

Risk Management and Regulation Newsletter

Welcome to the Risk Management and Regulation Newsletter

Welcome to the fourth issue of this newsletter. In the last issue of this newsletter I talked about the four stages we saw companies and institutions going through as they respond to the effects of the pandemic: **Reaction** – responding to immediate challenges; **Resilience** – managing through uncertainty; **Recovery** – resetting and identifying opportunities; and the **New Reality** – adapting to a new world. While in the summer my feeling was that many institutions in Hong Kong were very much into the Recovery stage we are definitely seeing more and more actively considering the New Reality stage and that is reflected in some of the topics we cover in this newsletter.

In this issue we will discuss:

- **Green and Sustainable Banking:** How banks manage climate risks in their business models and asset portfolios is likely to be one of the key defining trends of banking in the 2020s. We look at a recent paper by the HKMA on its future supervisory approach to this issue which should inform any framework which a bank puts in place to manage this risk.
- **Operational Resilience:** The operational resilience of banks in Hong Kong has been tested since June 2019 – and by and large the sector has responded well. Building in much greater resilience to allow banks to absorb and deal with operational shocks is however an area which requires more focus. We highlight the recent BCBS consultation document which could be implemented in Hong Kong in due course.
- **IBOR Reform:** This continues to be a topic which is driving discussions we are having with clients in Hong Kong as the deadline for new alternative reference rates to replace LIBOR is looming. As the deadline approaches we summarise the latest from the HKMA but also the latest from regulators in other jurisdictions.
- **AML/CFT and Sanctions:** This is a recurring topic in these newsletters reflecting that the fight against financial crime is one where the landscape is changing fast. In this issue the use of technology, particularly for remote onboarding, is a common thread which runs through many of the recent regulatory announcements.

We hope you find this issue informative and look forward to hearing your feedback.



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Topics in this issue:

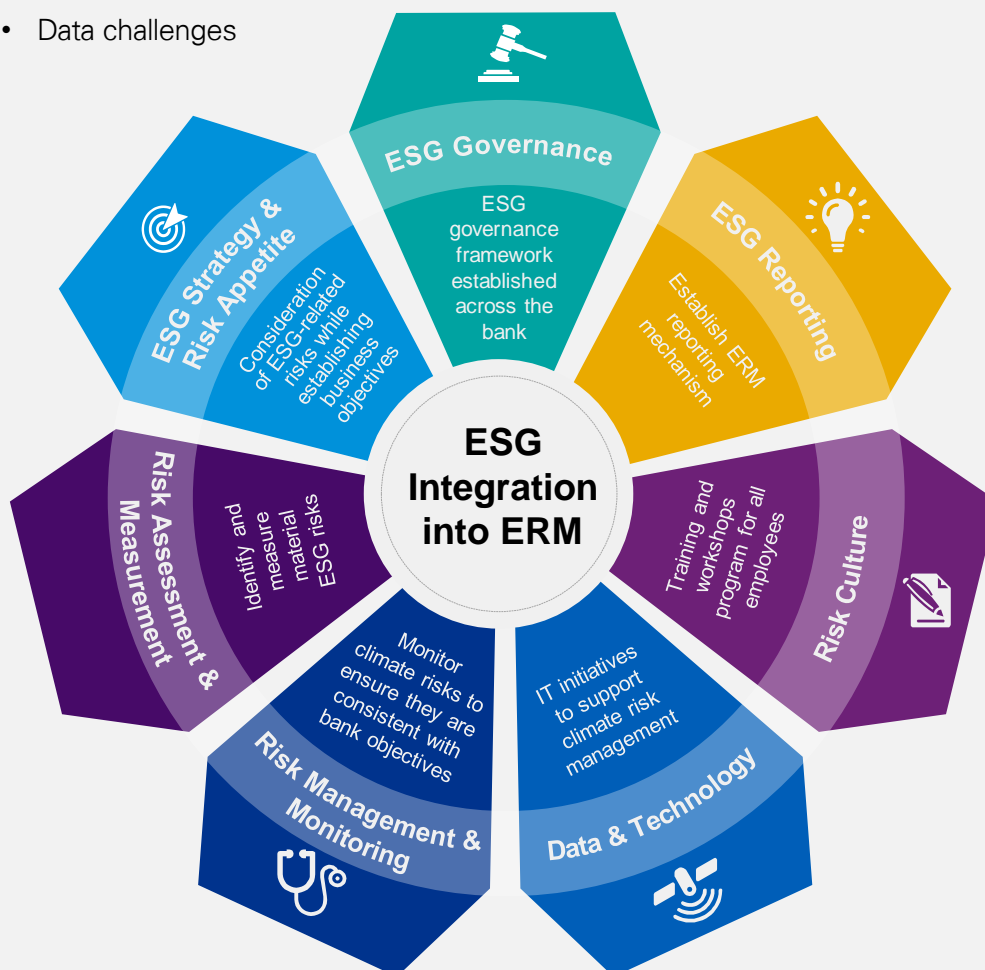
1. Green and Sustainable Banking
2. Operational Resilience
3. IBOR Reform
4. Anti-Money Laundering / Counter-Financing of Terrorism and Sanctions

