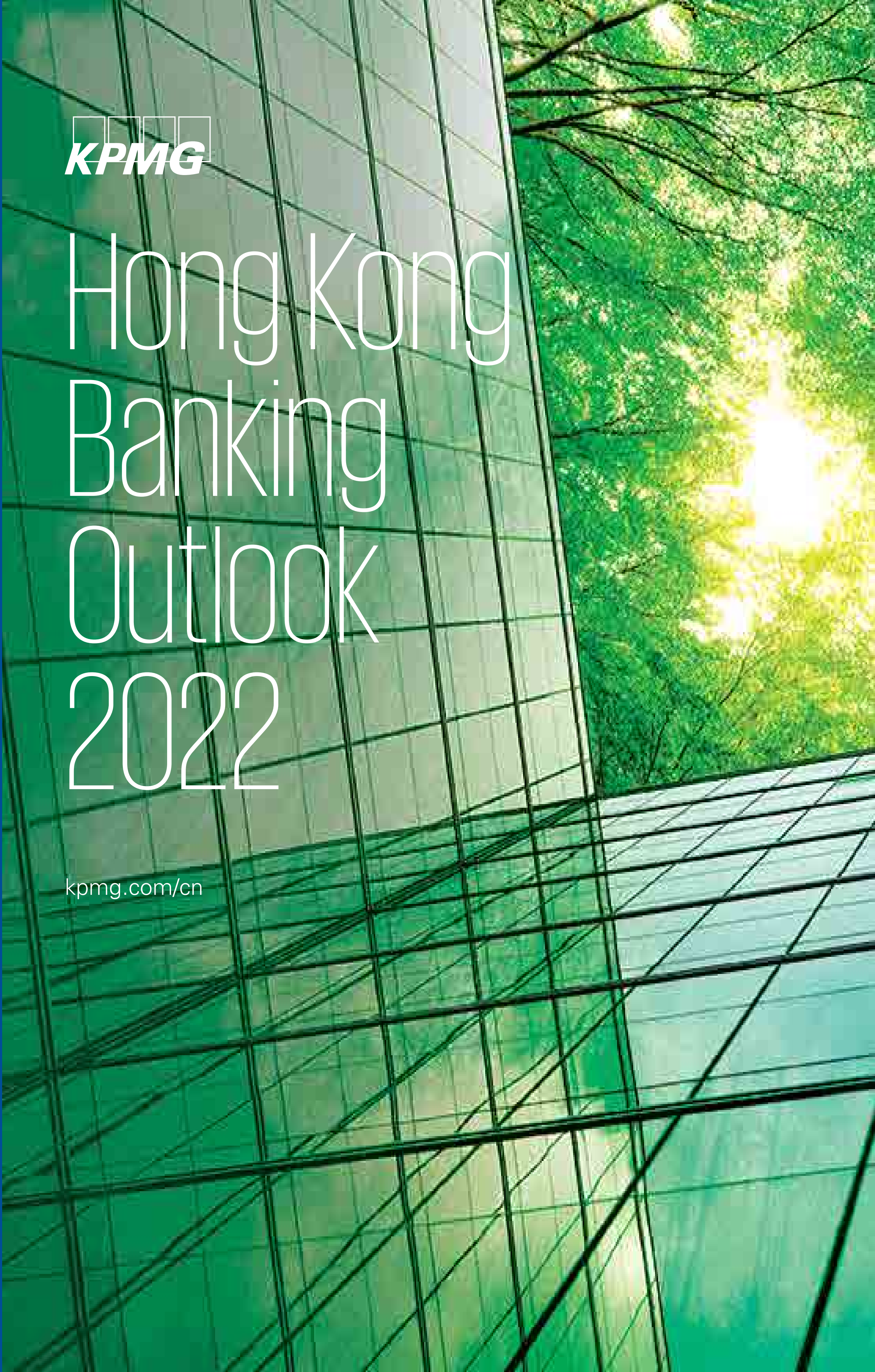

Hong Kong Banking Outlook 2022

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Contents

Foreword

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Welcome to our outlook for 2022, where we forecast the key developments and trends that will impact and shape Hong Kong's banking industry over the year ahead. Banks are looking forward to 2022 with more optimism in terms of their financial performance. Higher interest rates should feed through into improved margins, while non-interest revenue should also increase as initiatives such as Wealth Management Connect offer new growth opportunities. The continued economic development in mainland China and Hong Kong is also expected to have a positive impact on credit growth. The loan books of banks have shown to be resilient during the pandemic and as such we do not expect to see a significant increase in non-performing loans in 2022.

In this report, KPMG subject matter experts provide a number of predictions for the banking industry across 11 key areas. A number of recurring trends cut through all of the articles. Firstly, there is the issue of talent. From the second half of 2021, there has been an acute contraction in talent in the financial services industry. Our clients have told us that the shortage of talent is proving to be more severe than in previous years and they are facing difficulties in obtaining specialist expertise. The attraction and retention of talent will therefore be a major priority for banks.

