Hong Kong embraces the emergence of virtual banks

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The HKMA has announced that as part of the package of initiatives it introduced in September 2017 to bring Hong Kong into a new era of smart banking, it will facilitate the establishment of virtual banks in Hong Kong. In February, it launched a consultation on proposed revisions to the *Guideline on Authorization of Virtual Banks* issued in 2000.

The HKMA views the development of virtual banks as an important initiative to promote fintech and innovation in Hong Kong, and to offer a new kind of customer experience. In addition, the HKMA sees virtual banks as helping promote financial inclusion, and expects them to target the retail segment, including small and medium-sized enterprises (SMEs). To that end, the HKMA has stated in its consultation paper that it expects virtual banks not to impose any minimum account balance requirement or low-balance fees on their customers.

Key revisions to the *Guideline on Authorization of Virtual Banks* in the consultation include the following:

- An indication that non-financial firms, and in particular technology companies, may apply to open a virtual bank (previously there was a requirement that virtual banks be at least 50% owned by a well-established bank or other financial institution), subject to the continued application of the principle that virtual banks must have a strong parent behind them to provide managerial, financial and technology support
- A change from the previous requirement that virtual banks are profitable in the initial years of operation to a new requirement that they have a credible plan for profitability in the medium term
- A new requirement for virtual banks to prepare an exit plan in case their business model turns out to be unsuccessful, to ensure that they can unwind their business operations in an orderly manner without causing disruption to customers and the financial system.

The successful growth of virtual banks can be a big factor in the long-term success of Hong Kong's banking sector

The HKMA's proposal is a timely update to the original guidelines for virtual banks

The HKMA's proposed revisions to the *Guideline on Authorization of Virtual Banks* are to be applauded. When the original *Guideline on Authorization of Virtual Banks* was issued back in 2000, the risks presented by banks interacting with customers solely through non-physical channels were only just beginning to be understood. In the meantime, we have seen the development of mature banking technology which enables a full customer experience to be delivered through mobile phones. We believe that the time is right for the HKMA to encourage the development of virtual banks in Hong Kong and, indeed, that the establishment of virtual banks in Hong Kong and the development of customer-focused digital services by existing banks can be a big factor in maintaining the long-term success of the banking sector.

Successful virtual banks will provide a boost to the competitiveness of the whole banking sector

Mobile banking technology is by no means unique to the financial technology ("fintech") sector, as many traditional banks already have well-developed mobile banking platforms. Nonetheless, allowing technology companies to set up virtual banks will significantly enhance the sophistication of the technology used.

Many fintech companies have developed innovative technology that can enhance the overall customer experience, lower the costs of financial products and facilitate the granting of loans to consumers who otherwise do not have the credit history to obtain finance from traditional banks. This could significantly boost financial inclusion and encourage traditional banks to further develop their own platforms, thereby raising the bar across the whole industry.

"*Our experience from working with digital banks overseas is that their strong emphasis on technological innovation requires the adoption of a new approach to risk management.*"

Simon Topping
Banking Regulatory Partner,
KPMG China

The successful growth of virtual banks can be a big factor in the long-term success of Hong Kong's banking sector (continued)

Innovation in banking brings new risks

We have worked with a number of digital and challenger banks in mainland China, Europe, the US and Australia. One of the lessons we have learned from the successful cases overseas is that these new institutions, with their strong emphasis on technological innovation, agile development and simple products targeted at defined customer segments, require the adoption of a new approach to risk management.

The risk profile of a start-up virtual bank will be very different. For example, while a successful cyber attack is a serious matter for an established traditional bank, it could strike a fatal blow to the reputation of a virtual bank with technology at the core of its brand. From a conduct perspective, there are also new risks arising from the targeting of potentially vulnerable customer segments which have previously been underserved by traditional financial institutions. Mobile apps need to balance simplicity and ease of use with the need to ensure that risks and contractual terms are properly explained. Given the greater use of open application programming interfaces (APIs) and partnerships with third parties, data protection is another area which needs to be carefully addressed.

A new approach to risk management

Most of all, the emergence of virtual banks with their cutting-edge technical architecture allows the adoption of a much more dynamic approach to conduct, regulatory, and commercial risk management. Decisions can be made in a fraction of the time needed in institutions with more fragmented systems and slower reporting cycles. Technology used to on-board customers and address know your customer and anti-money laundering requirements can be integrated with the overall platform in a much more efficient way.

Not only can this create an important competitive advantage, but it can also allow virtual banks to operate safely, without replicating the costly risk and compliance infrastructure developed by traditional banks since the financial crisis. It also means that supervisors will need to consider adapting some of the existing regulatory requirements to address this new approach to risk management, balancing the need to maintain a safe banking system against an imperative to encourage innovation, enhanced customer service and financial inclusion.

How KPMG can help prospective virtual banks

Development of a viable strategy & business model

Strategic insights into digital banking

Leveraging our experience of working closely with digital and challenger banks in other markets, our Strategy team is able to assist prospective virtual banks to prepare a detailed strategic plan, including three-year financial forecasts, as well as outline business models which are required by the HKMA to support the application for authorisation. For those potential applicants who are deciding whether to proceed with the application, we can prepare a detailed feasibility study.

Support throughout the virtual bank authorisation process

Proven authorisation track record

Our regulatory subject matter experts have deep experience helping banks, stored value facilities and other regulated entities obtain authorisation from the HKMA. We can provide support throughout the process including:

- Preparation or review of application pack
- Preparation or review of key policies
- Preparation or review of exit plan
- Assistance in responding to questions raised by the HKMA on the application

Independent assessments of the key areas required by the HKMA

Understanding regulatory expectations

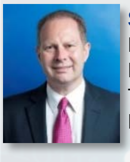
We regularly perform independent assessments of technology risk management, business continuity planning, outsourcing, cybersecurity and electronic banking services in accordance with the relevant requirements in the HKMA guidelines. Our teams of IT risk and security specialists have a strong understanding of the banking sector's needs, as well as the HKMA's expectations in these areas.

Designing and implementing an effective IT target operating model

Digital banking technology transformation

Our Advisory team is able to assist applicants in performing a cybersecurity assessment, developing an appropriate IT target operating model and technology roadmap that are aligned to your business strategy. The team can also support the selection of vendors and technology platforms to fill any gaps in technology capabilities.

Contact us



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