

Risk Management and Regulation Newsletter

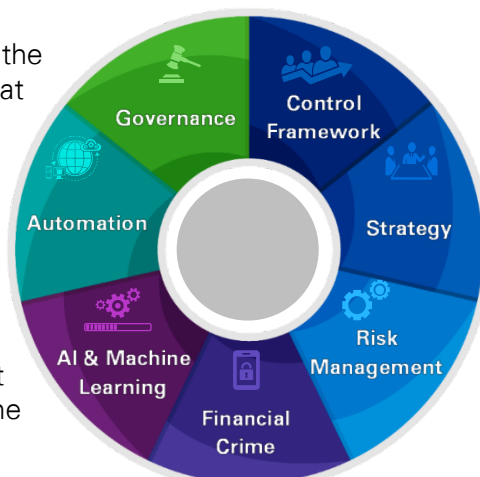
Welcome to our first Risk Management and Regulation Newsletter

In the last ten years risk and regulation have been at the forefront of many of the C-level discussions we have had with our clients and while the pace of change in banking is slowing the intensity of regulators shows no sign of slackening. The other main trend we are seeing is that companies in other sectors are starting to realise that they need to up their game in risk management and regulation, either because of regulatory pressure, or because of queries from the board. All of this means it is increasingly important for executives in all sectors to stay on top of the latest trends and developments in risk management and regulation.

We will be issuing this newsletter on a quarterly basis – the intention is not to cover all the risk management or regulatory developments, but those which we think are most interesting and which could have wide applicability across our clients.

In this first issue we deal with a range of topics:

- **Remuneration and incentives:** Culture is being recognized as an increasingly important part of a sound risk management and internal control system and regulators currently see incentives as a key lever in driving the right culture. We examine the latest proposals from the HKMA.
- **Complex financial products:** Suitability of products is a key issue in determining if FIs are treating customers fairly. We examine the implications of the recent SFC guidance in this area.
- **Credit risk:** Banking is changing with the advent of virtual banks. We take a look at new approaches to credit risk management.
- **LIBOR reform:** Are you ready? Our recent ASPAC survey suggests not many are and we examine some key issues.
- **Financial crime:** Hong Kong performed well in the FATF Mutual Evaluation, but this is an area where the fight against crime will continue.



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Topics in this issue:

1. CG-5 "Sound Remuneration System"
2. Online distribution and advisory platforms
3. Credit Risk Challenges & Innovations
4. LIBOR Reform
5. Anti-Money Laundering / Counter-Financing of Terrorism and Sanctions

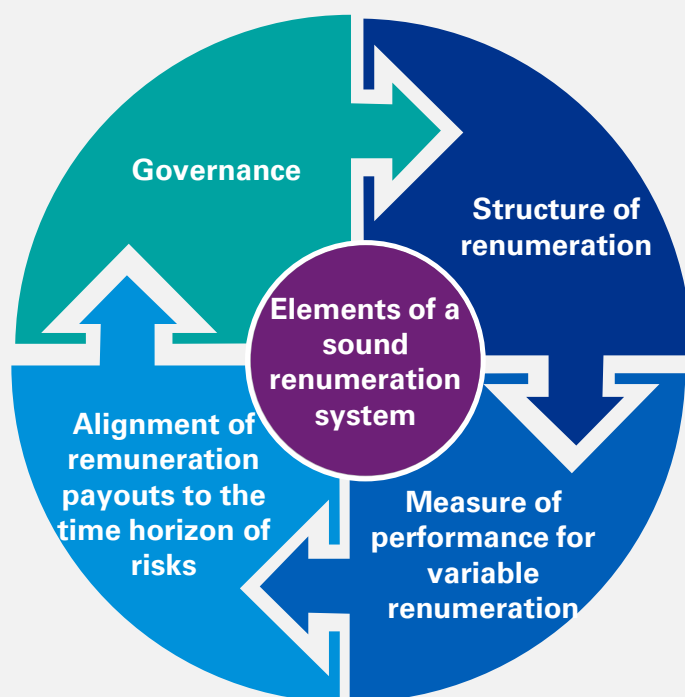
We hope you enjoy this issue and would love to hear feedback from you.