Business models in the industry are expected to continue to change on the back of investment in technology. While digital transformation has already been ongoing for many years, it remains a key focus for banks. This is evident in areas such as customer experience, operations, regulatory compliance and risk management. Technology is a constant theme through many of the articles in this report and we expect that banks will continue to invest heavily in this area.

Lastly, 2021 was the year that ESG became mainstream and this is also reflected in the content of this report. We predict that ESG will become important for all stakeholders in a bank, investors, customers, employees and increasingly the regulators too. ESG will change how banks are operating internally, but also how they interact with customers externally. It needs to be factored into everything a bank does and not be restricted to the development of new ESG-related products and climate risk testing. The increased importance of ESG calls for a different approach to tackle this issue and we are looking forward to seeing how banks in Hong Kong take up this challenge.

I hope you enjoy our predictions for the sector in 2022 and would welcome the opportunity to discuss the current industry landscape.

Sector outlook

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Digital transformation, talent, ESG reporting and improving margins are likely to be key themes for Hong Kong banks

Hong Kong bank operations were challenged throughout 2021 on multiple fronts, including low net interest margins, lack of loan growth and a risk of increasing bad loans. Net interest margins are likely to have bottomed out and with inflation starting to rear its head there is expectation of interest rate rises in 2022. Impairment charges turned out to be less than originally expected given the ongoing pandemic. Hong Kong banks' loan books proved to be quite resilient in the face of a difficult year. There are signs of improved economic sentiment which could feed into loan growth over the year ahead.

All banks in Hong Kong are keeping a careful eye on any fallout from credit challenges associated with the Chinese real estate sector. The full impact of any defaults has yet to be felt, but this will be an area to watch in 2022.

Meanwhile mainland banks, a growing force in the sector in the last few years, have focused on stabilising their operations in Hong Kong and faced difficulties in moving management teams around. However, they are likely to expand their footprints again once borders reopen.

Digital transformation

Banks in Hong Kong have continued to increase their focus on digital transformation in all aspects. Technology is being used to improve operational efficiency and reduce costs, but also in areas such as KYC and AML. On the customer side, there is also demand for more seamless digital experiences and banks are being pushed to improve their offerings. Digital transformation is expected to remain a key pillar of growth and is critical for Hong Kong to retain its position as a leading international financial centre. As banks ramp up investments, they will need more qualified people to adapt and manage new digital solutions and data.

Fintech has emerged as a driving force of innovation in consumer banking in mainland China and this is now being seen in Hong Kong too. Such innovation is necessary for banks in Hong Kong to shore up their competitive edge, but a lack of scale could pose a challenge in terms of technology development. Ideally, banks should be looking to bring in the best-of-breed technologies from both mainland China and the US.

Virtual banks in Hong Kong have completed their first full year of operation. While a few have performed well, most are struggling to find a clear path to growth and have been investing heavily in customer acquisition. These banks are now also facing stiffer competition from traditional banks that have strengthened their own digital offerings in response to the arrival of the virtual banks. We do not believe there is enough room for eight virtual banks in the market and we expect that some may shut down or quietly cease operations.

ESG

A major theme is also the increased focus on environmental, social and governance (ESG) reporting for the year ahead. Hong Kong banks are currently tackling increased ESG reporting requirements and there is the expectation that regulators will have a common standard in place in 2022. The key challenge for banks will be to manage ESG data, which cannot be underestimated. While the major banks have plans in place to manage this, smaller banks are taking a wait-and-see approach and watching how their bigger competitors handle compliance issues.

Talent

Discussions with senior management of many banks in the last few months of the year have highlighted that the tight labour market is a key concern. Global demand across all roles including digital transformation and ESG has been strong. This is likely to remain a challenge that banks will need to address in 2022 and could limit the extent to which banks are able to realise their ambitions.

ESG

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> *New regulatory requirements mean Hong Kong banks will need to do a lot in a short amount of time. Climate-related risk might start off in the risk function, but it will permeate out across the rest of organisation.*

Focus of banks in 2022 will be on climate risk disclosure requirements

Green and sustainable finance, and environmental, social and governance (ESG) have been top of mind for many financial institutions in Hong Kong and this will remain the case in 2022. This is in no small part due to recent regulatory moves from the Hong Kong Monetary Authority (HKMA), which is looking to banks to drive change as Hong Kong aims to become a green and sustainable finance hub. While new regulations are focusing on assessing the climate resilience of the sector, we believe that banks will prioritise the front office impacts in 2022.

In January 2021, the Hong Kong Monetary Authority (HKMA) launched a pilot, with participating banks required to conduct climate risk stress testing ("CRST") for two major types of climate risk - physical risk and transition risk – which are seen as the most likely pathways to a low-emission economy.

