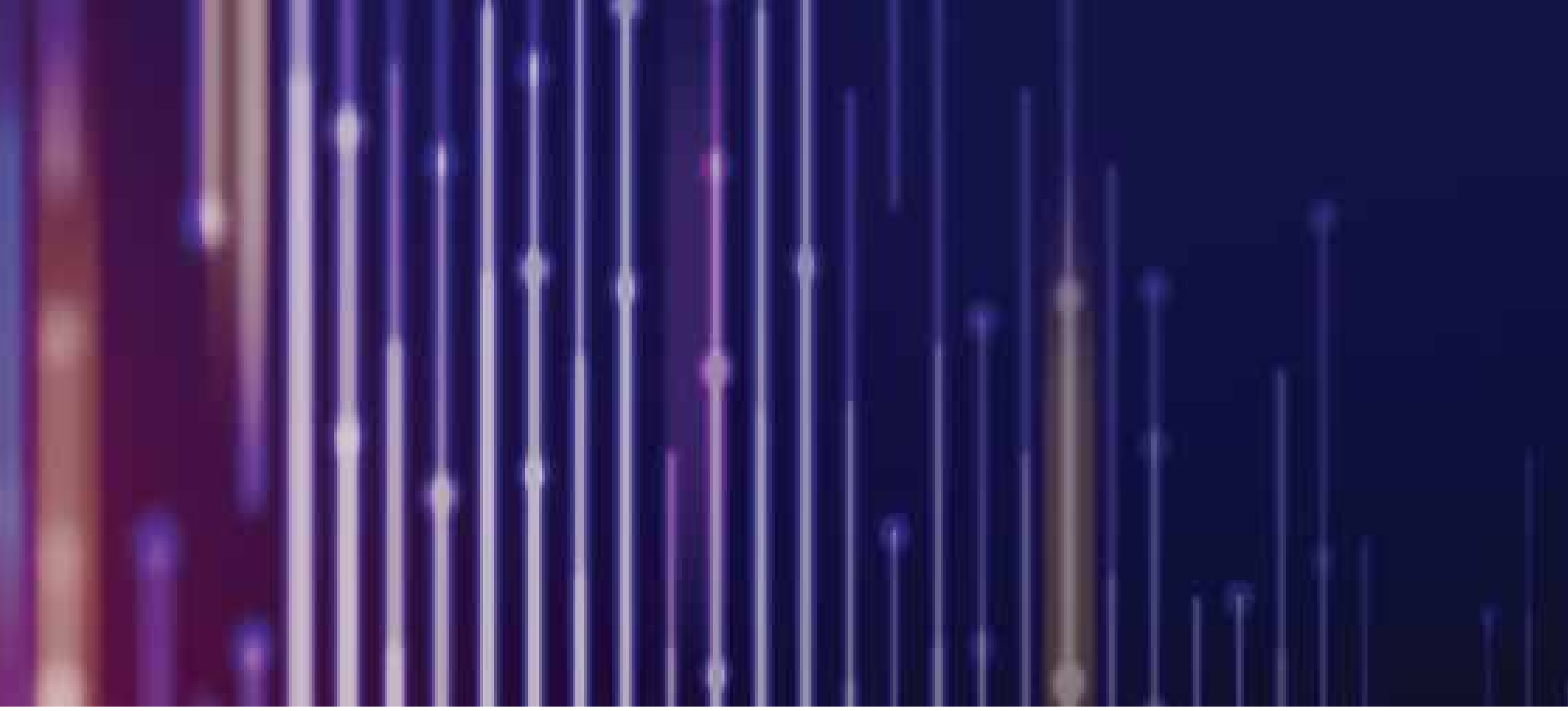
Hong Kong Banking Outlook 2021

kpmg.com/cn

Contents



Overview

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

Despite challenging times, there are bright spots ahead for the industry in 2021

Welcome to our outlook for 2021, where we forecast the key developments and trends that will impact and shape Hong Kong's banking industry. When we issued our outlook for 2020 last December, Hong Kong's economy and banking sector were facing market uncertainty and disruption largely due to social unrest and US-China trade tensions. It is safe to say that everyone was looking forward to 2020 as a chance for Hong Kong to reset and start the year with a clean slate.

However, the last 12 months have proven to be an unprecedented period of uncertainty, disruption and difficulty not just for Hong Kong, but for the entire world. As the end of 2020 nears, we once again look forward to putting the year behind us and are hoping that the next year is brighter. There are positive signs on the horizon, with potential vaccines showing encouraging results, travel bubbles starting to open up, and life starting to return to normal in some areas. However, we expect 2021 to still be a year where economies, industries, businesses and individuals grapple with the challenges that COVID-19 has brought in terms of how we live and work.

In this report, KPMG subject matter experts provide a number of predictions for the banking industry across 10 key areas. Unsurprisingly, the transition to a new reality brought about by COVID-19 is a key theme that is woven throughout many of these focus areas.

