Hong Kong Banking Outlook 2017

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Overview

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Welcome to our outlook for 2017, where our Banking team takes a look into our crystal ball and forecasts what developments and trends we expect for the next year.

Banks in Hong Kong have had to navigate an uncertain market environment in 2016, and we expect this to continue in 2017. The recent US elections in particular are adding to this uncertainty as banks wait to get a better sense of the policies the new Trump administration will put forward. In the meantime, this could weigh on investment decisions, demand for lending, and ultimately the results of Hong Kong's banks.

We are seeing an increase in longer term USD interest rates, which signify in part that the market expects new US policies to lead to inflation, and possibly further interest rate hikes in the coming year. This should lead to opportunities to improve net interest margin – a welcome sign for Hong Kong banks.

Increasing regulatory scrutiny has been a trend for a number of years and we do not expect any lessening of this through 2017. One area to watch is whether certain US regulations that have extraterritorial reach – for example, Dodd-Frank – will be rolled back by the Trump administration. Nonetheless, in the short term we don't expect to see a significant reduction in the regulatory burden for banks in Hong Kong, especially as local regulators are increasingly requiring banks to meet compliance standards that are similar to those in the US.

Regulatory and compliance matters have been noted as a key driver of costs for banks. This will continue in 2017, but we expect banks to start turning the corner in managing the cost of meeting regulatory and compliance obligations by adopting innovative, technology-enabled solutions. As discussed elsewhere in this forward-looking report, we expect to see banks collaborate more with FinTech and RegTech providers in 2017, as well as develop their own technology solutions to address compliance and operational issues.

The report also shares our 2017 outlook for a number of key focus areas for banks in Hong Kong, including regulation and conduct, anti-money laundering, non-performing loans, financial transformation, M&A, tax and securities.

Financial Risk and Regulation

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"The BCBS's proposals have led to differing opinions between the US and Europe, especially around whether there should be stringent restrictions on the use of credit models. As it stands, the EU is reluctant to accept a package that includes a capital floor, while the US is pushing for its inclusion."

As 2017 approaches, banks in Hong Kong are seeking greater clarity around capital requirements, particularly in the areas of credit risk and operational risk. The Basel Committee on Banking Supervision (BCBS) has issued consultation papers that propose significant changes to the calculation of risk-weighted assets – particularly for credit risk – as well as restrictions on the extent to which banks can use credit risk models in their calculations. The purpose of these proposals is to promote financial stability and confidence in the global banking sector. However, naysayers argue that this risks slowing economic growth because it reduces a bank's capacity to lend.

The BCBS's proposals have led to differing opinions between the US and Europe, especially around whether there should be stringent restrictions on the use of credit models. As it stands, the EU is reluctant to accept a package that includes a capital floor, while the US is pushing for its inclusion.

These developments are important for banks in Hong Kong as most of them – including the major PRC financial institutions – use credit risk models. The Hong Kong Monetary Authority has already placed an informal floor on the potential capital savings from using these models, but the BCBS consultations could raise that floor, which would increase the capital requirements for Hong Kong banks.

Although the general aim of the proposal is not to increase the overall amount of capital in the banking system, it makes the capital requirements more risk sensitive. This is therefore likely to lead to banks with riskier portfolios having to hold more capital, and those with more conservative books holding less.

However, it is worth noting that we are yet to see any negative effects of higher capital requirements in Hong Kong. Nonetheless, this is a growing concern, with potential significant implications for Hong Kong banks. This concern, coupled with lingering global uncertainty, underscores the need for banks to carefully assess their capital requirements and portfolio mix in the coming year.

Financial Conduct

We see Hong Kong's regulators focussing more on conduct issues to ensure that financial institutions treat customers fairly and maintain market integrity. Conduct has been a big issue in the UK and Europe, and is fast moving up the agenda in Hong Kong.

With conduct issues gaining prominence, banks in Hong Kong should start thinking about whether they are upholding market integrity and treating their customers and clients fairly. This involves ensuring that conduct is embedded in their business operations – from the hiring, training and promotion of employees, to the design and sale of products, as well as post-sales services. Banks also need to focus on developing their organisational culture, as this is often seen as a primary determining factor behind conduct and behaviour.