The results of this pilot were shared at the end of 2021, with the HKMA observing a material reduction in participating banks' profitability, as well as a weakening of capital positions under the extreme climate scenarios. The report also summarised the major challenges and actions that banks will need to take. Starting from 2022, banks will need to incorporate a broader range of climate risk factors into their risk assessment frameworks and strategic allocation of additional resources to climate resilient activities, such as green financing and providing transition finance to support their customers' transition to low-emission business models.

At the end of 2021, the HKMA also finalised the Supervisory Policy Manual (SPM): GS-1 Climate Risk Management, which provides guidance on their expectations for climate-related risk management. By end-2022, banks are required to have implemented a climate risk management framework that incorporates climate considerations into governance, strategy, risk management and disclosure. It will apply to all Authorised Institutions (AIs), including locally incorporated AIs, as well as the Hong Kong subsidiaries and branches of international banks. This framework will assess how climate-related physical and transition risks, whether quantifiable or non-quantifiable, may affect an AI's traditional risk types, such as credit, market, liquidity, operational, legal, reputational and strategic risks.

Under the SPM, the HKMA also announced its requirements that climate-related disclosures should be aligned with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). The TCFD was established by the Financial Stability Board (FSB) to develop a consistent global standard for climate-related financial risk disclosures. The first submissions for local Hong Kong banks are due no later than mid-2023, which is expected to pose a significant challenge. While all of these disclosures focus on the environmental aspects of ESG, the HKMA has stressed that financial institutions should not lose sight of other sustainability issues that could pose risks.

Looking ahead, banks will not only need to comply with the climate risk management and TCFD disclosures, but also consider how to leverage the outputs from these new risk management tools and adjust their business strategies towards climate resilient activities such as green financing. Climate-related risk might start off in the risk function, but it will permeate out across the rest of organisation. This means that climate risk analytical tools are encouraged to be broadly used by the front office to review the business strategy, decide on onboarding and offboarding, and rollover of loans from customers in high carbon sectors.

Banks in Hong Kong will need to do a lot in a short amount of time. Adding to this challenge is an acute shortage of staff that can help drive these ESG strategies. Every jurisdiction around the world is competing for the same talent, meaning that this shortage will persist in the medium term.

Wealth management

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> *Competition in the wealth management sector will be fierce and come from beyond just banks themselves.*

Wealth managers need to consider their ESG, talent and digital strategies in 2022

Despite successive years of turbulent times, there remains genuine industry optimism around wealth management. It is not only traditional private banks and premium offerings of global banks increasing their investment in wealth in Hong Kong, but asset managers and insurers are also increasingly exploring opportunities and expanding headcounts. The overall low-interest rate environment, demand for more stable returns and regulatory changes in both mainland China and Hong Kong have all contributed to the rapid growth of the sector.

Hong Kong is in a particularly favourable position due to its links with mainland China and its foundational role within the Greater Bay Area (GBA). GBA-linked initiatives will continue to be a critical growth driver for the industry, with Hong Kong banks increasingly expanding into wealth management in mainland China. It should also be noted that mainland banks themselves are expanding their wealth management services into areas they did not offer a few years ago, such as more advisory-based private banking, both in mainland China and increasingly in Hong Kong.

The new Wealth Management Connect scheme – launched in September 2021 – is generating significant industry interest and will offer further opportunities going forward. The current focus has been on the upper affluent parts of retail banking, with private wealth management institutions urging for further enhancements to the scheme, such as a greater quota size and a wider range of products.

ESG is expected to remain a major focus in 2022 as banks work to differentiate themselves with their services and products. In previous years, banks were mainly pushing their ESG content to the industry, but now clients are also requesting more sustainable investment products and ESG advice from their banks. The ESG credentials of banks themselves have also come under the spotlight as Hong Kong customers increasingly want to invest with organisations and in products that align with their own values.

Interest in investing in virtual assets is also on the rise, however clients – and financial institutions – remain cautious. A joint survey by KPMG and the Private Wealth Management Association in 2021 found that just over half (51%) of all clients want less than 1% of their portfolio invested, with volatility in the value of digital assets seen as a major concern. Banks are assessing what products they can offer in this space, while taking into account the regulatory constraints they face.

To strengthen its role as an international financial centre, Hong Kong will continue to welcome and encourage family offices to expand their footprint. The Securities and Futures Commission (SFC) has issued several clarifications on regulations. Globally, we would expect further measures, which will be particularly helpful for family offices with complex structures. Banks also have a key role to consider the breadth of their offer to family office businesses.

Ultimately, shortage of talent remains the top factor that might limit expansion of the sector. Hong Kong has a solid base of financial services talent, but there are skill shortages in many areas including relationship management, compliance and technology. Longer term, these challenges can be tackled by getting stakeholders such as the government and financial institutions to work together to attract talent, including education and retraining initiatives.