Overall, our outlook for 2021 is focused on two broad themes. The first is the rapid transformation of business models and operating models as a result of the pandemic, and the acceleration of digital transformation initiatives as part of this. There are a number of opportunities that banks will seek to explore around this in 2021, including the adoption of Regtech solutions, the digitalisation of their tax function, and partnering with external vendors and service providers, all while keeping customer-centricity front and centre of their digital strategy.

The second theme is around Hong Kong's continued role as an international financial centre, and as a conduit for both inbound capital into mainland China and Chinese outbound investment. This includes opportunities around Hong Kong's role as the financial services hub for the Greater Bay Area, and its ambitions to develop into a green finance hub for Asia. These are both areas where we expect the government and regulators to continue to push for a bigger role for Hong Kong, which could lead to financing opportunities for banks.

Ultimately, the ability of banks to effectively transform their business and operating models will be the key to success in 2021. The banks that embrace digital transformation to manage costs, while at the same time provide an enhanced customer experience and safeguard the trust of their clients, will be best placed for success in the year ahead.

I hope you enjoy our predictions for the sector in 2021, and would welcome the opportunity to discuss the current industry landscape.

Sector outlook

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

The shift from interest income to fee-earning activities will create growth opportunities for banks that get it right, but be wary of the risks

With Hong Kong weathering the challenges brought about by COVID-19 relatively well in terms of containing the virus, ensuring operational resilience and pushing through financial relief measures for businesses, the banking sector has also remained in reasonable shape in 2020. The fact that mainland China is also returning to normal and economic growth is starting to pick up is another positive indicator for Hong Kong, as a key conduit for capital flowing into and out of mainland China.

However, interest rates will continue to remain low for the next few years, which will affect banks' ability to generate revenue from net interest income. Many banks will therefore explore how they can shift their reliance on interest income to a greater focus on fee-earning activities. With deposit accounts becoming less profitable, in the second half of 2021 we could see some banks in Hong Kong consider levying fees for account balances, particularly for smaller accounts.

The increased focus on fee-earning activities, particularly at a time when there is a lot of volatility and investment uncertainty, underscores the importance of ensuring proper conduct and treating clients fairly. In particular, there will be an increased focus on pricing and product suitability in the year ahead.

The relief measures offered by government authorities and banks such as loan deferral and employee support schemes helped many businesses through a challenging 2020. However, we do not expect these measures to persist throughout 2021, or at least not with the same level of financial support as in 2020. If the situation globally and in Hong Kong remains largely the same in 2021 with economic growth stagnating, we will start to see more defaults on loans – particularly unsecured debt such as credit cards and personal loans – as well as corporate non-performing loans. However, this may not lead to a flurry of bankruptcies as we predict that banks will take a more considered approach to distressed businesses and individuals and balance the financial return and the fair treatment of customers. A key success factor for banks in 2021 will be their ability to effectively assess which businesses can be turned around if the economic environment improves, and which organisations are likely to remain unprofitable irrespective of the situation.

The ability of banks to transform their business model will also be a key differentiator for success. Indeed, with increasing pressure on profitability, the successful banks will be those that can manage their operating costs while providing a holistic and digitally enabled customer experience. The banks that truly embrace digital transformation, thus lowering costs and enhancing customer experience, will start to pull ahead of the pack in 2021. This could have a virtuous cycle effect, leading to new customers and more business.

The key for banks that are pursuing digital transformation during this challenging period is to ensure that they safeguard the trust of their clients. As many banks embrace rapid digitalisation, it is crucial that they bring their customers along with them on the journey in a way that is safe and secure. Effectively managing cyber, emerging technology and third party risk, as well as ensuring data privacy and protection will therefore be key to retaining the trust and confidence of their clients, which will ultimately determine a bank's long-term success.

> *"With deposit accounts becoming less profitable, in the second half of 2021 we could see some banks in Hong Kong consider levying fees for account balances, particularly for smaller accounts."*

Non-performing loans

Patrick Cowley
Partner, Head of Restructuring Services, Hong Kong and Asia Pacific
KPMG China

Guy Isherwood
Senior Advisor
KPMG China

> *While disposing of NPLs will remain a key tool for banks, some will elect to continue to hold NPLs on their books, working with borrowers to turnaround stressed situations, rather than sell them off and thereby crystallise what could be a significant loss.*

NPLs in Hong Kong expected to increase as businesses face prolonged economic uncertainty

Despite signs of recovery in mainland China, banks in Hong Kong will need to maintain extreme vigilance as non-performing loans (NPLs) are expected to increase in 2021.