CG-5 Guideline on a Sound Remuneration System

In May 2019, the HKMA issued a consultation paper on the revisions to the SPM module CG-5 "Guideline on a Sound Remuneration System" to update the 2015 guidelines.

The main objective is to ensure that the remuneration systems of Authorized Institutions (AIs) are consistent with, and promote, effective risk management. It provides guidelines on inappropriate and excessive risk-taking which could threaten the safety, soundness and stability of AIs. It aims to reiterate the responsibilities of the Board and risk functions in regards to the effectiveness of the remuneration systems; emphasize the consideration of conduct risk in the remuneration system; and align the relevant disclosures with the Banking (Disclosure) Rules (BDR).

Elements of a sound remuneration system



Key changes / additions in the consultation

The consultation paper has several key updates in the following areas:

- Boards' responsibilities
- Risk control functions' responsibilities
- Consideration of misconduct risk in the remuneration system
- Pre-determined criteria for performance measurement
- Deferral portion and period
- Remuneration disclosure

KPMG released a publication which summarizes the key changes from the updated consultation paper. Click [here](#) to view the publication for more details on the updates.

May 2019

Consultation Paper on revisions to SPM CG-5



AIs should make remuneration disclosures at least **annually**.



The HKMA has set out both **qualitative** and **quantitative** information that an AI should include in its annual remuneration disclosure.

Online distribution and advisory platforms and new measures on complex products

The *Guidelines on Online Distribution and Advisory Platforms* (the "*Guidelines*"), issued by the Securities and Futures Commission (the "SFC") in 2018, became effective on 6 July 2019.

The *Guidelines* apply to all SFC-licensed corporations and registered institutions when conducting their regulated activities in providing order execution, distribution and/or advisory services in respect of investment products targeting Hong Kong investors via online platforms ("Platform Operators"). The *Guidelines* aim to provide tailored guidance to the industry on the design and operation of online platforms, and to clarify how the suitability requirements would operate in an online environment.

The *Guidelines* cover four key areas of: governance and controls; guidance for robo-advisers; triggering and discharging of suitability requirements; and additional protective measures for the sale of complex products.

1 Governance & controls

- Proper design and operation
- Information for clients
- Risk management
- Review and monitoring online platform
- Change and incident management
- Resources and capabilities
- Record-keeping requirements
- Monitoring of outsourced service providers

3 Guidance for robo-advisers

- System design and development
- Adequate contingency plans to deal with emergencies
- Supervision and testing of algorithms
- Information for clients
- Client profiling
- Portfolio rebalancing

4 Additional protective measures for the sale of complex products

- Classification of complex products and risk-based approach to due diligence
- Suitability requirements for the sale of complex products on an execution-only basis, and the available exemptions
- Minimum information and warning statements for the sale of complex products

2 Triggering & discharging of suitability requirements

- Triggers of suitability obligations in an online environment
- Discharging sales suitability requirements by performing appropriate assessments in a virtual environment



KPMG released a publication which summarizes the key changes from the published *Guidelines*. Click [here](#) to view the publication for more details on the updates, as well as a summary on the implementation of regulatory requirements for online and offline sale of complex products.

6 July 19

Effective date of the
*Guidelines on Online
Distribution and
Advisory Platforms*



Further key effective dates:



Paragraph 5.5 of the *Code of Conduct*, covering additional protective measures for the sale of offline complex products, became effective on **6 July 2019**.



The HKMA issued *Requirements Applicable to Online and Offline distribution of Non-SFO-Regulated Structured Investment Products* became effective on **23 August 2019**.