As we look to 2022, it is clear that wealth management will remain a top priority and growth area. Competition in this sector will be fierce and come from beyond just banks themselves. Banks looking to succeed in this space must consider as a priority their talent strategy, digital investment, approach to mainland China expansion and ESG differentiation.

Global tax reforms

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The ongoing trend of shifting the burden of compliance from tax authorities to banks will continue in 2022.

Banks must consider a wide range of tax reform beyond BEPS 2.0 in 2022

Banks in Hong Kong will need to take account of a number of recent and pending tax developments. The headline act is undoubtedly the OECD's BEPS 2.0 initiative, which will fundamentally change the way a multinational entity will be taxed. Banks will not be immune to this change.

There are two pillars to BEPS 2.0. The first pillar focuses on ensuring that corporates pay taxes in the "right" place(s), while the second pillar will establish a global minimum taxation regime. Pillar One is unlikely to be directly relevant to banks in Hong Kong – there will almost certainly be a carve out for financial institutions. However, banks may have a role to play in both reporting and potentially collecting taxes from their customers.

Pillar Two is almost certainly going to have an impact on banks and whether they are paying the global minimum corporate tax rate, which has been set at 15%. While the position Hong Kong will take is not yet certain, the OECD published rules in late December 2021 that provide a template for governments to move forward with legislation ahead of 2023 and will provide a basis for requisite legislative reform in Hong Kong. In the meantime, banks will need to analyse what tax they are paying and in which market.

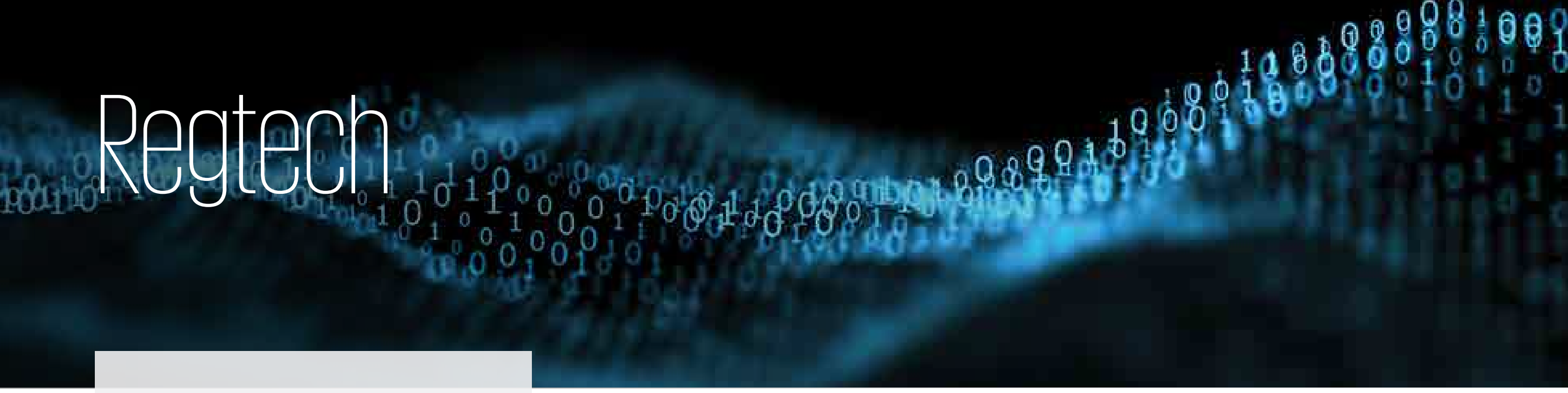
BEPS 2.0 will also create a significant compliance burden that goes with reporting from local jurisdictions into regional offices and eventually into group consolidations. The new tax rules will be based off the accounting position rather than domestic tax legislation, meaning accounting choices will have a significant impact on the ultimate effective tax rate of banks.

In this respect, 2022 should also see the Hong Kong SAR government implement tax reform to get the territory removed from the EU's grey list of non-cooperative jurisdictions for tax purposes. New legislation will likely target passive income derived by corporations without substantial economic activity in Hong Kong, so may not have a significant impact on most banks, but could impact non-banking entities within a banking group and banks' customers.

The tax aspects of environmental, social and governance (ESG) issues are also becoming more prominent in the banking sector. Taxes are increasingly being used as a lever to enable positive policy for banks and their customers, but also to penalise organisations that are not meeting their obligations – primarily related to environmental issues initially, but also increasingly broader concerns. Of course, an appropriate tax policy has been an important part of governance for banks for quite some time and that will continue to be the case going forward.

Banks are also expected to be increasingly burdened with the reporting of tax profiles and positions of customers, as well as the collection agent role delegated to them by tax authorities. The ongoing trend of shifting the burden of compliance from tax authorities to banks will also continue – with cross-border ecommerce likely to be an area of focus in 2022 and beyond. This could potentially see banks being deputised to police whether organisations are paying the appropriate taxes in Hong Kong.