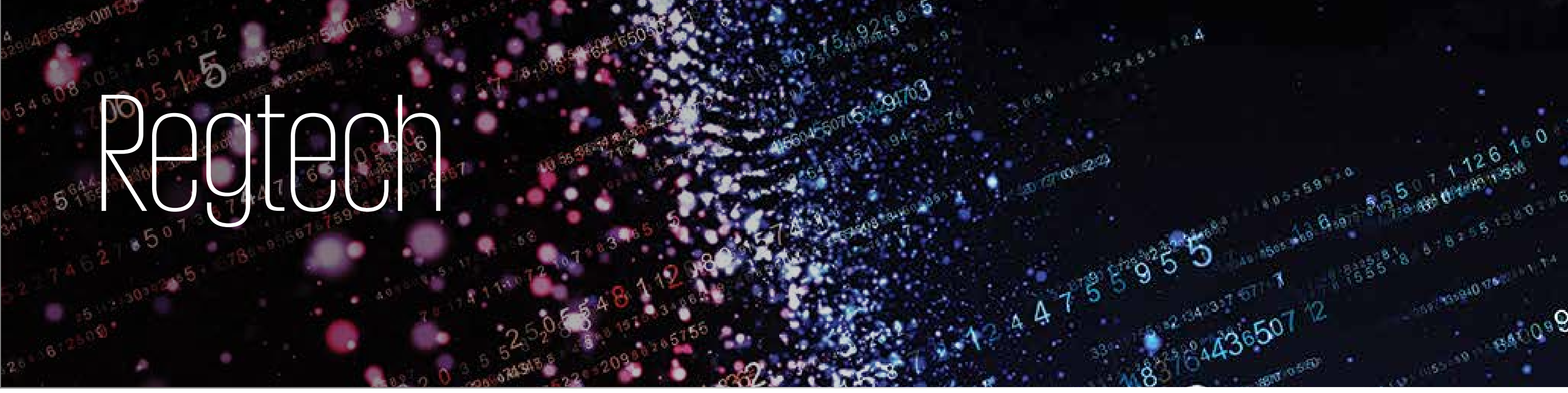
Mainland China continues to show signs of recovery from the COVID-19 pandemic. Gross domestic product grew 4.9% in the third quarter of 2020 (compared to 3.2% in the second quarter), domestic aviation is picking up as people increasingly travel within the country, and life is generally returning to normal. The recovery of mainland China is also expected to generate some positive momentum in Hong Kong's economy and financial services sector, although it should be noted that an increasing number of defaults among China's SOEs is suggestive of stress in the economy.

The banking sector will need to remain vigilant as there remains a concern about the quality of the assets in banks' loan portfolios. Many companies are still struggling with the consequences of ongoing US-China trade tensions, protectionism around supply chains, and changing commercial patterns as a result of COVID-19. These are causes for concern, particularly for the banks in Hong Kong that are exposed to mainland China's SME sector. Many banks will use the year ahead to ensure that, in the new reality where there the ability to conduct site visits is limited, they have full transparency and visibility into the financial state of their clients.

In Hong Kong, both government and non-government led assistance and relief efforts, such as the Employee Support Scheme, bank moratoriums on loans, voucher programmes and other fiscal measures are potentially generating a sense of recovery or stability in Hong Kong that may not be sustained into next year. The relief measures have undoubtedly benefitted many businesses and created demand in some sectors, but they cannot last forever. Once the relief packages have been exhausted – which we expect to happen in 2021 – then we will start to see real volatility across a number of sectors. At that point, banks will start to see decreasing asset quality across their portfolios. While disposing of NPLs will remain a key tool for banks, some will elect to continue to hold NPLs on their books, working with borrowers to turnaround stressed situations, rather than sell them off and thereby crystallise what could be a significant loss.

Leading banks in 2021 will pay close attention to what other lenders are doing across their portfolio. This will help them identify earlier which lenders are pulling customers' credit lines and demanding repayment – which can create a domino effect as other lenders follow suit.

Sadly, as the situation deteriorates in 2021, instances of fraud are also likely to increase. To be successful in 2021, banks will need to invest in and leverage data analytics tools and solutions to gain more in-depth insights and transparency into their customers to identify indicators of fraud earlier. This data-based approach needs to operate in tandem with repeated coaching of relationship managers, as the bank's first line of defence, to help them recognise the different red flags and indicators of fraud.



Regtech

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

Jianing Song
Partner, Head of Banking Advisory Hong Kong
KPMG China

> *The successful banks in 2021 will be the ones that look beyond deploying Regtech as a purely defensive strategy – solely for risk management and regulatory compliance – and instead use these solutions to pursue their growth agenda.*

Regtech adoption will not be an aspiration in 2021, it will be a necessity

With COVID-19 rapidly transforming business and operating models, the application of regulatory technology – or 'Regtech' – will transform risk management and compliance and present significant growth opportunities for banks in Hong Kong in 2021.

There continues to be clear regulatory support for the adoption of Regtech and its underlying technologies, such as cloud. The Hong Kong Monetary Authority's recent white paper on Regtech[1] – which KPMG China was commissioned to help develop – sets out 16 recommendations that the regulator will focus on in the year ahead to boost awareness and promote greater adoption in Hong Kong.

This is also a sign that the regulators are becoming more technology savvy. We predict that in the coming year the regulators will increasingly demand more granular and near real-time data from banks. They are then likely to use these data sets and results from banks with their supervisory technology (Suptech) platforms to form a holistic risk view of the broader market, down to the client, bank segment or individual bank level, and even to specific divisions, teams or individuals within a bank.