Building Climate Resilience in the Banking Sector

On 30 June 2020, the Hong Kong Monetary Authority (HKMA) issued the [White Paper on Green and Sustainable Banking](#) to present its initial thinking about supervisory approaches to address climate-related issues. This paper is an excellent resource to understand the future policy direction of supervisory expectations in Hong Kong, laying out **9 guiding principles** to help AI's implement a framework for managing the risk and opportunities brought by climate change. It outlines a clear regulatory roadmap with dates and upcoming activities. **The next step will be a consultation on supervisory expectations in the first half of 2021** followed by a second self assessment later in 2021.

Integration of Environmental, Social and Governance (ESG) into bank-wide Enterprise Risk Management (ERM) and governance frameworks is the first major step to take. Senior management will need to set the tone from the top to start the integration process. Moreover, oversight of the ESG strategy implementation should be effective and measured. Moving towards full integration does present some challenges for banks in Hong Kong, which include:

- Lack of tools, methodology, and experience
- Identifying the right people to take on the ESG initiatives within the bank
- Prioritization of ESG integration activities (particularly given COVID-19)
- Data challenges



June 2020

White Paper on Green and Sustainable Banking



9 Guiding Principles:

- 1 Board Accountability in Climate Resilience
- 2 Board's Oversight of Climate Strategy Development & Implementation
- 3 Strategy Formulation
- 4 Strategy Implementation
- 5 Risk Identification
- 6 Risk Measurement
- 7 Risk Monitoring & Reporting
- 8 Risk Expose Control & Mitigation
- 9 Disclosure of Climate Related Information

Click [here](#) for the full paper KPMG published in August 2020, which includes further details of the guiding principles, how ESG can be integrated into ERM, and assessing the impact of climate-related risks.

Operational Resilience

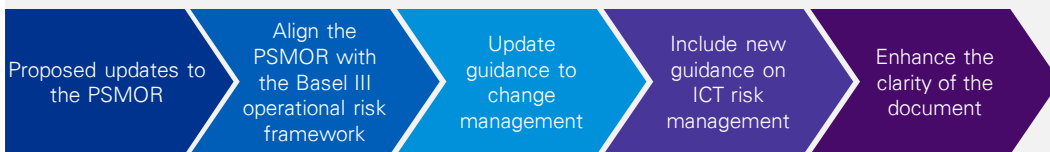
The Basel Committee for Banking Supervision (BCBS) released a consultative document [*Principles for operational resilience*](#) on 6 August 2020. Banking regulators in key jurisdictions (including Hong Kong) are expected to implement these requirements once the BCBS has finalized the consultative process.

Higher levels of capital and liquidity have improved banks' ability to absorb financial shocks, but further work is necessary to strengthen banks' ability to absorb operational risk-related events. The COVID-19 pandemic provides an example of how operations can be impacted by severe operational risk-related events and the need for banks to rapidly adapt their operational posture.

Operational resilience and the evolution of operational risk management

BCBS defines operational resilience as *the ability of a bank to deliver critical operations through disruption*. It enables a bank to identify and protect itself from threats and potential failures, respond and adapt to, as well as recover and learn from disruptive events to minimize their impact on the delivery of critical operations through disruption. In considering its operational resilience, a bank should take into account its overall risk appetite, risk capacity and risk profile.

In addition to the operational resilience principles, the BCBS has proposed updates to the [*Principles for the Sound Management of Operational Risk*](#) (PSMOR). The proposed updates are intended to address areas where, based on a 2014 BCBS review of 60 institutions, banks were found to need additional guidance to facilitate implementation of the principles.



Adopting these principles also brings business benefits

A broader approach to operational resilience is paying off. A more coordinated approach coupled with business or service simplification can result in efficiency and cost savings. A strategic and analytics-driven process can allow for better customer and supplier experience and more dynamic risk management. In addition, a strong and coordinated framework helps with regulatory compliance.