Another major focus area for banks deals with the taxation of their remote workforce. With talent in short supply, as well as COVID-related travel restrictions and quarantines, banks have become more flexible with allowing people to work remotely. Aside from regulatory concerns, there will be tax implications for staff that are working outside their "home" jurisdiction. In 2022, we would expect tax departments to help banks firm up their policies on remote working, and deal with additional compliance issues that will inevitably emerge. It is also possible that governments around the world may seek to make changes to their taxation on remote working as a way to raise revenues during these challenging times.



Regtech

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Regtech investment by banks is increasingly focusing on conduct and consumer protection, as well as the mapping of regulatory obligations

Halfway through the Hong Kong Monetary Authority's (HKMA) two-year roadmap to promote the adoption of regulatory technology (Regtech), there has been progress in terms of the market's awareness and education on its use. While there is still a long way to go in terms of broad Regtech adoption, speaking to both local and international banks in Hong Kong we have found there to be a marked change over the last year in terms of the level of focus and investment in this area.

Awareness of Regtech in the market has been boosted by a series of adoption and practice guides that the HKMA has developed in association with KPMG. These guides cover the application of Regtech in areas such as reporting and stress testing; governance, risk and compliance; anti-money laundering (AML) and cloud-based solutions. The HKMA has also made a number of helpful announcements on what their expectations are of the market and is broadly advocating the adoption of technologies to aid banks in discharging their regulatory responsibilities.

In terms of the technologies that have been adopted, and similar to last year, most of the focus by banks in Hong Kong has been on data rich areas such as financial crime, KYC and risk management. In 2022, we expect there to be a much greater focus around the conduct and customer protection space. Banks will want to be ahead of the regulator in this area and many have already begun to explore their options by trialling some of the solutions in the market.

Another major area of focus that we have seen market interest in is the interpretation and mapping of obligations. In the past it has been a drawn-out process for banks to understand what the impact of new obligations are, but regulators want to see a much higher level of automation and will start distributing those obligations in a much more digital format. Banks in turn, in the future, could then almost immediately map them into their system of control and within their policies, procedures and controls. This will enable them to quickly understand the impact of new regulations and importantly identify where they have gaps.

Intelligent process automation should also be higher on the agenda of financial institutions. This technology – although perhaps not the most glamorous – can result in major efficiency gains and cost savings as manual control checks are automated. But it is not just about risk compliance and reducing human error, it is also about providing a better digital experience for customers and bank employees to future proof a bank.

Looking ahead, banks that will be the most successful in adopting Regtech are those that understand that the technology is not only about risk and compliance, but it is at the heart of a fundamental transformation of the business led by the middle and back office. This is not work that can be done by a single technology team or division. Rather, this needs to be a holistic strategy that starts from the leadership and permeates across the entire organisation.

> *Banks that will be the most successful in adopting Regtech are those that understand that the technology is not only about risk and compliance, but it is at the heart of a fundamental transformation of the business led by the middle and back office.*

Regulatory focus areas

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We predict that in 2022 regulators will increase their focus on the use of artificial intelligence (AI) by financial institutions and require validation testing.

Basel III, LIBOR transition, the Hong Kong Investor Identification Regime and the use of AI technology are priorities

International regulatory changes continue to impact Hong Kong's banking industry, as deadlines for long-awaited transitions near. The final implementation of Basel III capital standards from the Basel Committee on Banking Supervision (BCBS) remains a major area of focus for Hong Kong banks, although they have been given more time after the Hong Kong Monetary Authority (HKMA) extended the deadline to July 2023. This is translating into greater data requirements across all risk types for banks as well as significant investment in IT systems. There will also be changes around the calculations that drive risk-weighted assets (RWAs).

Banks will need to be very clear about the capital and RWA impacts of these changes as certain products may become more advantageous under the new capital regime. For example, certain types of exposures might carry a higher RWA weight under the new regime such as unrated FI's, Banks, and Securities Firms. To make matters more complex, some regulators, in their jurisdictions, have applied local discretion to tweak the risk weighting mechanism for their markets. Understanding all these nuances is critical to help institutions understand impacts and then drive higher returns on capital.

Banks in Hong Kong are also at the tail end of the London Inter-bank Offered Rate (LIBOR) transition. They are now shifting from implementation to business and have started coming up with products that use the alternative reference rates (ARRs). In 2022, banks will focus on educating clients about the new rates, new product development and getting everyone in the bank up to speed on the changes. Banks will still need to be working through all the kinks in their internal systems that were less of a priority ahead of the transition. There will also be an element of educating clients – we have heard from banks that there are still corporates and SMEs that are not prepared for the transition.

Aside from the Basel III and LIBOR transitions, regulation around environmental, social and governance (ESG) reporting has undoubtedly attracted the most headlines and will be a major focus for Hong Kong banks in 2022, but is dealt with in detail elsewhere in this Banking Outlook report.