Leading banks will follow suit in the year ahead to ensure that they adopt Regtech solutions effectively and focus on taking a data-driven approach to meet regulatory requirements. They will also rapidly adapt to the much more digitalised execution and delivery model in the new reality brought about by COVID-19. Banks that have not implemented Regtech will start to explore these technologies, while those that have already adopted solutions will expand their use cases across more application areas. For example, while the most common Regtech use cases have traditionally focused on AML and KYC, in 2021 we will see banks explore Regtech solutions that are more focused on the middle and front office.

Leading banks exploring Regtech are building this at an enterprise level and are adopting a platform-based rather than a team/division-specific approach. While this approach may take longer, the holistic value and benefits of this integration will be much greater over time, and the foundations of this platform will ultimately enable banks to quickly iterate and roll out different versions. This will transform a risk or compliance use case into something that can benefit markets, client-facing staff and client engagement. This is the same approach that regulators are also moving ahead with – looking at the right foundations they need to build (such as data, common development process, information sharing across divisions) to enable a more holistic Suptech solution.

The successful banks in 2021 will be the ones that look beyond deploying Regtech as a purely defensive strategy – solely for risk management and regulatory compliance – and instead use these solutions to pursue their growth agenda. The right tailoring and tweaking of certain solutions can enable banks to not only reduce costs and drive greater efficiency and transparency across their organisation, but also to create a better customer experience and support revenue-generating activities.

In the year ahead, we expect many banks to actively consider the areas that can be addressed with Regtech solutions, engage with Regtech providers, trial new technologies in a controlled manner and co-invest in proofs of concept. Importantly, the successful banks in 2021 will be the ones that embrace innovation with regard to Regtech, understanding that there will be success and failure along the way, and take bold steps to sponsor initiatives that can unleash the full potential of Regtech throughout their organisation.

[1] 'Transforming Risk Management and Compliance: Harnessing the Power of Regtech', Hong Kong Monetary Authority, November 2020, https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2020/20201102e3a1.pdf

Financial crime compliance

Kyran McCarthy
Partner, Asia-Pacific Head of AML & Sanctions Services
KPMG China

Rani Kamaruddin
Partner, Head of AML & Sanctions, Hong Kong
KPMG China

Mary Wong
Partner, AML & Sanctions Services, Greater Bay Area
KPMG China

Regtech, network analytics and information sharing key to combating increasing financial crime in 2021

COVID-19 has created a new reality for banking, transforming business and operating models and ways of working, and accelerating digitalisation efforts across the front, middle and back office. We predict that one outcome of this in 2021 will be that all retail banks in Hong Kong will have a digital on-boarding channel, with a significant majority of new customers being on-boarded entirely digitally.

However, the rapid digitalisation of banking is also increasing risks and exposure to bad actors in the financial system. We expect instances of fraud and cybercrime to increase significantly in the year ahead as criminals seek to exploit and target banks that are seen to be more willing to pay ransoms at the threat of customer data being compromised if they refuse to pay.

We will therefore see banks place a significant amount of focus on ensuring that these heightened and emerging risks are properly managed and that they remain resilient. Leading banks will adopt a more holistic approach to financial crime and wider compliance in the year ahead, and will seek to embrace Regtech solutions to achieve this.

As part of this, there will be a greater focus on improving the quality and analysis of data to enable banks to effectively deploy their Regtech solutions and pursue an intelligence-led approach to financial crime compliance. For example, the effective use of network analytics will make banks' transaction monitoring systems more effective, allowing them to better identify potential red flags and hotspots that will actually result in criminal prosecutions.

We will also see more discussion and focus on public-private partnerships in Hong Kong in 2021. There will be greater collaboration among banks and also between banks and regulators in Hong Kong through the sharing of information, data and expertise. The greater adoption of Regtech solutions and data analytics tools will help to facilitate greater sharing of strategic and operational intelligence on financial crime.

Ultimately, the rapid transformation of ways of working for all stakeholders in the ecosystem – regulators, banks, employees and customers alike – has also served to further emphasise the importance of trust. The successful banks in the year ahead will be the ones that are able to maintain – or even strengthen – the trust of their customers and the community in this new reality, and by demonstrating that they are able to protect the community against harm and are of service to society. Ensuring robust risk management of financial crime will go a long way in achieving this ambition in 2021.

> *We expect instances of fraud and cybercrime to increase significantly in the year ahead as criminals seek to exploit and target banks that are seen to be more willing to pay ransoms at the threat of customer data being compromised if they refuse to pay.*

Digital transformation

Stanley Sum
Partner, Advisory, Management Consulting
KPMG China

Sean Ren
Associate Director, Strategy and Performance, Hong Kong
KPMG China

> *2021 might be the year where we see the formation of creative partnerships where the banking brand takes a back seat in order to be more relevant to the end customer.*

Digitalisation set to transform SME banking in 2021, while non-banking-led partnerships will emerge in retail banking

With Hong Kong's banking sector undergoing rapid digital transformation this year, the banks that venture beyond pursuing fundamental digital initiatives such as basic automation will reap the benefits, while those who do not will struggle to remain competitive.

