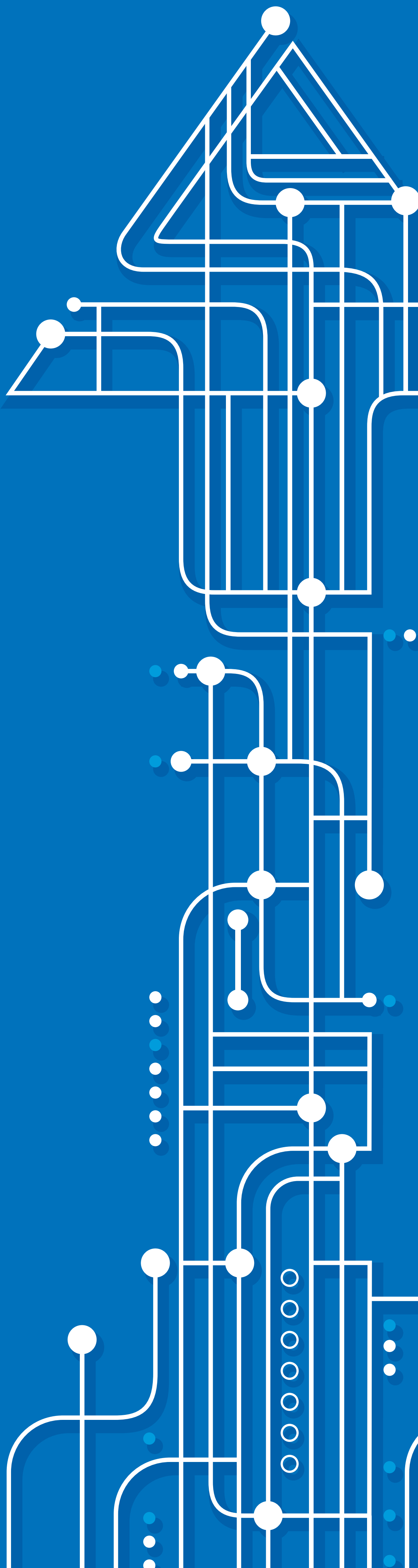
KPMG

Hong Kong Banking Outlook 2020



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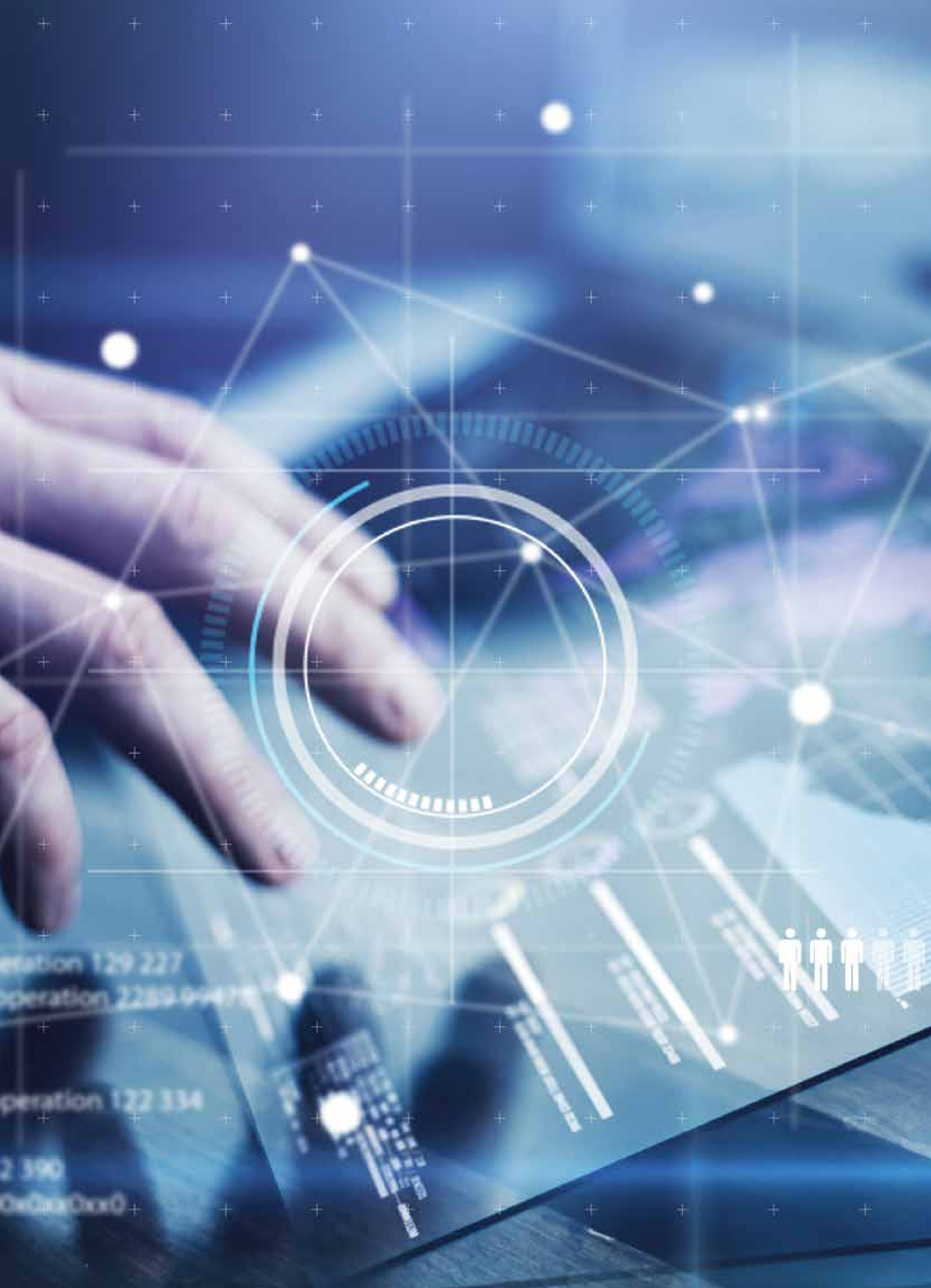

Overview

Paul McSheaffrey
Partner, Head of Banking & Capital Markets, Hong Kong
KPMG China

> *With 2020 around the corner, our focus is on what the future of banking looks like. One thing is certain: rapid change will be the new constant.*

Change is the only constant in 2020

Welcome to our outlook for 2020, where we forecast the key developments and trends that will impact and shape Hong Kong's banking industry. Reflecting first on 2019, we expect to see muted financial results across Hong Kong's banking industry this year, with ongoing market uncertainty around the US-China trade tensions and the low interest rate environment being the key drivers. The recent events and business disruption in Hong Kong has also impacted retail investor confidence.