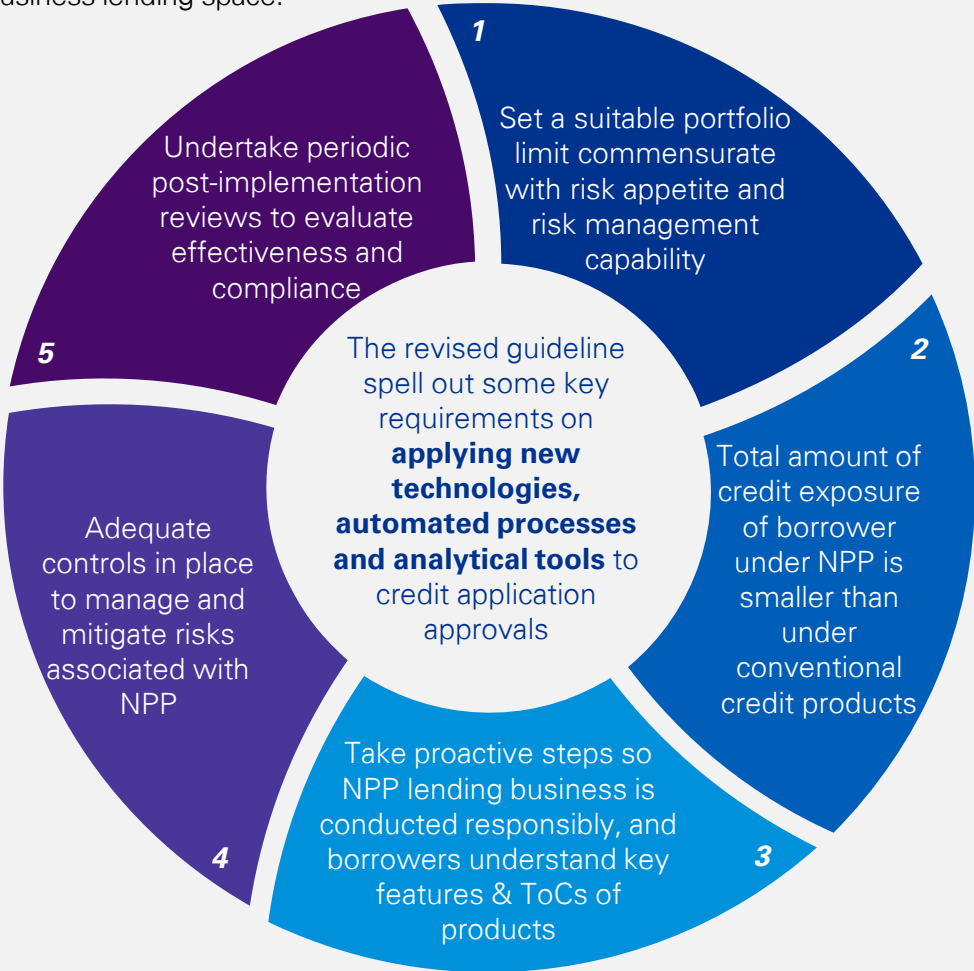
Credit risk challenges in Hong Kong

This year finds the banking industry in Hong Kong assessing the impact of economic uncertainty and regulatory hesitation around Basel IV implementation, together with the challenges of new entrants into the local banking market and new initiatives to promote smart banking by the HKMA. These market shifts have combined to intensify competition and change the nature of credit risk management in Hong Kong.

Changing landscape and new guidelines from the HKMA


A mix of changing customer expectations, new technology, and new disruptors are combining to advance the playing field for Hong Kong-based lenders. In the face of more compressed net interest margins and stiffer competition, banks are being forced to transform their credit lending operating models to be more automated, agile and scalable than ever.








As part of their [seven initiatives](#) to promote smart banking in Hong Kong, the HKMA has established a [“Banking Made Easy”](#) taskforce to identify and streamline regulatory frictions to smooth online customer journeys. As part of this, in August 2019 the HKMA released a circular entitled [“Guidelines on Credit Risk Management for Personal Lending Business”](#), modified from May 2018’s guideline on “New Personal-Lending Portfolio” (“NPP”). These guidelines are intended to support innovation and technology in the personal and small business lending space.