On the SME banking side, after several years of inertia, 2021 will be a year of significant transformation. The ambitious traditional banks will go beyond existing services on electronic channels such as transaction processing and treasury, and seek to become more integrated with client business, covering their needs in day-to-day operations and providing insights to their business with different solutions and analytics capabilities.

In addition, many virtual banks, having established their retail banking business in Hong Kong this year, might step into the SME banking space in 2021. They are likely to target SMEs for treasury management, financial product, and payroll and payment activities. This push from both traditional and virtual banks will make the SME banking industry in Hong Kong more digitalised and competitive in the year ahead.

From a retail banking perspective, the launch of virtual banks in Hong Kong, coupled with the impact of COVID-19, will continue to accelerate digitalisation efforts among traditional banks. The key to success will lie in banks that place customer-centricity front and centre when driving their digital strategy in 2021. There will be an increasing focus on their front end, specifically on improving customer engagement and experience – this has now become a mainstream expectation for all retail customers that conduct activities through their mobile devices. Leading banks will not only be targeting the next generation of clients, but any digitally savvy client.

The more ambitious retail banks will seek to rapidly grow their broader ecosystem by partnering with the right brands and start-ups relevant to their customers to help take customer engagement and experience to the next level. There are significant opportunities for the banks that do this right to differentiate themselves by introducing new use cases that address a range of financial and broader lifestyle needs. 2021 might be the year where we see the formation of creative partnerships where the banking brand takes a back seat in order to be more relevant to the end customer.

The new reality for banks brought about by COVID-19 means that digital ways of working are now the minimum expectation. Leading banks will be the ones that embed a digital mindset across everything that they do – from undergoing a truly agile digital transformation that will replace traditional ways of working with new digital solutions, to effectively conducting all customer-facing and revenue-generating activities digitally.

Ultimately, the trend toward digital transformation will not stop. If anything, it will continue to accelerate. With the hope that the pandemic situation improves in 2021, banks will make a renewed effort to push their products and services out via digital channels.

Operational resilience and third party risk management

Isabel Zisselsberger
Partner, Strategy and Performance, Financial Services
KPMG China

Banks that bolster their operational resilience and third party risk management in 2021 will be best placed for success

Operational resilience and being resilient has become the de facto norm in 2020. Banks are now recognising and adapting to the new reality brought about by COVID-19, and the resulting impact this is having on business and operating models. We predict that banks will significantly increase their focus in the year ahead on optimising their setup for more remote and agile working. However, the reality is that some banks are still not fully equipped or ready for this change. Leading banks will therefore proactively take a client-centric view and assess their readiness and resilience in providing critical services to their clients in the new working environment. This means bringing departments and teams across the organisation together to manage an end-to-end resilience framework.

Resilience covers a broad range of topics and disciplines that work together to protect the organisation from disruption. In particular, third party risk and resilience has received significant focus and will continue to do so. As traditional banks increasingly engage and partner with third party vendors to enhance their digital capabilities, this also heightens the need to ensure robust third party risk management (TPRM). While we do not predict any major operational resilience and TPRM incidents among banks in Hong Kong in 2021, we do expect to see an increasing number of issues and challenges arise as the impact of the economic downturn and the reduced ability to conduct audits as a result of COVID-19 is felt across the value chain. In addition, there will continue to be regulatory focus on both resilience and third party management.

While we do not predict any major operational resilience and TPRM incidents among banks in Hong Kong in 2021, we do expect to see an increasing number of issues and challenges arise as the impact of the economic downturn and the reduced ability to conduct audits as a result of COVID-19 is felt across the value chain.

Banks are realising that they have not been as good at managing third party risk as they might have previously thought. This is because their TPRM processes have not been kept up to date and do not allow for dynamic risk assessment, and because the pandemic has influenced risk patterns. This could be a cause for concern as many of the fintech firms, start-ups and emerging platforms that banks have partnered and worked more closely with in recent years might have been impacted by the challenging economic environment. Banks will therefore invest more in suitable digital solutions and control mechanisms in 2021 to ensure more robust TPRM.

Banks will also increasingly focus on traceability and transparency of their external service providers, partners and suppliers, and ensure that they effectively monitor and manage not just third party risks, but fourth party risks along the chain as well.

Related to this, sustainability and social issues are becoming increasingly important focus areas for banks, with the pandemic leading many customers to place a greater focus on family, well-being and sustainability. Leading banks will be able to successfully incorporate these views and preferences into their processes and across their business. This includes factoring in sustainability-related issues when assessing and working with third party providers and suppliers. Banks that work with third parties that are doing right by their community will see their brand recognition grow, while those that are seen to be working with dubious vendors risk damaging their reputation.

In 2021, the successful banks will be those that transform their resilience frameworks to become more holistic, and that focus on new and existing third parties being subject to ongoing risk management throughout the relationship lifecycle. Leading banks will ramp up investment in digital and Regtech solutions to help them manage all of these processes on a timely basis. Resilience and TPRM done well will present a positive business case for banks, reaping rewards from better client experiences and third party engagement.