In our annual *Hong Kong Banking Report*[1] launched in June this year – which summarised the 2018 financial performance of Hong Kong's banks – we correctly predicted that we would see interest rate cuts in the second half of 2019. Coupled with muted loan growth in the first half of the year, this pressure on margins will mean revenue growth will continue to be a challenge for banks in 2020.

Despite a challenging year, we continue to see opportunities for investment and growth for banks in 2020. For example, mainland China continues to open up its financial services sector to foreign investment, and a number of international banks in Hong Kong are looking to capitalise on this opportunity to take a majority or wholly-owned stake in their mainland Chinese securities and asset management businesses. The Central Government's recent announcement to explore the establishment of a cross-boundary wealth management scheme in the Greater Bay Area is another development that has great potential for banks in Hong Kong.

With 2020 around the corner, our focus is on what the future of banking looks like. One thing is certain: rapid change will be the new constant. In this report, KPMG subject matter experts offer a number of predictions for the industry which also shed light on three broader trends. First, risks continue to change, and so does the nature of those risks. In particular, we are seeing a greater focus on non-financial risks, ranging from cyber and climate-related risks to conduct and culture.

Second, we continue to see a fast evolving and increasingly competitive landscape in Hong Kong. The launch of the city's first virtual banks in the coming months will certainly add new players into the mix, but it also forms part of a broader trend where the lines are blurring between sectors. Many technology and telecom companies are seeking to expand into financial services in order to build and strengthen customer relationships across all areas of their daily lives. At the same time, the way in which people use financial services is changing, and so too are banks' operating models.

Lastly, we expect digital transformation to become an increasingly important business imperative to enable banks to improve cost and operational efficiency, capitalise on new opportunities and win new customers.

Data underpins each of these key trends, and will be a crucial area of differentiation among banks in 2020. We believe the banks that will be successful in the long run will be the ones that have a comprehensive data strategy and that can leverage their data to increase revenue, and enhance regulatory compliance and operational efficiency.

[1] 'The future of banking – Hong Kong Banking Report 2019', KPMG China, June 2019, https://home.kpmg/cn/en/home/insights/2019/06/hong-kong-banking-report-2019.html

Virtual banks

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James Harte
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> *By the end of 2020, we predict that virtual banks will have attracted tens of thousands of customers each. However, we still expect deposits at virtual banks as a percent of total balances to be relatively minor.*

Competition heats up for customers and deposits

In 2020, Hong Kong will witness the launch of its first virtual banks following the issuance of eight licences by the Hong Kong Monetary Authority earlier this year. The new entrants will come out of the gate running, aggressively seeking to compete with the existing traditional banks for customers and market share, with a number of exciting developments expected throughout the course of the year.

First 30 days: Great initial fanfare

The first 30 days will serve as a soft launch for virtual banks, which are likely to have limited functionality during this time. However, the launch of these digital players will certainly generate much fanfare and a buzz on media and social media, with early adopters likely to sign up for multiple virtual banks (account opening is expected to be relatively seamless) to compare their products and services. Virtual banks will therefore have to be ready for this intense scrutiny in terms of the overall look and feel of their platforms, and must use the months ahead to ensure that all their systems are rigorously tested before launch.

First 3-6 months: The beginning of deposit outflows

If the launch of the virtual banks is successful, we expect to see deposit outflows from traditional bank accounts into the accounts of the new entrants. However, we don't expect this impact to be material, at least during this period.

Where we do expect to see a greater impact is in the SME space, with many in Hong Kong currently underserved and hungry for credit – around a quarter of SMEs find it difficult to access credit today. SMEs may be tempted to switch their accounts as they will likely start to see an improvement in their ability to open bank accounts (there is currently about a 10% rejection rate) and obtain access to finance through the new virtual banks.

In response, many traditional banks will seek to accelerate their IT and systems transformation, invest in new technologies and upgrade their digital platforms to compete. We expect a flurry of new features to be launched throughout the year from traditional banks, some of which we saw recently at Hong Kong FinTech Week.

End of 2020: New customers, but minor share of banking assets

By the end of 2020, we predict that virtual banks will have attracted tens of thousands of customers each. However, we still expect deposits at virtual banks as a percent of total balances to be relatively minor, at 2-3 percent of the total by year end. We predict banks to respond through more aggressive pricing, particularly in term deposits to lock in deposits throughout the course of the year. This will not just impact banks, but money lenders and finance companies will also see competition from virtual banks on lending rates.

We don't think it will be until beyond 2020 that customers start to switch their payroll accounts to virtual banks – which will have a more tangible impact on outflows from traditional banks – but only once they are confident that they have identified the virtual bank that is the best fit for them.

An exciting year for the industry, advisors and particularly customers. Stay tuned.

Cost and operational efficiency

Isabel Zisselsberger
Partner, Head of Customer and Operations, Hong Kong
KPMG China

> *Banks will start to consolidate different pockets of automation projects that are currently scattered across their organisation to gain a more comprehensive and strategic view of their automation programme.*

Invest more to save more in 2020

With margins continuing to be squeezed and global macroeconomic uncertainty set to carry over into 2020, managing costs will continue to be a key focus for banks in Hong Kong. Coupled with an increasingly competitive landscape – virtual banks are expected to launch in the coming months – 2020 will be crucial for banks to focus on costs and operational efficiency in a sustainable way.

We expect leading banks to become more creative with regards to their business and operating models, and in their approach to achieving longer-term savings. The successful banks will take greater strides in the year ahead to embrace technology and adopt artificial intelligence (AI) and related digital solutions. These banks will work on more proofs of concept using complex technologies to generate greater returns and to solve labour-intensive and difficult processes – for example, the research-intensive parts of the onboarding process, or complex product due diligence procedures. Some will continue to invest in fintech to find innovative and cost-effective solutions to legacy problems.