Anti-Money Laundering

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"The HKMA has emphasised that banks should adopt a risk-based approach related to account opening and ongoing customer due diligence, and is expected to issue more guidance and initiatives in the coming months."

Anti-money laundering (AML) has been in the spotlight in Hong Kong this year, with regulators, stakeholders and the general public demanding more stringent AML compliance procedures from banks.

We expect this trend to continue in 2017, especially as the Financial Action Task Force (FATF) – which conducts reviews of each of its member countries – prepares for its next mutual evaluation of Hong Kong in 2018. In the lead up to this, Hong Kong's regulators – the Hong Kong Monetary Authority (HKMA), Securities and Futures Commission and the Office of the Commissioner of Insurance – have publicly stated their intentions to ramp up on-site supervision and enforcement activity.

When preparing for the next mutual evaluation of Hong Kong, the regulators will take note of the FATF's recently issued report on Singapore, where it concluded that the country can do more to address money-laundering risks and improve effectiveness. This is in line with our observations made earlier this year that the FATF has shifted its focus from the design of AML legislation in Hong Kong to the effectiveness of these regulations. Facing increasing levels of regulatory scrutiny and enforcement activity, banks in Hong Kong will use the coming year to enhance their risk awareness, bolster their AML capabilities and improve effectiveness.

We also expect to see the HKMA issue more guidance notes next year on issues like onboarding, transaction monitoring and institutional risk assessments. In particular, the approach taken by banks regarding onboarding and account opening has been a major topic of discussion recently, especially with regards to SMEs. The HKMA has emphasised that banks should adopt a risk-based approach related to account opening and ongoing customer due diligence, and is expected to issue more guidance and initiatives in the coming months. One initiative put forward by the HKMA is to commission covert shopping programmes and pose as customers to monitor the effectiveness of regulations and standards adopted by banks. As a result, we expect to see more banks take steps to improve their account opening processes, as well as evaluate their risk-based approach to strike a balance between de-risking and financial inclusion.

Finally, we are seeing increasing interest from banks on using forensic technology solutions to effectively address on-boarding issues and minimise costs, and this is likely to continue in 2017.

Non-Performing Loans

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The number of non-performing loans (NPLs) in China has rapidly increased in recent years, and policy makers and banks are making a concerted effort to swiftly and effectively address this concern. The frequent disposals of NPL portfolios by the banks to the asset management companies, the piloting of securitisations of such loans and the recent rule change to allow banks to swap debt into equity are all palliatives designed to improve the banks' balance sheets and, along the way, improve the chances of survival of at least some companies whose balance sheet burden of debt causes them to limp along in a 'zombie' state.

But NPL resolution should also be seen in the context of the broader imperative among China's banks; the accepted need to bring greater discipline and sophistication to the whole framework of risk management and lending, from the pre-lending assessment through to post-lending monitoring and collection.

It may be that the trend towards a more rigorously managed credit environment in China will, by playing a part in improving asset quality in the corporate sector, also further improve the competitive landscape for foreign banks, adding to the attractiveness of the mainland as a growth opportunity for them.

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FinTech

James McKeogh
Partner
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> ***"The HKMA emphasised in its recent report on Distributed Ledger Technology that despite its ability to save time and money, blockchain technology also raises significant legal and regulatory issues. While this should not detract Hong Kong banks from exploring blockchain opportunities, they should also carefully monitor regulatory developments and take steps to enhance their risk management procedures around this new technology."***

The FinTech industry in Hong Kong continues to develop at a rapid pace, with investment pouring into the sector. Early signs indicate that investment appetite for FinTech will continue to grow in 2017, especially as the demand for innovative products and technologies soars.

The Hong Kong Monetary Authority (HKMA) is part of this trend promoting the development of FinTech in Hong Kong. In March, the regulator set up the FinTech Facilitation Office (FFO), which is tasked with researching the potential application of new and unique FinTech solutions that could bring benefits to banking and payment services in Hong Kong, including a report on Distributed Ledger Technology released in November in conjunction with ASTRI (Hong Kong Applied Science and Technology Research Institute).

Furthermore, the HKMA enacted the Payment Systems and Stored Value Facilities Ordinance in November 2015 to enhance consumer protection and confidence. The one year transitional period for Stored Value Facility (SVF) issuers to obtain a licence to operate in Hong Kong ended on 13 November this year, with the HKMA granting 13 licences. Against this backdrop, banks will use 2017 to monitor the development of the SVF market in Hong Kong, assess their short and long-term strategies and identify new business opportunities.