Allow better work in a dynamic ecosystem e.g. use of Fintech and start-ups



Generate synergies across strategic, financial and operational resilience



Reduce operational risks and the costs of disruption
Enhance governance and inter-regional/global collaboration



Allocate resources more effectively and efficiently
Improve supplier and third party relationships



Enhance customer (buy- and sell-side) trust and loyalty

Aug 2020

Consultative Document Principles for operational resilience Banking



Principles for Operational Resilience:

- 1 Governance
- 2 Operational Risk Management
- 3 Business Continuity Planning and Testing
- 4 Mapping interconnections and interdependences
- 5 Third-party dependency management
- 6 Incident Management
- 7 ICT including cyber security

Click [here](#) for the full paper KPMG published in August 2020, which includes further details of considerations for designing the operational resilience framework based on the principles.

Updates on benchmark interest rates

Regulatory Updates

HKMA survey results on interest rate benchmarks reform

The survey results confirm that the LIBOR linked positions in Hong Kong are financially significant. More than half of the surveyed banks have established a steering committee and/or appointed a senior executive overseeing the transition preparation, but only 38% had developed a bank-wide transition plan as of the survey submission date in December 2019. While more banks have made progress in the development of bank-wide transition plans in Q1 2020, plans should also be made to renegotiate existing LIBOR-linked contracts that go beyond 2021, as well reduce the LIBOR exposures by introducing new ARR products.

The HKMA also announced transition milestones for AIs to achieve, which will impact the transition plans of the banks. Several banks find it most challenging to offer new products referencing the ARRs by 1 January 2021. Given the lengthy process of changing systems and processes to achieve this, banks should prioritize this task and initiate the conversations with third-party vendors and internal technology department.

Updates from global banks

The Bank of Canada became the administrator of the Canadian Overnight Repo Rate Average (CORRA) in June, publishing methodology and guidance materials to assist firms in incorporating the use of CORRA.

The Bank of Japan and Financial Services Agency have written a letter to CEOs of large FIs on the LIBOR transition, requiring them to submit their plans and required materials by Friday 10 July.

The Bank of England confirmed the methodology it will use to produce the SONIA Compounded Index, and provided an example of the calculation in its paper. Firms should prepare for the publication of the rate in August.

Industry Updates

ARRC best practices for LIBOR transition and 2020 key objectives

The Alternate Reference Rates Committee published best practices with recommendations for various products where institutions must take active steps to meet the timeline. FIs should have clear transition plans to move from USD LIBOR across all activities. Its 2020 objectives directly address the key challenges faced by FIs as indicated in the HKMA survey results.

Bloomberg published a rulebook for IBOR fallback methodology

Bloomberg calculated and published the final methodologies for the fallbacks of certain key IBORs, setting the foundation for adopting RFRs. While alternative RFRs are different in nature compared to IBORs, corresponding adjustments are necessary for RFR fallbacks on LIBOR-linked contracts. FIs should assess and prepare to implement the final fallback adjustment methodology in contracts expiring after 2021.

2021

LIBOR ceases at
end of 2021

HKMA transition milestones:

- I. AIs should be in a position to offer products referencing the ARRs to LIBOR from 1 January 2021;
- II. Adequate fallback provisions should be included in all newly issued LIBOR-linked contracts that will mature after 2021 from 1 January 2021; and
- III. AIs should cease to issue new LIBOR-linked products that will mature after 2021 by 30 June 2021.



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.

Landscape of Regtech and AI in Hong Kong

The Hong Kong Monetary Authority (HKMA) launched a [survey](#) with the help of KPMG on 27 July 2020 to understand the current state of Regulatory Technology (Regtech) adoption in the banking sector and will arrange a series of interviews with selected authorized institutions and technology firms to collect their views and insights. Based on the results of the survey and interviews, the HKMA will publish a white paper on Regtech which would analyse the Regtech landscape, identify the pain points for Regtech adoption, and set out a roadmap for encouraging Regtech growth and talent development.

The Hong Kong Institute for Monetary and Financial Research (HKIMR) released a report in August 2020, titled "[Artificial Intelligence in Banking: The Changing Landscape in Compliance and Supervision](#)", which is part of a research project on the adoption of artificial intelligence (AI) in banking and carried out in collaboration with the HKMA. The report indicated that there is a clear trend of using AI in banking, with over 80% of the banks planning to increase investment in AI over the next five years, and that interviews with industry practitioners revealed that AI applications empowered by machine learning are powerful tools for identifying suspicious activities and helps reduce the number of false alarms. The report also highlighted that the broader use of AI will create new opportunities and may expose banks to new risks including cyber threats and suggested that a robust governance framework would require effective monitoring of three key aspects of AI model risks including data inputs, model design and validation.