Many banks will continue to explore the use of cloud technology to increase efficiency. However, navigating the complex regulatory requirements and security implications around implementing a cloud programme will remain a significant challenge.

Some banks will also be more creative in terms of how they outsource or use managed services to make processes more automated and efficient. Banks will start to consolidate different pockets of automation projects that are currently scattered across their organisation to gain a more comprehensive and strategic view of their automation programme.

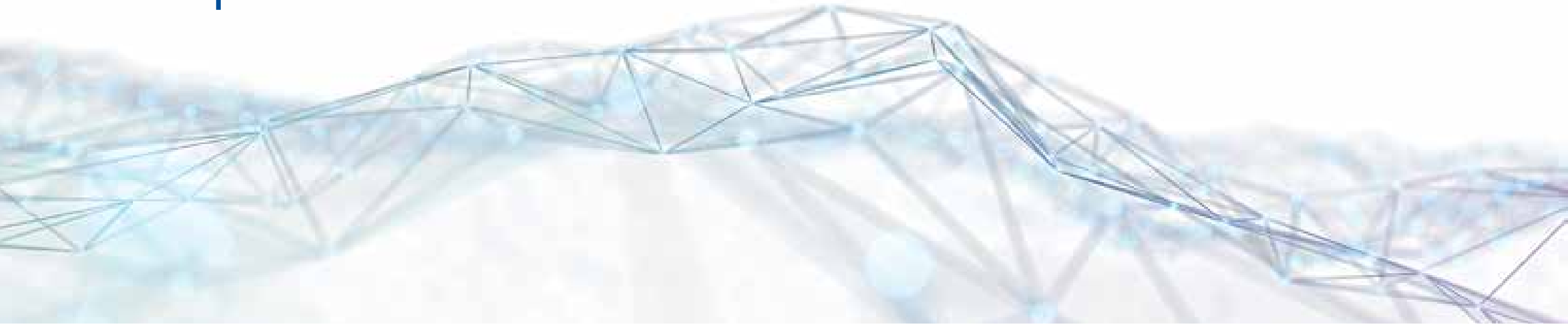
In 2020, banks will also continue to work on data projects that enable them to improve their cost reporting. In particular, leaders will invest further in using data lakes and different sources of information in order to create more transparency around how costs are generated and allocated. We also expect procurement teams to play a greater role in driving cost improvement through more leading practices and specialist cloud-enabled tools.

The really creative banks may also seek to partner with technology and consulting firms to build their own AI-enabled solutions, which can then be taken to market as a new revenue stream for the banks. This option presents a potentially lucrative opportunity to tap into a solution that can provide long-term cost savings while generating return on investment.

Lastly, banks will continue to look at their overall organisational design to optimise their local and regional structure and footprint.

With pressure on margins expected to continue in 2020, some banks will seek to make quick cuts to costs. However, we believe that the successful banks will be the ones that realise that they need to invest more in order to save more in the longer term.

Suptech



James O'Callaghan
Partner, Head of Technology Consulting, Hong Kong
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Jianing Song
Partner, Risk Consulting
KPMG China

> *With regulators increasingly demanding more granular and real-time data, leading banks need to invest in regtech and proactive data analytics solutions.*

Regulators to leverage suptech in 2020 to gain more granular and real-time insights into banks' business

With data more accessible and readily available than ever, regulators in Hong Kong are increasingly taking a more data-driven approach to supervision, and will use the year ahead to develop and deploy supervisory technology (suptech).

In 2020, regulators will increasingly leverage suptech and data analytics tools to enhance their regulatory oversight and enable access to real-time information, risk trends within an organisation and real-time trends across peer groups. Beyond 2020, we believe that regulators will start collecting data on a continuous basis from banks, meaning real-time surveillance and supervision will officially become a reality, and the norm.

As part of their data-driven approach, Hong Kong's regulators introduced several circulars and initiatives this year that require banks to submit more granular data and adopt new data standards. For example, the Securities and Futures Commission circulars that require licensed corporations (LCs) to comply with new data standards when submitting trading-related data upon request, and in-scope LCs to complete a Key Risk Indicator Survey, will be key areas of focus for banks in the year ahead. The scope of data collection – which currently relates to business operations, conduct and prudential risk exposure – will likely be expanded and additional LCs will be included going forward.

In addition, the Hong Kong Monetary Authority's (HKMA) Granular Data Repository pilot – launched earlier this year – will be another key focus for banks. The pilot, which is expected to be finalised at the end of 2020, aims to capture more granular data on residential mortgages and corporate loans to provide the HKMA with a more comprehensive and current view of banks' business.

With regulators increasingly demanding more granular and real-time data, leading banks need to invest in regtech and proactive data analytics solutions. The importance of being able to generate real-time, actionable insights from data, better management of risk, and showing how they get to more accurate and cost-effective regulatory compliance that is automated, is going to grow. If they do not, the banks may find themselves on the receiving end of fines, enforcement actions and potential reputational damage.

Banks will not have to do everything on their own. Regulators will also continue to encourage and work closely with banks to develop regtech solutions and data analytics capabilities as the banking industry moves firmly into the digital era – in which data underpins everything.

This will require a greater focus on the fundamental building blocks of infrastructure and data architecture, data governance and management, as well as updating talent demands to focus on employees who have a core competency in data analysis.

Greater Bay Area

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KPMG China

Cross-boundary wealth management and mortgage lending the next steps in GBA development for banks

Ongoing developments and reforms in the Greater Bay Area (GBA) will continue to create increasing demand for financial services in the region in 2020, presenting a number of business opportunities for banks in Hong Kong.

First, following the Central Government's recent announcement to explore the establishment of a cross-boundary wealth management scheme, in 2020 we could see the introduction of a pilot scheme that would allow – subject to a quota – wealth to flow more freely between mainland China and Hong Kong. This move would enable high-net-worth individuals in other cities in the GBA to easily access Hong Kong for their wealth management needs, and for the product and services that exist in Hong Kong to be available to the wider public in the GBA. Of course, the pilot scheme would need suitable risk management and investor protection provisions, but this development would aid the policy objective of having Hong Kong as a wealth and asset management centre, and contribute to the overall growth of the GBA.