Regulatory focus areas

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

Terence Fong
Partner, Head of Chinese Banks, Hong Kong
KPMG China

Edna Wong
Partner, Financial Risk Management
KPMG China

Credit risk and emerging risks arising from new business models will be front and centre for regulators in 2021

Hong Kong's banking industry has faced unprecedented challenges over the past 12 to 18 months as a result of COVID-19, social unrest and ongoing US-China trade tensions. These challenges have brought operational resilience and credit risk management to the fore, and have given rise to new and evolving risks as banks transform their business models to adapt to the new reality. In 2021 we expect banks to continue with their agile working arrangements, and therefore we expect the regulators to increase their focus on ensuring that banks demonstrate sound and robust risk management practices, systems and controls to effectively manage the increasing levels of credit and emerging risk.

As credit quality continues to deteriorate, robust credit risk management will be essential

2020 saw the government, regulators and banks in Hong Kong provide a number of relief measures in the form of loan guarantee schemes and principal payment moratoriums to support businesses in light of COVID-19. While these measures are aimed at stimulating the economy and encouraging lending, they are simultaneously presenting additional challenges for banks in terms of their credit risk assessments. We therefore expect an increasing regulatory focus on the overall credit risk outlook in Hong Kong and on banks' processes and controls to ensure that credit risk is effectively managed.

The year ahead will be critical for the Hong Kong Monetary Authority (HKMA) to manage the tension between focusing on the financial soundness of banks and encouraging the sector to increase lending to get more capital flowing into the economy. For their part, banks will also use 2021 to strike the right balance between managing their credit risk tolerance and their social responsibilities.

Operational, technology and third party risk will increase as banks transform

The significant disruption experienced this year has led banks to transform their business and operating models to become more agile and digitally enabled. However, these new ways of working are not only creating new risks for banks, but also increasing certain traditional risks. For example, the rapid digitalisation of banks' business models is increasing operational and technology risk, and has broadened the cyber threat landscape. We expect the regulators to increase their focus on these areas in 2021, particularly around operational resilience, outsourcing risk and data leakage risk. Furthermore, with banks increasingly leveraging emerging technologies such as artificial intelligence, we expect to see a continued focus on ensuring that appropriate governance and controls are put in place to manage the evolving risks these new technologies can bring.

As banks' business models continue to become more platform-based and reliant on external vendors and suppliers, the regulators in Hong Kong will also place cybersecurity and third party risk management front and centre in the year ahead.

Capacity building a key enabler for transformation

Another key focus area for regulators will be on whether banks have the right skill sets and resources to effectively transform their business and operating models. The HKMA is expected to work with industry stakeholders in the year ahead to tackle skill gaps and nurture the development of professionals that possess both soft skills such as creativity and adaptability, and technological and data skills.

Pat Woo
Partner, Head of Sustainable Finance, Hong Kong
KPMG China

> *Leading banks will focus on setting a firm-wide ESG strategy covering all aspects of governance and planning through to disclosures and communication – with a focus on climate and environmental risks – and conducting relevant scenario analysis and stress testing.*

Banks will take firm action to integrate ESG into their business in 2021, with a focus on capacity building

Despite a challenging and disruptive 2020 that has caused banks to rethink their business and operating models, environmental, social and governance (ESG) issues will remain a key priority for banks in Hong Kong in the year ahead. The first set of 50 licensed banks have completed their self-assessments as part of the Hong Kong Monetary Authority's (HKMA) Common Assessment Framework – which measures an institution's readiness to manage climate and environmental-related risks – and the HKMA is expected to call on the remaining banks to follow suit.

As part of the next phase in 2021, the HKMA will ask the banks that have completed their self-assessments to perform a gap analysis and develop a roadmap for ESG development and integration. Leading banks will focus on setting a firm-wide ESG strategy covering all aspects of governance and planning through to disclosures and communication – with a focus on climate and environmental risks – and conducting relevant scenario analysis and stress testing.

However, we expect many banks to find their climate change analysis to be too academic and technical. Many banks will seek to carefully balance the practicality and usefulness of their analysis and efforts to ensure that the results are meaningful and the subsequent actions are achievable in the short to medium term.

There will also be a greater need in 2021 for capacity building across different parts of the bank, especially as ESG gets woven into the lending practices in corporate banking. More relationship managers in corporate banking and private banking will be trained on what this means to their day-to-day practice. There will also be more discussions with private banking clients as to what ESG investing looks like beyond thematic products. From a product perspective, we will see an increase in green and sustainability-linked loans and bonds being issued in the market.

Beyond risk management, one key to success will be whether banks' boards are fully aligned and supportive of ESG integration throughout the organisation. For international banks, many of which have deferred ESG activities to their head office, they will need to ensure that their local board members in Hong Kong are brought up to speed and are driving development.

Importantly, the banks that will make the most headway in ESG development and capacity building in 2021 will be the ones that recognise that incorporating ESG thinking into existing systems and frameworks does not mean that they have to invest significant resources into new hires. Instead, these banks will seek to utilise and upskill their existing teams that manage risk management, governance, strategy, stress testing and scenario analysis.