KPMG's [Sanctions Alert Classifier](#), which leverages AI to automate the sanctions alert review process, has helped a large international bank to reduce false positives by 80% and recently won [OpRisk Awards 2020](#).




HKMA amends Guideline on AML/CFT for Stored Value Facility (SVF) licensees

The HKMA published the revised the [Guideline on Anti-Money Laundering/Counter-Financing of Terrorism \(AML/CFT\) \(for SVF licensees\)](#) on 18 September 2020. The new guideline will [take effect](#) on 2 July 2021 to allow sufficient time for SVF licensees to make preparations to implement the revised guideline.



The amendments took into account the assessment made by the Financial Action Task Force (FATF) in the Hong Kong Mutual Evaluation Report (MER) issued in 2019 and international developments in the regulatory regimes for SVF. It also updated emerging money laundering/terrorist financing (ML/TF) risks identified in some aspects of SVF licensee operations as the sector develops, while retaining flexibility in customer due diligence (CDD) requirements. In particular, key amendments include introducing a "tiered approach" to CDD which replaced the existing "streamlined approach" and providing additional guidance for remote customer on-boarding, articulating the principles of identity authentication and identity matching.

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

Takeaways from HKIMR report on AI in Banking:

-  Optimistic prospects on the use of AI by the banking industry
-  AI poses new risks and challenges including cyber threats
-  Governance framework should monitor three key aspects of AI model risks including data inputs, model design and validation

Key amendments on AML/CFT Guideline for SVF licensees:

-  Tiered approach: account limits and different functions depending on whether the customer's identity has been verified
-  Remote customer on-boarding: guidance on the principles of identity authentication and identity matching

HKMA circulars on remote customer onboarding

The HKMA issued a [circular](#) on 3 June 2020 to share key observations and good practices in AML/CFT control measures that have been identified in recent thematic reviews of remote on-boarding initiatives of authorized institutions and technology firms in the Fintech Supervisory Sandbox and Chatroom, as well as supervision of virtual banks. The HKMA recommended that AIs should: (i) adequately assess Money Laundering/Terrorist Financing risks associated with a remote on-boarding initiative prior to its launch; (ii) apply a risk-based approach in the design and implementation of relevant control measures; (iii) monitor and manage the ability of the technology adopted to meet AML/CFT requirements on an ongoing basis; and (iv) take into account the vulnerabilities associated with the product and delivery channel during on-going monitoring of customers' relationships.

The HKMA issued a [circular](#) on 24 September 2020 to articulate key principles in relation to remote on-boarding of corporate customers based on use cases and proposals gathered through our ongoing engagement with the industry. The HKMA highlighted in the circular that the CDD requirements for corporate customers are more extensive compared with individuals. For instance, Authorized Institutions (AIs) are required to identify and verify the connected parties (e.g. the representatives and beneficial owners) of the corporate customers. The HKMA suggested that AIs may utilize various means, including but not limited to, using third party intermediaries to conduct CDD on their behalf; using an independent and appropriate person to certify identification documents; and using appropriate channels such as video conference for customer interaction. The HKMA also suggested that the use of technological solutions can enhance the remote onboarding process for corporate customers as well as manage the respective risks more effectively and efficiently.

SFC's consultation on AML/CFT Guideline

The Securities and Futures Commission (SFC) has launched a three-month [consultation](#) on proposals to amend its AML/CFT guidelines on 18 Sep 2020.

The proposed amendments would facilitate the adoption of a risk-based approach to AML/CFT measures by the securities industry and address some areas for enhancement identified in the latest FATF MER of Hong Kong. The amendments also include additional measures which would help mitigate risks associated with business arrangements such as cross-border correspondent relationships. Market participants and other interested parties are invited to submit their comments to the SFC on or before 18 December 2020.

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



Thematic reviews feedbacks:



Adopt risk-based approach in design and implementation of control measures



Perform ongoing monitoring of the technology and the vulnerabilities associated with the product and delivery channel



Remote onboarding of corporate customers



Consider appropriate channels (e.g. video conference) for customer interaction



Use reliable technology solutions to facilitate verification of identity of a corporate's representatives and beneficial owners



SFC's consultation on AML/CFT Guideline



Amendments considered FATF MER of Hong Kong



Include additional risk mitigating measures on cross-border correspondent relationships

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