We also expect to see some positive movement around Hong Kong's development as a cash management and corporate treasury centre. A number of China based state-owned enterprises (SOEs) and privately-owned enterprises (POEs) – many with multi-jurisdictional operations – continue to look at expanding overseas, especially into the ASEAN region, and are increasingly thinking about how to manage their cash centrally. This opens up opportunities for banks in Hong Kong to provide support to these companies in the year ahead.

With Hong Kong the most internationalised city in the GBA, more SOEs in the region would prefer to set up a regional corporate treasury centre in the city. More SOEs will seek to use Hong Kong's longstanding position as an international financial centre as a platform for their investments abroad, particularly to fund projects related to the Belt and Road Initiative. Overall, the banks that drive closer collaboration between their operations in the GBA and the ASEAN region will be best placed for long-term success.

On the retail banking side, banks with operations in the GBA will continue to work towards creating a more seamless banking experience across the region. We saw positive steps towards this in 2019, with Bank of China (Hong Kong) moving to allow their existing customers in Hong Kong to open accounts in the bank's mainland China branches without having to travel to mainland China in person. The recent government announcement also includes a measure to introduce a pilot scheme to allow greater access to banking services in the GBA for Hong Kong residents.

We believe the next evolution of seamless banking services could extend to mortgage lending, where customers in Hong Kong are permitted to take a Hong Kong-dollar mortgage against a property in another GBA city, for example in Shenzhen or Guangzhou. Recent measures introduced by the Central Government aim to ease restrictions on the purchase of homes in Guangdong by Hong Kong residents, and we therefore expect to see the development of an initiative promoting more seamless cross-boundary mortgage lending in 2020.

"We believe the next evolution of seamless banking services could extend to mortgage lending, where customers in Hong Kong are permitted to take a Hong Kong-dollar mortgage against a property in another GBA city."

Wealth management

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Wealth in 2020: Digital, China, Family Offices

2020 needs to be a year of action for both the industry and government if Hong Kong is to remain the premier wealth management centre in Asia. Our recent joint White Paper[2] with the Private Wealth Management Association (PWMA) outlined many key areas of focus for the industry around growth, technology, regulation and talent. Here, we cover a few of our larger predictions for 2020.

The use of digital technologies across wealth management firms will continue to deepen, with distribution to wealthy clients expected to become faster and increasingly conducted through digital channels. Also, technology will play an increasingly important role in matters of operational efficiency, such as client onboarding, product due diligence, data analytics and regulatory reporting.

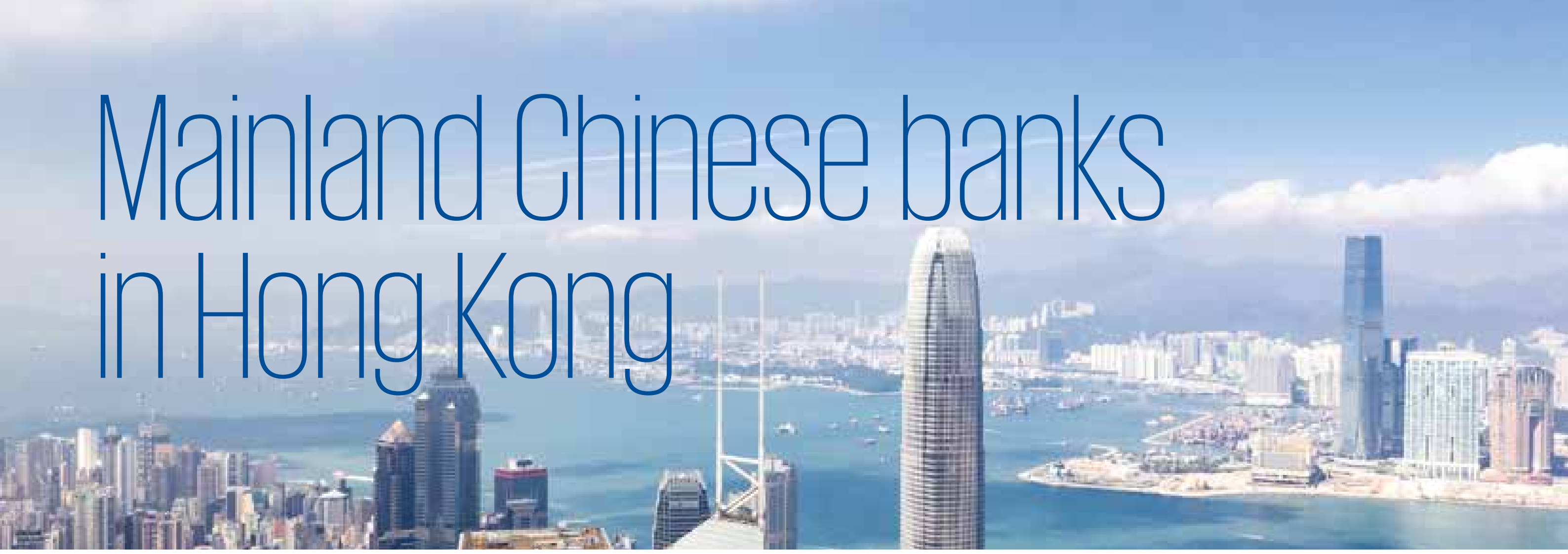
More specifically, a number of players may seek to revamp their digital offering in response to the launch of virtual banks in Hong Kong. Although virtual banks will not pose a competitive threat to wealth managers in the short term, we expect their presence in Hong Kong to create an impetus for leading traditional banks to 'get more digital' in their wealth management services to appeal to increasingly digitally-savvy customers.

Meanwhile, mainland China continues to open up its financial services sector to foreign investment by easing ownership restrictions and investment quotas. Based on the work we have done with our clients, we expect most wealth and asset managers with operations in Hong Kong to revisit their China strategy in 2020 and consider how best to either enter the market or, for incumbents, to increase their stake in their mainland China operations or convert their existing mutual fund businesses into Wholly-Foreign Owned Enterprises.

Another angle to capitalise on the China opportunity is in the form of a cross-boundary wealth management scheme for the Greater Bay Area (GBA), which looks increasingly more likely following a recent announcement on the programme by the Central Government. The launch of a GBA wealth connect scheme, which was a key recommendation in the 2018 White Paper, would allow the cross-boundary flow of financial products between mainland China and Hong Kong, and present new business opportunities for banks in the region.