Aug 2019

New HKMA Guidelines on Credit Risk Management for Personal Lending Business

 7 Smart Banking Initiatives:

-  Faster Payment System (“FPS”)
-  Enhanced Fintech Supervisory Sandbox (“FSS”) 2.0
-  Promotion of Virtual Banking
-  Banking Made Easy initiative
-  Open Application Programming Interface (“API”)
-  Closer cross-border collaboration
-  Enhanced research and talent development

Credit risk innovations in Hong Kong

Innovation on the way for credit approvals and risk management

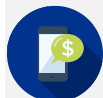
Lenders that focus on retail and small business loans are starting to combine multiple transformational levers across loan origination, customer onboarding, credit scoring and risk management to create innovative products and customer experiences that look to leverage the latest technology. These levers include:



Modernising loan origination and onboarding capabilities



Streamlining and automating processes



Automated credit decision engines



Risk and portfolio management



Replacing core systems

With the introduction of virtual banks and higher expectations from customers, banks are feeling more pressure to update their operating models, with several considering straight-through-processing for retail and SME credit approvals.

China: New innovations, new lenders and key trends

Chinese lending companies are innovating the way they score credit applications through enhanced techniques and a wide range of additional data points, such as analyzing facial recognition and mobile phone usage.

Moreover, Chinese banks are partnering with technology companies, such as online media giants and online retailers in China, to offer small unsecured retail loans to customers. This allows the banks to reach a new group of potential customers and to rely on the large amounts of data collected by technology companies in order to assess creditworthiness.

For further details, click [here](#) for the full paper KPMG published in September 2019, which includes the credit risk trends the financial services industry will face in 2020.

Aug 2019

New HKMA Guidelines
on Credit Risk
Management for Personal
Lending Business



How KPMG can help:



Designing optimized credit approval models by identifying areas that would benefit most from automation.



Supporting improved efficiency through Robotic Process Automation.



Performing an independent review of the credit approval process.



Automating and enhancing existing credit scorecards, models, and decisions.



Optimizing credit decision rule-based strategies, particularly the credit score threshold by performing simulation and profitability analysis.

Regulatory updates on benchmark interest rates

In October 2019, the Hong Kong Monetary Authority (HKMA) issued its [second circular](#) this year on the reform of interest rate benchmarks. It outlined the next steps for monitoring the progress of Authorized Institutions (AIs) in preparing for the transition from interbank offered rates (IBOR) to alternate reference rates (ARRs).

Significant progress has been made by standard-setting bodies, international authorities, and industry organizations in defining the essential components required for the transition, including ongoing work to develop term rates for ARRs and spread adjustments to address differences between ARRs and IBORs. In line with these developments, AIs have also made some progress in preparing for the transition to ARRs which the HKMA will initially begin monitoring through a survey to collect information on AIs' exposures, referencing IBORs and the progress of their preparatory work for the transition.

Key insights

Conducting impact assessments of the LIBOR transition

As noted in the [March 2019 circular](#), the HKMA continues to encourage firms to carry out impact assessments by undertaking risk assessments and making necessary arrangements. Banks should begin preparing responses to the pending HKMA surveys, especially preparing a detailed plan for the transition, and ensuring that all relevant stakeholders are aligned on the transition approach. A recent [readiness survey](#) undertaken by KPMG member firms in the Asia-Pacific region highlighted that, although most market participants are aware of the LIBOR transition, not many firms have started to actively prepare for this. Some firms have yet to put in place transition plans and carry out impact analysis to assess their LIBOR exposures.

Alternative risk-free rate: HONIA (HKD Overnight Index Average)


Although the HKMA has stated that HIBOR will be used as a reference rate, it also wishes to accelerate the use of ARRs and has been working closely with the HIBOR benchmark operator, the Treasury Markets Association (TMA), to adopt HONIA as an alternate risk-free rate. Certain firms identified OTC derivatives, credit agreements, and repos as the financial products most impacted by the transition, although many firms have still not fully assessed their quantification exposures, which includes identifying the fallback language in the impacted contracts and/or systems.


Other risks to consider


Beyond the operational risks raised by the transition, legal and litigation risk were also raised as significant concerns for firms, along with a heightened focus on conduct risk to ensure customers are treated fairly as terms are renegotiated and contracts are amended. Contract amendments may be challenging for certain non-standardised products that contain a complex structural set-up and multiple classes of holders. Firms should also be aware of the changes made to product offerings and contracts as part of the transition will also impact certain accounting treatments, such as hedge accounting, and model calculations and documentation.