Lastly, China's recent announcement that it will commit to becoming carbon neutral by 2060 will have a significant impact across sectors. Leading banks will proactively monitor developments in this space, and focus on what the affected sectors are likely to be, what the transition might look like, and what opportunities this presents to the banking sector.

Tax Reimagined

John Timpany
Partner, Head of Tax, Hong Kong
KPMG China

Matthew Fenwick
Partner, Corporate Tax Advisory
KPMG China

Banks will increasingly consider leveraging external solutions and advisors that can provide greater efficiency and smart use of technology to transform their operating model, provide more support to the front office and enhance their day-to-day tax compliance.

BEPS 2.0 developments and the impact of COVID-19 will expedite the digitalisation of banks' tax functions in 2021

The rapidly changing environment caused by COVID-19 and the resulting disruption to organisations – including their tax functions – is spurring banks to explore a fresh approach to managing their tax obligations. Leading banks in this space in 2021 will expedite the use of approaches such as *Tax Reimagined* – a holistic KPMG framework that helps organisations devise a strategy to meet their tax obligations efficiently and effectively – to reduce costs, improve quality and unlock value from their tax function. The primary objective of this is to release the tax function from routine tax compliance to enable them to focus on value-added strategic business advisory and key risk management activities.

In particular, the old-fashioned manual model of triple handling information request lists – through a bank's tax function, finance function and offshore centre – for structured and unstructured data will become even more cumbersome and less efficient than before due to increased remote and agile working arrangements as part of the new reality of banking. Banks will therefore increasingly consider leveraging external solutions and advisors that can provide greater efficiency and smart use of technology to transform their operating model, provide more support to the front office and enhance their day-to-day tax compliance.

While banks will expedite their approach to *Tax Reimagined*, and in particular the use of technology to deliver the financial information required for tax returns, we also expect the Inland Revenue Department, like most tax authorities in Asia, to accelerate the automation of the processing and review of returns that are submitted to them. This will inevitably lead to different forms of data being provided to the tax authority, and it is possible that they will start asking banks for more granular transaction-level data. Looking further ahead, we anticipate tax authorities potentially receiving real-time financial information, perhaps facilitating assessments (and tax payments) during the basis period.

2021 will also be an important year for Hong Kong as it considers its position in light of a new OECD report on BEPS 2.0, which aims to develop a solution to the tax challenges of the digitalisation of the economy and the perception that large global corporate groups, including banks, are not paying their fair share of tax. We expect this development to almost certainly lead to some legislative changes in Hong Kong.

Pillar One of BEPS 2.0 proposes new profit allocation rules aimed to ensure that, amid increasing digitalisation, the allocation of taxing rights focuses on the attribution of additional value to the location where the goods or services are being consumed. While financial services are essentially carved out of Pillar One, banks will most likely play a role as a collection agent on behalf of the tax authorities in many jurisdictions.

Pillar Two seeks to implement a global minimum tax that would provide jurisdictions with the right to tax income that is subject to low or no tax in the jurisdiction with the primary taxing right. This will certainly impact banks, particularly around whether they are paying sufficient tax in Hong Kong to meet the minimum standard required under BEPS 2.0. Other aspects will include a subject to tax rule, which may complicate related party payments across Asia.

In 2021, we will see further discussions around what legislation will be considered in Hong Kong to comply with Pillar Two. The implementation of Pillar Two will require banks to have a large amount of information to model their position and assess what needs to be done. Leading banks will seek to invest in the right tools and solutions to ensure that they can generate the required information and effectively assess their position on a global basis.

Greater Bay Area

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

Ivan Li
Partner, Head of Financial Services, Southern Region
KPMG China

Terence Fong
Partner, Head of Chinese Banks, Hong Kong
KPMG China

The Greater Bay Area will remain a key growth driver for many domestic and international banks in Hong Kong

As mainland China continues along its path to recovery from the disruption and challenges caused by COVID-19, we expect to see renewed interest from international and domestic banks in Hong Kong in expanding onshore, with the Greater Bay Area (GBA) a key opportunity.

For some medium to large commercial banks in Hong Kong, the GBA has become a crucial part of their business and growth strategy, and we therefore expect to see more investment from them in the region in 2021. This year already saw Standard Chartered create a new GBA CEO[2] role and announce a USD 40 million investment into the setup of a GBA Centre in Guangzhou[3], reflecting the importance of the region. Some banks may seek to invest in or set up wealth management or technology subsidiaries in the region, while we will also continue to see mainland Chinese banks expand their footprint in Hong Kong.

International and domestic banks expanding into the GBA will use the year ahead to invest in digital solutions and capabilities as a means to achieve scale quickly, and consider how these can be tailored for the digitally savvy clientele in the region. Given the level of technological advancement of their peers in mainland China, investment into and implementation of new technologies will be a key success factor for banks seeking to expand in the GBA and more broadly in mainland China in 2021. However, the customer experience and expectation will be different.