The Hong Kong government, regulators and the IRD may also seek to implement measures to attract family offices, namely the extension of the offshore funds tax exemption to explicitly cover family offices – another key opportunity to grow the wealth management industry in 2020. There is already at least HKD 1 trillion of family office assets being managed in Hong Kong, and this is expected to rise with the increasing fashion for family offices among clients. Serving these clients requires significant adaption of private banks' traditional business and operating models. Swiftly implementing concrete measures to attract family offices will be key for Hong Kong's wealth management industry in 2020, especially given the development and attractiveness of other alternative jurisdictions in the region.

[2] 'Hong Kong: A leading global wealth management hub of the future', KPMG China and PWMA, September 2018, https://home.kpmg/cn/en/home/insights/2018/09/hong-kong-a-leading-global-wealth-management-hub-of-the-future.html



Mainland Chinese banks in Hong Kong

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Ryan Zhou
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> *“With data a key enabler for their digital initiatives, leading banks will explore and identify the appropriate data governance approach and path for value realisation that are in line with their own unique characteristics.”*

Beefing up digital capabilities and attracting mainland Chinese corporates to Hong Kong the keys to success

Mainland Chinese banks in Hong Kong have grown and diversified their business significantly in the last several years, and despite a challenging environment, their future prospects look promising.

In 2020, mainland Chinese banks in Hong Kong will seek to build on their strengths and leverage resources from their parent banks in the mainland to drive innovation and pursue further market growth. Hong Kong’s status as an international financial centre, offshore renminbi hub and premier regional wealth and asset management centre will help to open up new opportunities for those banks as they continue to support the overseas expansion of Chinese companies, particularly as part of the Belt and Road Initiative.

At the same time, these banks will further broaden the channels for allocating assets to mainland customers by introducing new wealth management products to middle and high-end customers, and expanding the size of their high-net-worth customer base.

Chinese banks in Hong Kong will also continue to leverage their parent banks’ large customer base in the mainland market to attract more high-quality corporate customers to the Hong Kong banking market. Leading banks will do this by offering a comprehensive package of core banking services such as payments and settlement, corporate finance, M&A financing and cash management to meet their customers’ business development needs.

With Hong Kong’s government and regulators encouraging the development of fintech, coupled with the launch of virtual banks in the city next year, innovative mainland Chinese banks will continue to actively invest in developing their big data application and advanced technology capabilities to improve customer experience. Notably, a number of major mainland Chinese banks are key stakeholders in some of the new digital banking players. Partnering and increased collaboration with leading fintech firms will also be a key consideration in the year ahead.

With data a key enabler for their digital initiatives, leading banks will also explore and identify the appropriate data governance approach and path for value realisation that are in line with their own unique characteristics. Initially, the priority for many mainland Chinese banks will be to choose the most pressing data governance and application issues that are closely related to current business pain points, and focus on actual business use cases to gradually implement a full data application framework through a combination of long-term planning and short-term quick wins.

We believe that the mainland Chinese banks in Hong Kong that will achieve long-term success will be the ones that recognise the value of data governance is not only limited to control. Instead, it should also be used to transform their customer data to make it more user-facing and service-oriented.

Risk and regulation

Simon Topping
Banking Regulatory Partner
KPMG China

> *In 2020, leading banks will explore opportunities to strengthen their operational resilience in a way that brings business benefits.*

Three emerging risk issues for banks in Hong Kong

Over the last decade or so, regulators worldwide have enacted a number of measures to strengthen the resilience of the banking sector. Banks in Hong Kong have done well to strengthen their balance sheets and risk management accordingly. However, there are three key areas where we expect the regulators in Hong Kong to turn up the heat in 2020, and which therefore require a greater focus from banks.

Basel 4

While Basel 4 is due to be implemented in January 2022, regulators – with the exception of Europe – are yet to consult the industry or provide advice on how they plan to implement the new framework. However, while the Hong Kong Monetary Authority (HKMA) and other regulators are not yet committing themselves to implementation, banks cannot neglect this area. There is still a lot of preparation work to be done, as regulators are expected to conduct quantitative impact studies and consult the industry on how banks calculate the risk weighted assets for credit, operational and market risk. At the same time, proactive banks will conduct gap analyses to determine whether their data and systems are fit for purpose for Basel 4.

Operational resilience

Banks have for many years had contingency/disaster recovery plans in relation to specific problem areas, such as IT breakdowns or security breaches, liquidity problems or outsourcing issues. However, regulators in Asia are starting to take a much broader view of operational resilience, focusing on how the continuity of key business services could be preserved in the event of disruptions occurring. We expect banks in Hong Kong to think much more about how to reduce operational risks and the potential costs of disruption – to themselves, their customers and the financial system as a whole.

In 2020, leading banks will explore opportunities to strengthen their operational resilience in a way that brings business benefits. These banks will take a more explicit end-to-end view of key business services to generate synergies across strategic, financial and operational resilience. This comprehensive view will also help many banks generate better customer outcomes, enhance customer trust and loyalty, reduce their operational risks and the costs of disruption, and allocate resources more effectively and efficiently.

Third party risk management (TPRM)

Banks have always made some form of assessment of their customers, their main outsourcing providers, and to some extent their main suppliers – but they generally do not have a comprehensive and effective process for assessing the full range of third parties to which they are exposed. However, the world has moved on, and in 2020 banks will continue to seek to collaborate closely with fintech players, and will be increasingly interlinked with technology providers, telecoms firms, and potentially other third parties (through open banking).

We expect the HKMA to increase their focus on how banks manage their relationships with third parties and how they risk assess them. The more forward-looking banks will start to treat TPRM as a standalone subject instead of as a piecemeal exercise. The successful banks will consider not just the potential financial impact of these relationships, but also how these third parties handle the bank's customer data, and the associated reputational risk.

Cybersecurity

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Brian Cheung
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> *With the proliferation of start-ups hitting the market with new and innovative solutions, this adds a layer of complexity – and risk – for even the most digitally-enabled banks.*

As banking and technology converge, bolstering cyber resilience is the key to success

In 2020, we will continue to see more banks embrace artificial intelligence and cloud technology, as well as partner with fintech firms. Coupled with the ongoing development of the Hong Kong Monetary Authority's (HKMA) Open Application Programming Interface framework, banks are becoming increasingly interconnected with fintech players and other third party service providers.