Another major regulation that is on the horizon for banks is the implementation of the Hong Kong Investor Identification Regime (HKIDR) in the second half of 2022, as mandated by the Securities and Futures Commission (SFC). This will allow the SFC to identify investors that place orders through intermediaries and will bring Hong Kong into line with other markets such as the US and mainland China. We expect the implementation of HKIDR to place greater pressure on financial institutions' own trade surveillance programmes since the regulators will now have greater access to information on their clients' trading activities. This is likely to result in increased enquiries from regulators on suspicious trading activities, enquiries which the financial institutions will be expected to respond to quickly and accurately.

Lastly, we predict that in 2022 regulators will increase their focus on the use of artificial intelligence (AI) by financial institutions. We are starting to see that banks are implementing AI and machine learning technology in areas such as credit decisioning, onboarding of new customers, and for example to monitor calls between relationship managers and clients for any potential compliance issues. Regulators may require financial institutions to enhance model governance and model validation routines to ensure the technology meets its intended use as well as being used in an ethical and unbiased way.

Digital transformation and Fintech 2025

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In 2022, developments around central bank digital currency (CBDC) will be on the radar of most banks in Hong Kong.

Technology adoption continues apace, but full-scale digital transformation will require banks to rethink how they operate

Banks in Hong Kong have been on their digital transformation journeys for several years now and have had some success, especially on the retail banking side. Progress has been clearly visible in areas such as the virtual onboarding of new customers, the Faster Payment System (FPS) and rapid iteration of mobile banking apps – making banking services more seamless. With more mature technologies in this space, it is easy to see why the new virtual banks in Hong Kong have tended to focus on retail banking.

While banks have adopted technology to streamline commoditised, high-volume, low-complexity areas like payments or day-to-day banking, it is also clear that many are not yet using technology to truly transform the way they do business and rethink the role of a bank in society. This is illustrated by the adoption of open banking in Hong Kong. Open banking facilitates the sharing of information between banks and third-party service providers and will enable the creation of new services for customers. However, aside from a few trials, developments so far have been few and far between.

In corporate and investment banking, we have seen a degree of technology adoption, but we would not call this a full-scale transformation that makes processes fully automated and autonomous. In 2022, we expect banks to become a lot more digital on the corporate banking side, particularly in their offerings for small and medium enterprises. They could potentially expand into areas such as supporting their customers' back office operations. This trend is already visible in mainland China, where some banks have begun to form ecosystems with their customers.

We also expect that the Fintech 2025 initiative will provide renewed impetus for digital transformation at banks. This initiative has been launched by the Hong Kong Monetary Authority (HKMA) to drive fintech development and the adoption of technologies such as artificial intelligence, machine learning and big data. A first impact has been that banks need to complete a questionnaire to determine current and planned fintech investment. This is forcing banks to think about what fintech means to them and how it will change the way they operate.

In 2022, developments around central bank digital currency (CBDC) will be on the radar of most banks in Hong Kong. Major banks will be thinking about how they can be a leader in this space and how to use it to recapture the market that has been lost to digital payment services over the last few years. Smaller and medium-sized banks will be considering how to link their infrastructure with this future payment method.

When it comes to fintech, nurturing talent will also be a key focus for banks as there is a clear skills gap combined with high demand for qualified staff. It will probably take a few years to resolve this, although it is worth mentioning the launch of the Enhanced Competency Framework on Fintech by the HKMA in December 2021. This initiative aims to develop a sustainable pool of fintech talent for the banking industry and raise the competencies of existing fintech practitioners. Current talent shortages are triggering some banks to invest in or acquire fintech companies in the region to strengthen their fintech capabilities. We expect more banks to be open to this approach over the coming year.

Non-performing loans

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NPLs expected to increase as government support winds down and interest rates rise

As we enter 2022, banks face a question: will non-performing loans (NPL) rise? It is indisputable that over the past two years many companies' revenues and balance sheets have weakened from prolonged uncertainties from US-China trade friction, demand slashed by COVID-19 and supply frustrated by logistics challenges. History suggests NPLs and credit impairment will again rise as government financial support winds down, regulators revert to tighter loan classifications, inflation curbs demand and interest rate rises start to constrain debt service capability.

As credit conditions tighten for corporates in 2022, we expect to see a rise in lending fraud. Experience shows us that a company under financial stress may resort to fraud to overcome what they see as a temporary liquidity problem. Fraud supported attempts at self-rehabilitation rarely end well. Eventual default will reveal fraudulent transactions and misrepresented financial statements that banks have relied on to support financing ("Lending Fraud").

Some banks have begun to invest materially in technology and specialist teams to identify and manage potential Lending Fraud exposures at an early stage. We expect to see this investment trend continue in 2022. Investment in technology is important, but this should not stop banks from taking immediate practical measures to identify Lending Fraud. Past cases show that there are normally warning signs signalling a Lending Fraud well in advance of a corporate failure.