One particular area of interest for banks in Hong Kong is the development of blockchain technologies. Blockchain is growing in popularity in terms of payments and lending services, and we are seeing blockchain companies starting to attract a significant amount of funding. However, the HKMA emphasised in its recent report on Distributed Ledger Technology that despite its ability to save time and money, blockchain technology also raises significant legal and regulatory issues. While this should not detract Hong Kong banks from exploring blockchain opportunities, they should also carefully monitor regulatory developments and take steps to enhance their risk management procedures around this new technology.

Nonetheless, with the FinTech market in Hong Kong expected to flourish in 2017, we are likely to see more cooperation between FinTech and financial services firms in Hong Kong. This is further supported by the Hong Kong government's aim to launch more dedicated services and programmes in the city to connect FinTech start-ups with financial institutions and other potential investors and collaborators. The 2017 period will begin with the second annual FinTech Finals as part of the startmeup festival organised by InvestHK.

Finally, banks should also monitor areas such as RegTech and InsurTech, which are also starting to gain traction in Hong Kong.

RegTech

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The rapid development of FinTech in Hong Kong is fuelling the latest wave of innovation in the form of RegTech, which is aimed at enabling organisations to address regulatory and compliance issues more effectively. Faced with increasing regulatory scrutiny and compliance costs, we expect to see more banks in Hong Kong harness RegTech solutions in 2017 to boost their responsiveness to regulatory changes, reduce costs and improve profitability.

In order to do this, banks will seek to implement the latest blockchain, artificial intelligence, cloud computing and data analytics tools and technologies across the entire organisation – from front to back office. This will not only encompass functions like onboarding, know-your-customer and anti-money laundering processes, but also compliance surveillance tools that monitor the interaction between traders, relationship managers and clients.

RegTech solutions that automate regulatory reporting processes will also be in greater demand in 2017. With compliance costs rising, banks are increasingly recognising that streamlining regulatory reporting processes is an effective way to meet compliance obligations, improve data accuracy and minimise costs.

Furthermore, the perception of RegTech companies as a threat to the traditional financial services sector in Hong Kong is changing, with banks increasingly viewing RegTech solutions as complementary to their business models. We therefore expect to see a lot more collaboration between banks and RegTech firms in Hong Kong in the coming year.

While banks continue to embrace FinTech and RegTech solutions, they will also need to use the next 12 months to consider putting appropriate risk management controls in place around the use of technology, cybersecurity and data confidentiality.

> ***“With compliance costs rising, banks are increasingly recognising that streamlining regulatory reporting processes is an effective way to meet compliance obligations, improve data accuracy and minimise costs.”***

Tax

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A major focus area for Hong Kong banks will be the implementation of the Common Reporting Standard – a set of guidelines developed by the OECD and introduced into Hong Kong law covering the exchange of tax information between jurisdictions – which comes into force in Hong Kong on 1 Jan 2017. The new law requires banks to adopt new onboarding procedures and conduct due diligence on existing customers, prior to reporting in 2018. This is likely to be both time consuming and challenging for banks given the size of their customer base and potential customer outreach required.

Meanwhile, transfer pricing is another key focus area going into 2017. Hong Kong's Inland Revenue Department has issued a consultation paper on the OECD's initiative on Base Erosion and Profit Shifting (BEPS) with a particular focus on transfer pricing, with comments due by 31 December 2016. Under this timeline, transfer pricing rules could be passed by the Legislative Council next year, with a target implementation date of 2018. Since Hong Kong currently does not have specific transfer pricing rules other than non-binding guidelines provided in Departmental Interpretation and Practice Note No. 46, it is vital that banks begin assessing how best to navigate the complexity of intra-company charges, review their operational structure to validate whether their structure is still viable in the BEPS era, and ensure there will be sufficient documentation in preparation for the new rules.

Also on the radar is the commencement of the IFRS 9 accounting standard in January 2018. Banks should use the coming year to compare IFRS 9 to the existing IAS 39, and plan for the implementation of the new standard. Importantly, IFRS 9 will likely give rise to increased provisions, but since the Hong Kong tax rules have not changed, we may well see a bigger mismatch between accounting profit and tax profit.