The year ahead will also see the launch of virtual banks in Hong Kong, which will further disrupt the traditional banking model. This development may also be a tipping point for the increased acceptance and use of cloud technology by banks, as the new digital players will undoubtedly adopt a cloud-based model.

All of these developments, while positive, continue to bring cyber and third party risk to the fore. Traditional banks have strengthened their cyber maturity over the past few years on the back of the Cyber Resilience Assessment Framework, which formed part of the Cybersecurity Fortification Initiative introduced by the HKMA in 2016 to bolster cyber resilience. However, banks are now operating in a very different landscape than before. The successful banks in the year ahead will therefore be the ones that fully embrace their digital transformation initiatives – which include collaborating with fintech firms and third parties – while strengthening their cyber resilience to ensure that their business models and operations are not disrupted.

With banks increasingly seeking to partner with third parties, they are expected to face a number of challenges in 2020. The first is around vendor lock-in, where a bank partners with a fintech firm or cloud service provider but then cannot easily switch vendors. Traditionally, banks have conducted thorough due diligence of potential vendors and tended to partner with more established companies. But with the proliferation of start-ups hitting the market with new and innovative solutions, this adds a layer of complexity – and risk – for even the most digitally-enabled banks.

The second challenge is around service availability. Banks will increasingly need to consider appropriate responses to unforeseen IT problems and other technical issues that may cause disruption to the continuity of services. This can have a significant impact on a bank's operations and bottom line, and will be a key area of focus in the year ahead.

The third challenge is around supply chain risk. Some fintech firms have vendors of their own, such as cloud platforms, which makes it increasingly difficult for banks that have to cast a wider net to fully assess the cyber risk of their third party partners. The continuous and thorough monitoring of third parties – and their related partners – will be critical for banks going forward.

With increasing interconnectivity between banks and technology providers, those that invest in bolstering their cyber resilience and managing third party risk will gain a competitive edge, and will be best placed for long-term success.

Conduct and Culture

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More misconduct enforcement cases on the horizon, with culture a major contributor

The direction of travel driven by regulators globally, including the Hong Kong Monetary Authority (HKMA), continues to be towards the need for banks to proactively manage conduct risk and shape and promote the right culture within their organisations.

In 2020, we expect to see the HKMA pursue an increasing number of conduct-related enforcement cases, with culture playing a significant contributing factor to the conduct failures. This will continue to change how banks perceive conduct and culture. While the assessment of culture and the factors shaping conduct have often been viewed as a tickbox exercise in the past, the pendulum is swinging towards a more proactive, front-foot approach in order to prevent future cases of misconduct. Leading banks will focus on forward-looking real-time metrics and cultural assessments to provide them with greater insights into the day-to-day behaviours within their organisation, and to better understand the levers that can influence these behaviours and shape the desired cultural outcomes.

The fiduciary duty that banks have around client assets is another area of conduct that some banks in Hong Kong have not fully appreciated, and in the year ahead we expect to see an increasing number of enforcement cases with this as a focal issue.

We also expect the regulators to increasingly focus not just on accountability within banks, but also on the role that culture played in a case of misconduct. Put simply, the focus will not just be on 'what happened', but instead will dive deeper into 'why it happened'. Leading banks will therefore seek to ensure that their senior leadership clearly understands the role of culture as a key enabler to supporting good conduct, and takes ownership of driving the right culture throughout their organisation.

In 2020 and beyond, the successful banks will be the ones that proactively manage conduct risk, understand the current day-to-day behaviours of their employees, and assess whether their culture is encouraging, rewarding and shaping those behaviours in a way that is aligned with the values of the organisation.

Ultimately, the successful banks in the longer term will be the ones that treat their customers fairly and strive to provide value for money for their products, services and advice. Banks that fail to keep the customer at the heart of what they do, and therefore do not regularly assess whether their practices are fair to their customers, are likely to find themselves embroiled in culture and conduct-related enforcement actions in the future.

> *"In 2020, we expect to see the HKMA pursue an increasing number of conduct-related enforcement cases, with culture playing a significant contributing factor to the conduct failures."*

Credit risk

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New credit risk models set to emerge amid uncertain macroeconomic environment

With the uncertain global macroeconomic environment showing no sign of abating, we expect to see an increase in credit risk for banks in Hong Kong in 2020, as well as new ways of managing this risk.

The low interest rate environment in previous years led to a credit boom, and in the coming years, about 4 trillion US dollars in corporate bonds are due to mature. When that debt comes due, we could see a rise in non-performing assets or defaults, which could have a contagion effect on Asian credit markets.

If the macroeconomic environment continues to remain challenging and we start to see an increase in default rates, we would expect to see more loans migrating into IFRS 9 stage '2' and stage '3'. This would be the first time this happens under the new IFRS 9 accounting standard – which came into effect in 2018 – and it will be interesting to see how banks in Hong Kong navigate this. Generally, we expect to see higher loan loss provisions.

We also expect to see leading banks in Hong Kong make great strides in streamlining and automating their credit approval processes. There are currently varying levels of maturity among banks in Hong Kong in this space, and in 2020 the banks that adopt new technologies and integrate them into their credit origination processes to create a real-time credit approval engine will maintain a competitive advantage. 2020 may be the year where we see industry leaders start to apply machine learning models for credit approvals.

The traditional banks that can gain a competitive edge with regards to automating credit approvals will be well placed to compete against the new virtual banks that are set to launch in Hong Kong next year. These new digital players should, in theory, increase the velocity at which credit can be released to the consumer.

The Chinese banks operating in Hong Kong will also seek to optimise their credit approval processes. Most of these banks continue to service Chinese corporates that are investing offshore, and therefore the extent of their lending – and the associated credit risk – may be impacted by developments related to the Belt and Road Initiative, as well as the ongoing China-US trade tensions.

Lastly, the Banking (Exposure Limits) Rules are due to take effect in Hong Kong in 2020, and will have an impact on the way that banks measure and monitor large exposures. This regulation also includes updated rules on how banks calculate and mitigate exposures through the use of guarantees and collateral. These new rules will also have an impact on Chinese banks, in particular the way that they extend credit to connected parties and entities within their overall group structure.

