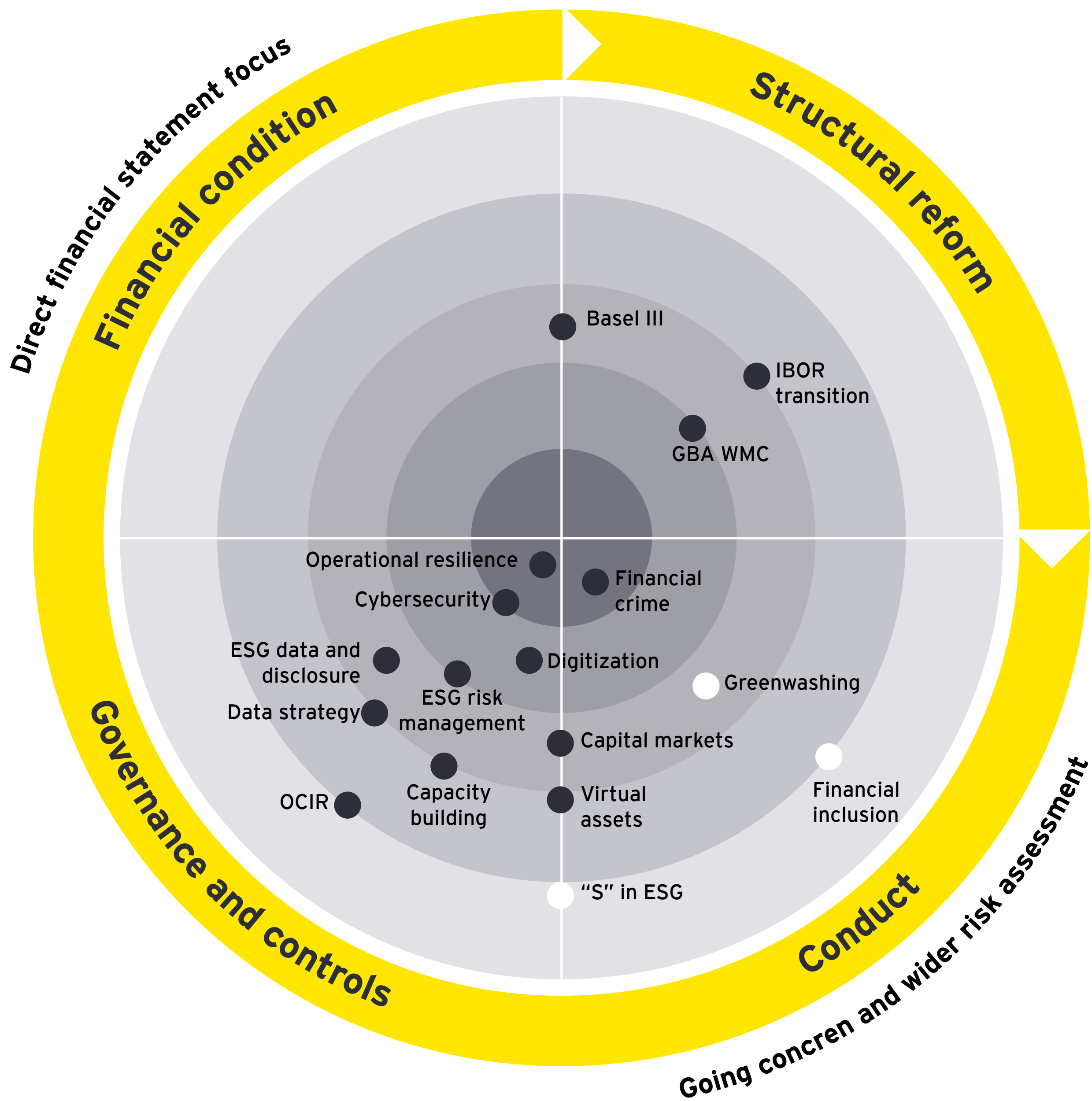
Finally, detecting risks in relation to FIs' exposures to practices of modern slavery and human trafficking are increasingly coming under regulatory scrutiny as an explicit component of financial crime compliance frameworks and firms should review the adequacy of their risk management capabilities in this regard. Negative news screening remains a key detective tool however more sophisticated analytical solutions for evaluating risks in clients' business models and supply chains are developing and FIs should plan ahead in anticipation that the bar will continue to rise – not just based on regulatory expectations but also on those of investors and other stakeholders with a focus on the "social" dimension of ESG.

10. The continuing regulatory reform agenda

Several longer-term regulatory reform agendas will continue, and in some cases conclude during 2022. Basel 3 implementation is entering what is likely to be its final stages in advance of the June 2023 deadline. Most banks still have work to do with respect to data and systems and continued analysis of the impact of the risk weighted assets (RWA) changes. The existing Basel framework has provided the basis for Hong Kong's banks remaining resilient throughout the economic uncertainty of the last couple of years with healthy capital and liquidity ratios throughout the pandemic and Basel 3 has provided the HKMA with tools to steer the sector through its use of the Countercyclical Buffer. Notwithstanding this financial resilience, recent data shows some potential concerns around asset quality and banks should expect some additional focus by the regulator on their credit risk management and review frameworks. Securities firms will continue to apply the updated FRR and the aggregate implications of these capital reforms are likely to keep booking model optimization on the agenda for many institutions, IBOR reform also moves toward its conclusion in 2022 and while most banks have moved past the most intensive parts of their implementations, work remains to be done with respect to some products and broader communication to clients.

Lastly, the HKMA's resolution framework should be a priority for many firms with a focus on the operational continuity in resolution requirements. While the regulatory objectives may be somewhat different, there are a number of overlapping operational and planning considerations between the capabilities required for OCIR and operational resilience and firms will benefit from an integrated view of planning and implementation.

Our view on regulatory risks for 2022 and beyond



Low relevance

High relevance

Our priority themes for 2022

Emerging theme for 2023

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