2021
LIBOR ceases at
the end of 2021


Priority Actions:


 **Quickly** mobilise and conduct impact assessments

 **Quantify** exposures for product inventory referencing LIBOR

 **Rework** contracts and develop client outreach strategy to communicate to clients on the impact of the LIBOR transition

 **Implement** monitoring procedures, including quantitative and qualitative tools and metrics to assess the impacted exposure to LIBOR over time

 **Deliver** internal training programs to increase awareness and impact across the organization

 Click [here](#) for all the issues of KPMG's monthly LIBOR newsletter, which provides updates on LIBOR and other benchmark interest rate developments that directly impact banks and considers the potential implications of the related regulatory requirements.

Financial Action Task Force ("FATF") and Asia/Pacific Group on Money Laundering ("APG") published the Hong Kong Mutual Evaluation Report ("MER")

FATF and APG published the MER of Hong Kong on 4 September 2019 which assessed the effectiveness of Hong Kong's AML/CFT measures and their level of compliance with the FATF recommendations. The report recognised that Hong Kong has a strong foundation and effective system for combating Money Laundering and Terrorist Financing ("ML/TF") and the authorities in Hong Kong as well as the larger financial sector entities generally have a good understanding of ML/TF risks. Overall, Hong Kong's results make it the first jurisdiction in the Asia Pacific region to have achieved an overall compliant result in the current round of FATF evaluation while the MER also highlighted a number of areas that would benefit from a more detailed consideration. Click [here](#) to view the full report.

KPMG released a publication which summarised a selection of key topics from the MER report that were interesting themes, such as fraud-related money laundering, foreign corruption and foreign tax crimes, for more detailed consideration by financial institutions. Click [here](#) to view the publication.


The Securities and Futures Commission ("SFC") issued a circular on remote onboarding of overseas individual clients







The Securities and Futures Commission (SFC) issued a circular on 28 June 2019 on the new approach for the online onboarding of overseas individual clients which has been acceptable since 5 July 2019 when amendments to paragraph 5.1 of the Code of Conduct took effect. Compared with the previous SFC circular on online client onboarding dated 12 July 2018, the new circular provided Licensed Corporations ("LCs") with more specific guidance on the steps to be performed when they onboard overseas clients through a non-face-to-face channel.

The seven steps in the circular include: (i) identity document authentication; (ii) identity verification; (iii) execution of client agreements; (iv) designation of overseas bank accounts; (v) record keeping; (vi) training and (vii) assessment. Where LCs would like to onboard any overseas clients through a remote channel, they should ensure these steps were duly completed. Click [here](#) to view the circular.

KPMG issued a publication on [Digital onboarding in the era of Smart Banking](#) in April 2019 which highlighted six key considerations and practical applications for banks on the digitalisation of the customer on-boarding process.

Anti-Money Laundering / Counter-Financing of Terrorism and Sanctions

 6 key considerations on the digitalisation of the customer on-boarding process:

-  Regulatory framework
-  Money laundering / terrorist financing risk
-  Data governance
-  Data protection and cybersecurity
-  Governance and oversight
-  Customer experience

The U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC") published a Framework for OFAC Compliance Commitments

The OFAC published a Framework for OFAC Compliance Commitments in May 2019 to provide organizations guidance on the expectations of the essential components of a robust sanctions compliance programme.

The framework provides guidance on employing a risk-based approach to sanctions compliance by developing, implementing, and routinely updating a sanctions compliance programme.

The framework is applicable to U.S. entities as well as foreign entities that conduct international business in or with the United States or with U.S. persons, or that use U.S.-origin goods or services. Click [here](#) to view the document.



Through periodic assessments of its sanctions risks, institutions can identify and measure its sanctions risk exposure. Based on the results of this assessment, the existing sanctions compliance programme can be enhanced in order to establish the appropriate control measures to prevent inadvertent violations of OFAC sanctions.

Anti-Money
Laundering / Counter-
Financing of
Terrorism and
Sanctions

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