The focus areas mentioned above, as well as other issues including regulatory capital securities, anti-money laundering and tax evasion, present a challenging environment for banks in Hong Kong. Moreover, given the resource constraints at most banks, they will need to ensure proper governance and oversight are in place, and proactively prepare for and tackle these issues to stay ahead of the curve.

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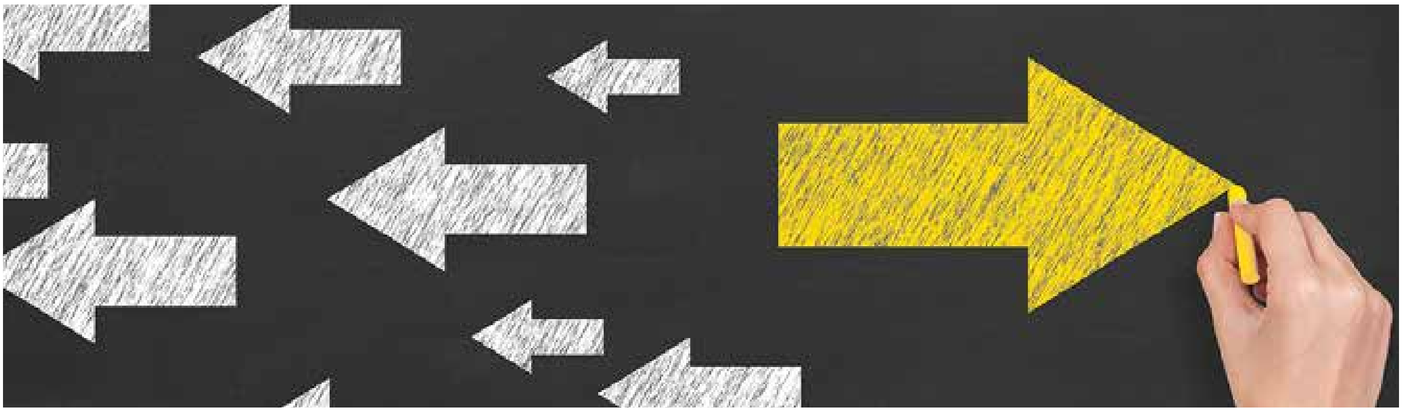
Financial Transformation



Isabel Zisselsberger
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"In the last 12 months, we have also started to see banks take a keener interest in robotics. We believe that this will continue and banks will start experimenting with proofs of concept."

Ensuring effective cost management to drive profitable growth is becoming more important than ever for banks in Hong Kong, especially as many of them are still experiencing cost pressures in the face of mounting regulatory demands. In 2017, we expect that banks will continue to look for efficiencies and savings through streamlining and automation. This will also likely continue to include some degree of offshoring, centralisation, and in some cases, outsourcing. With regulatory reporting – including stress testing – still often a very manual and laborious process, we will see banks continue to explore opportunities to streamline and automate their regulatory reporting procedures to enhance efficiency. Through the deployment of cloud-based platforms and data analytics tools and technologies, banks will be able to conduct improved data modelling and analysis to reduce costs and ensure more timely and comprehensive regulatory compliance.

In the last 12 months, we have also started to see banks take a keener interest in robotics. We believe that this will continue and banks will start experimenting with proofs of concept (POC). Instead of having to shift certain processes to a shared service centre, banks can use advanced robotics technologies to automate processes in-house and achieve greater cost savings and profitable growth.

As this technology becomes increasingly intelligent, we expect banks to pay closer attention to robotics and automation to better manage costs in 2017. Existing business cases and POCs have shown that robotics lends itself well to finance, particularly in stable, repeatable process areas such as Balance Sheet Substantiation or Reconciliations. These significant process and structure changes will also continue to influence organisation design and people strategies. Banks will undoubtedly be developing their people and talent programmes to attract and retain the right skills.

Finally, we also expect that a number of banks will start tackling the cumbersome budgeting and planning process. While efficiencies have already been gained in the finance operations space, budgeting and planning typically still shows scope for transformation. The organisations that see and do this in the context of an Enterprise Performance Management framework that is strongly aligned with the business will reap the highest rewards.