Technology can enhance the detection of such suspicious transactions and trading patterns, but specific training, and basic controls and checks can often be sufficient to identify such warning signs. Progressive banks have also developed their own analytical models that help scan portfolios for the warning signs of Lending Fraud in customers' financial statements. KPMG's equivalent model ranks the risk profile of companies through an analysis of selected financial ratios over time and against peer groups.

The table below is an illustration of KPMG's model, comparing the 2020 position with that of 2019 (immediately pre-COVID). It shows the top five highest and top five deteriorating risk scores for industry sub-sectors of listed companies on the Hong Kong Exchange (adjusted for immaterial-sized and inapplicable financial statement profile sub-sectors). While higher company scores do not prove that there is Lending Fraud, we would expect banks to keep a close eye on higher risk companies in these and other sectors in 2022. Moving forward, we expect more banks will be looking to invest in the necessary data, technology and analytics to support their Lending Fraud risk assessments.

HKEX industry sub-sectors ranked by highest and deteriorating risk scores:

		Aggregate Average Risk Scores		Change
	Sub Industry Sector	**2020**	**2019**	**(2020 v 2019)**
Ranked Highest	Trading Companies and Distributors	17.87	16.44	1.44
	Apparel, Accessories and Luxury Goods	15.36	16.26	(0.90)
	Environmental and Facilities Services	15.30	15.34	(0.05)
	Oil and Gas Exploration and Production	14.79	13.66	1.13
	Construction and Engineering	14.66	15.31	(0.66)
Weakening Score	Distillers and Vintners	14.11	11.34	2.77
	Casinos and Gaming	13.84	11.43	2.41
	Consumer Electronics	12.63	10.17	2.45
	Apparel Retail	12.18	9.85	2.33
	Health Care Services	11.14	9.59	1.55

NB: industry scores are average of constituent companies based on analysis using KPMG proprietary metrics.

Virtual assets

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Adoption of virtual assets driven by regulation and institutional money, but views differ on the full extent of impact

Virtual assets continued their ascent in 2021 and we expect them to become much more prevalent in mainstream financial services over the coming years. Virtual assets such as crypto currency and asset-backed tokens had previously been the preserve of retail investors, but over the last year we have seen more institutions moving into this area, with for instance listed companies adding virtual assets to their balance sheets.

In the US, virtual asset-backed ETFs have been approved by regulators, large virtual asset enterprises have listed on the stock market and this 'professionalisation' of the sector will pave the way for more institutional capital to flow to these trading platforms. Regulatory developments will be key in shaping what will happen over the coming years, particularly as institutional and private wealth investors will likely demand an element of regulation over the platforms and exchanges that they will be dealing with.

There are two key areas in which banks may be impacted by the rise of virtual assets. Firstly, there is direct disruption. Insights from the market seem to suggest that customers, particularly high net-worth-individuals and family offices, want exposure to virtual assets. If banks do not offer products that can meet this demand, these customers will look elsewhere or invest directly via exchanges.

A second issue is that if virtual assets become more effective as a medium of exchange, banks will want to be part of that market infrastructure and will need to invest into it to be competitive. We see the development of central bank digital currencies as being an important catalyst for this investment with the mBridge initiative between HK, China, UAE and Thailand an example of this.

While we expect virtual assets to continue to grow, opinions differ on how this will be serviced and the amount of disruption that banks may face over the coming years. As the initial centralised exchanges for virtual assets have become regulated then decentralised exchanges have become more popular. These decentralised exchanges are based on agreed protocols but have no governing body or operations to be regulated. The extent to which these decentralised exchanges will become predominant is a matter of fierce debate.

A less aggressive view of the level of disruption is that many customers will want access to virtual assets but will prefer to deal with a trusted intermediary or deal with a regulated exchange. This will likely include institutional investors such as pension funds, who will look for the comfort that regulation provides, and HNWIs who may want to invest through their private wealth manager.

The more enthusiastic proponents of virtual assets believe that the decentralised exchanges will increase in popularity as their unregulated nature means they are more flexible and can generate higher, but more volatile returns. There are signs that the day trader/retail investment flows are moving to the decentralised exchanges, which will impact liquidity and pricing in the centralised exchanges.

Opinions differ but the virtual asset industry has now become so big that financial institutions can no longer afford to ignore it.

> *"The virtual asset industry has now become so big that financial institutions can no longer afford to ignore it."*

Data

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> *Banks that undertake a comprehensive review of their data strategies will have a much smoother transition to GDR and can plan for growth in areas such as ESG and the opportunities of the GBA.*

Banks in Hong Kong are increasingly considering data as an asset and opportunity

Banks in Hong Kong are expected to continue ramping up investments into their data capabilities through 2022 to deal with increasingly stringent regulatory reporting and disclosure requirements. There are three key drivers to explain why investment in data capabilities has become imperative. Firstly, Granular Data Reporting (GDR) demands of the Hong Kong Monetary Authority (HKMA) means that banks will need to analyse greater volumes of data. Much work remains to be done by banks to bring about more transparent and seamlessly integrated data.