> *“2020 may be the year where we see industry leaders start to apply machine learning models for credit approvals.”*

Sustainability

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Partner, Head of Sustainable Finance, Hong Kong
KPMG China

Sanel Tomlinson
Partner
KPMG China

> *We believe that a climate crisis is potentially just around the corner, and incremental change will therefore no longer suffice.*

Time for a step change: regulators and industry to increase their focus on sustainable banking

The Hong Kong Monetary Authority (HKMA) is expected to increase its focus on sustainability and climate change risk in 2020, following the introduction of a number of measures this year to promote sustainable banking and the development of green finance in the city.

One key measure calls for the development of a common framework to assess the "Greenness Baseline" of individual banks, after which the HKMA intends to engage the industry in a consultation on the supervisory expectation or requirement on green and sustainable banking. By the end of 2020, we expect these two phases to have been completed, with the HKMA and industry equipped with a clearer view and an action plan to promote the sustainable development of the banking sector. Banks will also begin their preparations for the final phase which includes implementation, monitoring and evaluating progress.

The developments we have seen in the asset management industry this year – investors increasingly demanding that asset managers integrate ESG into their investment decisions and offer more sustainability-related products – will extend into Hong Kong's banking sector next year. We also expect the cost of capital to increase for corporates – including banks – that do not actively manage ESG matters, in particular climate-related matters. The flow of capital will be directed more towards a low-carbon economy and industries and companies that are setting themselves up for this. The impact will be even more pronounced as this is one of the Central Government's top priorities, and we therefore expect a greater focus on sustainability in the 14th Five-Year Plan which will be announced next year.

Leading banks will therefore, if they haven't already, start to incorporate ESG into their strategy across different service lines. Part of this could include opting into the voluntary climate-related financial risk disclosures – developed by the Task Force on Climate-related Financial Disclosures – to provide information to investors and other stakeholders. Some major international banks have already done so, and in 2020 we may see more leading banks follow suit.

We believe that a climate crisis is potentially just around the corner, and incremental change will therefore no longer suffice. What is needed is a significant step change, which will likely be driven by new and more stringent regulations. This change will also be driven by a shift in the mindset of the industry, with banks looking at sustainability as more than just a compliance tickbox exercise, and seeking to genuinely implement ESG-related products and initiatives into their core business and strategy.

In the long term, the successful banks will be the ones where the board and senior leadership truly recognise that sustainability is a real business issue – with financial implications – and take the lead in initiating a cultural shift within their organisation. To do this, banks will also need to be agile, proactive and able to change or adopt new sustainability-related strategies swiftly and efficiently.

Customer intimacy

Neil Macdonald
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Those that can leverage data to drive personalised outcomes will earn the right to survive

Creating a 'seamless experience to achieve optimal customer outcomes' is the grand ambition espoused by many banks. Hyperbole aside, what will industry leaders do in 2020 to improve the lives of their customers? Put simply, they will seek to use the vast swathes of data they have on our lives and our real, expressed preferences and nudge us, as individuals, towards improved financial health.

Banks that get this right will be less concerned about pushing their products, and more concerned about what customers are trying to achieve with their finances. This is far from being a new concept. The recent rise of credible (and scalable) challenger and digital banks whose business models are centred around customer outcomes has sharpened the minds and loosened the wallets of senior banking teams around the globe. The proliferation of technologies that can free banks from the encumbrance of their legacy infrastructure and finally open up their customer data sets is making a reality of the ambition to offer more personalised products and services.

On top of the wealth of historical information on their customers – both individuals and businesses – banks possess, they now have the ability through internet and mobile technology to monitor the behaviour of their customers in ways that they haven't been able to in the past. By bringing past and present together, leveraging data analytics at scale, leading banks can predict the products and services customers will benefit most from. Banks can then encourage customers, using the skills of behavioural economists, to take a financial decision in a fiscally responsible way. Mis-selling could become a thing of the past as the algorithm becomes our new financial guardian.

"By bringing past and present together, leveraging data analytics at scale, leading banks can predict the products and services customers will benefit most from. Banks can then encourage customers, using the skills of behavioural economists, to take a financial decision in a fiscally responsible way."

Banks that think they can win in this space but are concerned about their ability to deliver it using BAU technology management processes could create a 'digital twin' in 2020; the twin will be unhindered by the legacy processes that might otherwise delay/strangle the customer intimacy programme. This is an area where the virtual banks that are launching in Hong Kong have an edge over their traditional banking peers. What the virtual banks don't have, however, is the treasure trove of historic data locked up in banks' current systems. A digital twin – backed by a major bank – is a distinct possibility in 2020.

2020 may also see an increased focus on customer intimacy in the corporate market. There are undoubted opportunities for banks to use data to serve their corporate customers better. For example, leading banks could use their knowledge of one corporate customer and link them with another, harnessing the information they have on the expressed preferences of both to drive a friction-free transaction.

In an age where loyalty to financial services providers is declining – if indeed it ever existed beyond the gravitational pull of inertia – banks that are able to leverage the data they are sitting on to predict behaviour and create personalised experiences for their customers – personal and corporate – will give themselves a chance of long-term survival. Getting serious about achieving that in 2020 should be on the agenda of every bank that wants to still be in business in 2030.

Financial crime compliance

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"It is clear that underlying problems with combating financial crime remain. We believe the issue lies in the fact that many banks tend to focus more on technical compliance to avoid failures rather than on directly combating financial crime."

2020 will see new technology-driven, intelligence-led approaches to combat financial crime

Hong Kong's regulators and financial services industry will be pleased with the Financial Action Task Force's (FATF) recently issued Mutual Evaluation, which notes that the city has made great strides in maintaining a strong legal and institutional framework for combating money laundering and terrorist financing.

However, with a recent United Nations estimate indicating that less than 1 percent of global illicit financial flows are currently seized and frozen, it is clear that underlying problems with combating financial crime remain. We believe the issue lies in the fact that many banks tend to focus more on technical compliance to avoid failures rather than on directly combating financial crime. In 2020, we therefore expect to see continued debate around the effectiveness of the current approach to financial crime compliance.

The Hong Kong Monetary Authority (HKMA) recognises this, and in 2020 will seek to adopt approaches that were not part of the Mutual Evaluation assessment to improve financial crime compliance. This starts with looking at financial crime holistically, through a lens that covers not just money laundering, but also fraud, bribery and corruption, and conduct.