In summary, with ongoing regulatory, accounting and finance change and transformation, we predict another busy year ahead for the finance organisation.

Customer Experience

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Despite Hong Kong's status as a global financial centre, banks in the city lag behind their peers in other developed economies on customer experience. With the focus primarily on the client, banks can often miss the link between customer experience and their employees – including front-line and back office staff – who are ultimately tasked with delivering the experience. The need to recognise the importance of training and empowering both front-line and back office staff to deliver on the customer promise is critical to success.

With indications that over the next five years, customer experience will overtake price and product as the number one brand differentiator, organisations across sectors will increasingly seek to compete primarily on the basis of experience in 2017. Financial institutions in particular can often undermine their customer-centric efforts by only comparing themselves to their direct competition, rather than analysing and drawing lessons from leading practices in other market segments. This shift in mindset should be a key focus for banks in the coming year.

There is somewhat of an idealism emerging in the market today around customer experience, that delighting customers regardless of cost will reap financial return, when in fact the relationship between customer experience and financial return is much more complex. As customer experience grows in importance alongside rapid advancement in technology, capital investment and operating costs to provide these experiences will increase. In 2017 and beyond, successful organisations will be those that strike the right balance between what customers expect, the value they bring and what makes financial sense for the company to deliver, and optimising investments while delivering leading customer experiences.

> ***"With indications that over the next five years, customer experience will overtake price and product as the number one brand differentiator, organisations across sectors will increasingly seek to compete primarily on the basis of experience in 2017."***

M&A

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Much like this year, Hong Kong's M&A landscape in 2017 is expected to feature fewer landmark bank transactions. There is, however, increasing interest in areas such as private banking and wealth management, where the market continues to consolidate at the top end and participants seek new ways to capture the outflow of wealth from China.

On the investment banking side, Hong Kong is set to be the largest global fundraising market this year, retaining the top spot it secured in 2015. Current consultations on market reform may lead to changes, but we expect Hong Kong to continue to be an active market for fundraising through initial public offerings (IPOs) and bond issuances. Interestingly, the competitive landscape has changed, with PRC and regional banks now prevalent in league tables, and we expect this to continue in 2017.

In addition, there are interesting M&A opportunities in the FinTech space in Hong Kong, as banks seek to innovate and acquire new tools and technologies to drive growth. The FinTech sector has received a lot of institutional and government support in recent years, and we expect this momentum to continue in 2017. Furthermore, corporate development teams at banks are increasingly considering engaging in contractual alliances rather than M&A activity, such as bancassurance arrangements.

"Current consultations on market reform may lead to changes, but we expect Hong Kong to continue to be an active market for fundraising through initial public offerings (IPOs) and bond issuances. Interestingly, the competitive landscape has changed, with PRC and regional banks now prevalent in league tables, and we expect this to continue in 2017."

Securities and Investment Management

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As 2017 approaches, all eyes are on the launch of the Shenzhen-Hong Kong Stock Connect on 5 December. While there are similarities to the Shanghai-Hong Kong Stock Connect – which was established in 2014 – the Shenzhen-Hong Kong Stock Connect is expected to be a game changer due to the mix of companies listed in Shenzhen. The companies listed on the Shanghai Stock Exchange are mainly large state-owned enterprises – many of which are already listed in Hong Kong – whereas the Shenzhen bourse comprises a number of innovative small and medium-sized enterprises from the technology sector. The Shenzhen-Hong Kong Stock Connect will therefore give international and Hong Kong investors a channel to companies that many would not have previously had access to.

We are also seeing a greater focus on private banking and wealth management, and expect these areas to continue to attract attention and drive business strategy in 2017.

Lastly, financial institutions should closely follow developments around the topic of management responsibility for licenced entities. The Securities and Futures Commission (SFC) has emphasised that since senior management drives the strategy and direction of a business, they should ultimately be held accountable – rather than the relevant officers within the organisation who are licensed with the SFC – for any issues within a licensed entity. We expect to see further discussion and developments around this issue in the coming year, and it is certainly an essential area for financial institutions in Hong Kong to monitor.

> *"The Shenzhen-Hong Kong Stock Connect has potential to be a game changer as it will give international and Hong Kong investors a channel to companies that many would not have previously had access to."*

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