In the year ahead, we also expect to see an increasing number of partnerships between traditional banks and fintech players in the region. With Shenzhen identified as a key innovation and technology centre in the GBA, there are significant opportunities for banks expanding in the region to explore tie-ups and alliances with suitable local start-ups, fintech firms and technology companies.

Furthermore, 2020 saw the launch of virtual banks in Hong Kong, several of which have mainland Chinese non-banking companies as key stakeholders. In the GBA however, there is only one private purely digital bank. After setting up a virtual bank in Hong Kong, some of these players may seek to explore how to grow their presence in the rest of the GBA going forward.

In 2021, we also expect the issuance of more detailed implementation guidelines on the GBA Wealth Management Scheme as the initiative moves closer to a full launch. If the scheme is successful, we expect to see incremental relaxations and enhancements around areas such as quotas and product eligibility. With the implementation of more guidance, many banks will start to fine-tune their strategy to capitalise on the opportunities arising from the scheme.

There are also cross-border financing opportunities for banks in Hong Kong. For example, with the easing of property ownership rules in the GBA, Hong Kong citizens can take a Hong Kong-dollar mortgage for property in another city in the region, which presents mortgage lending opportunities for banks in Hong Kong. With the GBA continuing to rapidly develop, leading banks will also keep a close eye on developments outside of financial services that could lead to significant financing opportunities.

---

[2] Standard Chartered, August 2020, https://www.sc.com/en/media/press-release/anthony-lin-named-ceo-of-greater-bay-area-2/
[3] Standard Chartered, July 2020, https://av.sc.com/hk/content/docs/hk-greater-bay-area-centre-press-release-eng.pdf

About KPMG

KPMG China is based in 27 offices across 25 cities with around 12,000 partners and staff in Beijing, Changsha, Chengdu, Chongqing, Foshan, Fuzhou, Guangzhou, Haikou, Hangzhou, Hefei, Jinan, Nanjing, Ningbo, Qingdao, Shanghai, Shenyang, Shenzhen, Suzhou, 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 organisation of independent professional services firms providing Audit, Tax and Advisory services. We operate in 147 countries and territories and have more than 219,000 people working in member firms around the world. The independent member firms of the KPMG global organisation are affiliated with KPMG International Limited ("KPMG International"), a private English company limited by guarantee. KPMG International and its related entities do not provide services to clients. 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.

Contact us

Paul McSheaffrey
Partner, Head of Banking & Capital Markets, Hong Kong
KPMG China
+852 2978 8236
paul.mcsheaffrey@kpmg.com

Terence Fong
Partner, Head of Chinese Banks, Hong Kong
KPMG China
+852 2978 8953
terence.fong@kpmg.com

Ivan Li
Partner, Head of Financial Services, Southern Region
KPMG China
+86 755 2547 1218
ivan.li@kpmg.com

Kyran McCarthy
Partner, Asia-Pacific Head of AML & Sanctions Services
KPMG China
+852 2140 2286
kyran.mccarthy@kpmg.com

Patrick Cowley
Partner, Head of Restructuring Services, Hong Kong and Asia Pacific
KPMG China
+852 2140 2836
patrick.cowley@kpmg.com

John Timpany
Partner, Head of Tax, Hong Kong
KPMG China
+852 2143 8790
john.timpany@kpmg.com

James O'Callaghan
Partner, Head of Technology Consulting, Hong Kong
KPMG China
+852 2143 8866
james.ocallaghan@kpmg.com

Jianing Song
Partner, Head of Banking Advisory Hong Kong
KPMG China
+852 2978 8101
jianing.n.song@kpmg.com

Isabel Zisselsberger
Partner, Strategy and Performance, Financial Services
KPMG China
+852 2826 8033
isabel.zisselsberger@kpmg.com

Rani Kamaruddin
Partner, Head of AML & Sanctions, Hong Kong
KPMG China
+852 2140 2815
rani.kamaruddin@kpmg.com

Pat Woo
Partner, Head of Sustainable Finance, Hong Kong
KPMG China
+852 3927 5674
pat.woo@kpmg.com

Matthew Fenwick
Partner, Corporate Tax Advisory
KPMG China
+852 2143 8761
matthew.fenwick@kpmg.com

Edna Wong
Partner, Financial Risk Management
KPMG China
+852 2143 8693
edna.wong@kpmg.com

Mary Wong
Partner, AML & Sanctions Services, Greater Bay Area
KPMG China
+852 2685 7576
mary.wong@kpmg.com

Stanley Sum
Partner, Advisory, Management Consulting
KPMG China
+852 2143 8808
stanley.sum@kpmg.com

Guy Isherwood
Senior Advisor
KPMG China
+852 2978 8243
guy.isherwood@kpmg.com

Sean Ren
Associate Director, Strategy and Performance, Hong Kong
KPMG China
+852 3927 5818
sean.ren@kpmg.com

kpmg.com/cn/socialmedia

kpmg.com/cn/banking

For a list of KPMG China offices, please scan the QR code or visit our website:
https://home.kpmg.com/cn/en/home/about/offices.html

Publication number: HK-FS20-0006

Publication date: December 2020