The HKMA will also increase its focus on technology in the year ahead, particularly on regtech for the banking industry, and on supervisory technology – or 'suptech' – to facilitate their supervision through a more data-driven, predictive model.

The regulator has also signalled its intent to hold a series of AML/CFT RegTech Forums to encourage dialogue and collaboration between the banking industry and technology companies to address opportunities and challenges that regtech can bring to anti-money laundering and counter-financing of terrorism work.

From an industry perspective, leading banks will adopt new and innovative cost-effective ways to enhance financial crime compliance in 2020. These approaches could include the integration of financial crime risk into compliance functions, leveraging technology and data analytics solutions, and greater industry-wide information and intelligence sharing.

As both the industry and regulators continue to embrace technology in the year ahead, we expect to see reduced compliance costs, increased effectiveness of regulatory supervision and enhanced financial crime compliance. We could also see leading banks explore the use of managed services to streamline and improve the cost-effectiveness of their financial crime compliance programmes.

LIBOR

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Banks that do not use the year ahead to develop a comprehensive transition strategy to identify and remediate their LIBOR-linked contracts, models, systems and processes, will face higher costs, and will be exposed to greater operational and reputational risk.

Greater risks and costs for banks that do not have a LIBOR transition programme

With LIBOR set to be phased out by the end of 2021, many banks in Hong Kong are still not yet prepared. Banks are not currently addressing LIBOR transition in a meaningful way and will therefore need to roll out an accelerated programme early in 2020 or run the risk of not being ready.

Banks that do not use the year ahead to develop a comprehensive transition strategy to identify and remediate their LIBOR-linked contracts, models, systems and processes, will face higher costs, and will be exposed to greater operational and reputational risk. Programmes will need to include all relevant stakeholders within the bank, both horizontally and vertically, as well as an appointed programme leader to drive and monitor the transition effort. Programmes should also be contemplated to incorporate ongoing iterations of market and regulatory developments over several years, as opposed to short-term reactivity which can lead to costly workarounds and negative value transfer for clients.

Given the sheer volume of work and the fast-compressing timeline, many banks will seek to leverage technology and artificial intelligence-enabled solutions as part of their transition programme. The year ahead will feel hard and expensive for banks as they start to uncover LIBOR buried in many of their products and processes. We therefore believe that proceeding with the transition without the aid of technology is not an option anymore. Some banks will remember the size and scale of MiFID II that proved challenging to implement – the LIBOR transition undoubtedly exceeds that exercise.

Banks that are proactive and innovative will start offering more risk-free rate-based products to clients and issuing contracts that do not reference LIBOR. There will be a competitive advantage for banks that make the first move to create new product structures that can enable them to generate revenue using the new alternative reference rates. Conduct risk will also be a key consideration for banks as they look to develop these new products.

In the year ahead, we will also see a momentum shift on the part of those the banks are servicing. As the industry and clients get themselves up to speed on the risks related to the LIBOR transition, they are likely to start demanding answers and forcing renegotiated terms with their banks. We could therefore see the opening up of litigation risk for banks in 2020. Banks will therefore want to be ahead of the curve when it comes to client outreach. The market leaders will be the ones that are more advanced in their transition programme, and that implement an effective communication plan that facilitates the identification, development and execution of key communication and training activities in each of the main stakeholder groups. This will mobilise the organisation and minimise the impact on customers, along with operational, reputational and conduct risks.

Bancassurance

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Stronger digital partnerships between banks and insurers will create win-win scenarios for all, including customers

With customers increasingly favouring digital channels for managing their financial affairs, and banks reducing the number of their physical branches to manage costs, insurers in Hong Kong are starting to rethink how they generate optimal value from their bancassurance deals. Similarly, many banks are increasingly considering how to maximise the value of their bancassurance relationships as a result of decreasing customer footfall to physical branches leading to fewer opportunities for bank relationship managers to promote and sell insurance products.

Banks undoubtedly have a wealth of customer data which, if leveraged correctly, can be turned into actionable insights and monetised. In 2020, we expect that leading insurers will develop and provide data analytics tools to banks to help them to harness the power of their data and generate more targeted leads and conversions for their bancassurance products. Questions around customer data, privacy and consent will continue to be key considerations going forward, but the banks and insurers that get this right in 2020 will start to see an increase in value from their bancassurance arrangements.

Customers, in particular the younger demographic, are also increasingly seeking a one-stop shop for their financial needs, ranging from basic banking services to holistic wealth management services. In 2020, we believe that industry-leading banks seeking to capitalise on this opportunity will work more closely with their insurance partners to create a seamless customer experience and provide a full suite of wealth management services to their clients.

With customers increasingly embracing digital channels in their daily lives – including for financial services – leading banks and insurers will use the year ahead to refine their partnerships to ensure they can jointly respond to consumer demands, and improve their customer interactions and product and service offerings to transform the way they serve their shared client base. Those banks and insurers that can crack the code and get their data, digital platforms and partnerships right will create significant win-win outcomes for all parties, increase their customer base and generate greater returns over time.

> *Banks have a wealth of customer data which, if leveraged correctly, can be turned into actionable insights and monetised. In 2020, we expect that leading insurers will develop and provide data analytics tools to banks to help them to harness the power of their data and generate more targeted leads and conversions for their bancassurance products.*

About KPMG

KPMG China is based in 23 offices across 21 cities with around 12,000 partners and staff in Beijing, Changsha, Chengdu, Chongqing, Foshan, Fuzhou, Guangzhou, Haikou, Hangzhou, Nanjing, Qingdao, Shanghai, Shenyang, Shenzhen, Tianjin, Wuhan, Xiamen, Xi'an, Zhengzhou, Hong Kong SAR and Macau SAR. Working collaboratively across all these offices, KPMG China can deploy experienced professionals efficiently, wherever our client is located.

KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 153 countries and territories and have 207,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

In 1992, KPMG became the first international accounting network to be granted a joint venture licence in mainland China. KPMG was also the first among the Big Four in mainland China to convert from a joint venture to a special general partnership, as of 1 August 2012. Additionally, the Hong Kong firm can trace its origins to 1945. This early commitment to this market, together with an unwavering focus on quality, has been the foundation for accumulated industry experience, and is reflected in KPMG's appointment for multi-disciplinary services (including audit, tax and advisory) by some of China's most prestigious companies.

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