Another important and increasingly relevant area of focus for banks is ESG reporting. From the perspective of data, the fundamental challenge to ESG reporting is the need for standardised benchmarks. Still, we expect a significant amount of development on that front in the year ahead as regulation is increased. For instance, the HKMA's requirement for financial institutions to conduct climate risk stress testing has significant data implications.

Lastly, there are also significant expectations around the Greater Bay Area (GBA) and the opportunities it represents for banks. As a result, data regulations coming out of mainland China will likely impact the operations of banks across the border. A better understanding of these regulations and incorporating these into a data strategy will enable banks to capitalise on these disruptions.

While these drivers have already spurred banks to increase their data capabilities, two main challenges have become apparent. Firstly, reporting is very fragmented and may cover many different aspects such as benchmarks, capital requirements, sustainable finance and financial crime compliance. Banks have access to a large amount of data, but it often sits on different systems with no centralised way to access it. Secondly, while there is industry consensus that processes need to be streamlined and automated, questions remain about where data sits, who owns it and who ensures data quality and consistency.

In 2022 banks will need to recognise the need to address these challenges and consider how to achieve consistency and transparency to meet increased regulatory requirements through enhanced data capabilities. Furthermore, a major upside to this is that banks can take this as an opportunity to re-evaluate their data strategies – not just in Hong Kong, but also in their operations across the region as well.

We also expect to see a more progressive adoption of cloud computing. Many banks in Hong Kong are already running a significant number of cloud-based applications and there is a good understanding of its benefits – including by the regulators. Its usage is particularly widespread among international banks. Whereas mainland banks in Hong Kong are still mainly using on-premise computing, this is also slowly starting to change. The key challenge for banks operating in both mainland China and other markets is that a dual cloud presence is required for regulatory reasons.

Looking ahead, we are starting to see a mindset change among banks in Hong Kong, whereby data is viewed as an asset and opportunity, rather than as a problem that needs to be solved. Banks that have undertaken a comprehensive review of their data strategies will have a much smoother transition to GDR and can plan for growth in areas such as ESG and the opportunities of the GBA. As for banks that have yet to re-evaluate their data strategies, it is imperative for them to do so now to achieve a smoother transition into these areas.

Customer experience excellence

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“Banks need to continue their digital and technology investment in both client-centric online experiences and data analytics to deliver a more personal, values-aligned experience.”

Digital investment leads to improved customer experience scores for traditional banks in Hong Kong

In the Hong Kong edition of KPMG’s annual Customer Experience Excellence survey, financial services was ranked as one of the top performing sectors in 2021. The research draws on a survey of 1,100 consumers in Hong Kong to determine which brands are leading the way with their customer experience.

Banks in Hong Kong were able to improve their score compared with the previous year, but the overall financial services sector was boosted in particular by a positive perception of insurers in Hong Kong, which have benefitted from investment in their analytics capabilities to support the end-to-end client journey. As we look ahead to 2022, there are several key areas that banks can focus on to improve their performance.

First, it should be noted that the research looked at both traditional banks as well as virtual banks. While virtual banks arrived in Hong Kong with much fanfare, it is striking to see that on average their overall customer experience excellence score was rated only marginally higher than that of traditional banks. The acceleration of digital banking adoption by customers has been met with significant investments by traditional banks to step up their digital propositions. Over the coming year, we expect to see more new digital challengers in wealth management, which means that banks will need to continue to invest in improving all aspects of their digital experiences.

There are some lessons to be learnt for banks from the improved perception of insurers in this year’s research. Insurers were rated highly for the empathy they have shown to their customers, particularly with initiatives around well-being and mental health, as well as the level of personalisation. For banks in Hong Kong there is still work to be done on leveraging their customer analytics to make their interactions with customers much more personal. They should also focus on building better loyalty initiatives, to create a sense of shared value with their customers.

Another area where banks could seek to improve their score next year is by improving the communication of their values. The research showed that consumers in Hong Kong have a higher appreciation for brands whose values align with their own. ESG is already a major focus, but banks in Hong Kong should look to weave it into not only their products, but also their processes and advisory lifecycle. An additional benefit is that as banks more clearly articulate their purpose, they will be able to better attract high quality talent to their organisation. As is well known, banks will only be able to provide a good client experience if they have the best people on their teams.

A last trend that emerged from the research is that older consumers in Hong Kong have become more confident to engage with brands through digital channels. This suggests that banks should continue to expand the breadth of their digital offering. At the same time, banks need to continue to tailor the online experience and consider how they can make things easier for different customer segments. While it is encouraging that digital investment for banks appears to have paid off with an improved customer experience score in 2021, there is still room for improvement if the sector wants to move into the top tier.

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