Risk Management and Regulation Newsletter

Welcome to the Risk Management and Regulation Newsletter

Welcome to the latest edition of our Hong Kong Risk Management and Regulation newsletter. The second half of 2021 was a busy one for regulators in Hong Kong with a number of initiatives finalised and new consultations issued.

In August 2021 the SFC issued consultation conclusions on the new Hong Kong Investor Identification regime, which is due for implementation by the end of 2022. This new regime will impact all intermediaries in Hong Kong which engage in trading Hong Kong listed shares on behalf of clients, regardless of whether or not they are an exchange participant. The impact will be particularly significant for any intermediaries dealing on behalf of natural persons (both retail and private wealth management clients) since they will need to obtain consent from their clients to share their personal information with regulators.

A second key development was the HKMA's issuance of a consultation paper on Operational Resilience in December 2021. This is particularly timely given the ongoing impact of the COVID-19 pandemic and includes a requirement to identify critical operations and then map the interconnection and interdependences which underly these. This, in turn, will allow institutions to understand the risks associated with these critical operations and test the resilience of operations under various scenarios.

The third key development was the finalisation of the HKMA's Supervisory Policy Manual module on climate risk management. Banks now have 12 months to develop and implement their strategy to address climate related issues including conducting scenario analysis and implementing monitoring, reporting, controls and mitigation measures. An approach to disclosing climate-related information is also required.

Lastly, the HKMA has continued its focus on the RegTech agenda, encouraging banks to make greater use of technology such as cloud solutions, artificial intelligence, machine learning and natural language processing to achieve regulatory compliance or better risk management in a more effective and automated manner. Indeed, RegTech solutions can be adopted in all of the above three key areas (the Hong Kong Investor Identification Regime, Operational Resilience and Climate Risk Management).

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Topics in this issue:

Investor Identification Regime

In August 2021 the SFC issued consultation conclusions on proposals to: (1) implement an investor identification regime at the trading level for the securities market in Hong Kong (HKIDR), and (2) introduce an over-the-counter securities transactions reporting regime for shares listed on the Stock Exchange of Hong Kong (OTCR). These two proposals are aimed at improving Hong Kong's surveillance against market misconduct. The SFC has indicated it plans to implement the HKIDR in the **second half of 2022** and the OTCR in the **first half of 2023**.

The diagram below summarises the key obligations for Relevant Licensed or Registered Persons.

"relevant licensed or registered person" means a licensed or registered person which:
(1) submits (or arranges to submit) for execution an on-exchange order;
(2) carries out an off-exchange order; or
(3) conducts OE Trade Reporting,
in connection with its carrying out any of the specified activities.

"specified activities" means (i) proprietary trading and (ii) the provision of securities brokerage services for a person in respect of orders placed through an account opened and maintained for that person.

"relevant client" means the direct client of the relevant licensed or registered person (for collective investment scheme or discretionary accounts, reference is made to whichever individual/entity opened the account)

Explicit client consent must be obtained from the client clearly indicating his/her agreement to the purposes of use and transfer of his/her personal data to the SEHK and/or SFC in connection with the new reporting requirements. The client consent must meet minimum standards in a number of areas:

- Explanation of consent
- Authentication of client identity
- Purposes of use and minimum content of the consent
- Proper recording of consents and withdrawals of consents
- Maintenance of records

Existing consents can only be relied upon where they cover the same purposes of use as the new reporting requirements.

Must ensure that a BCAN is assigned to "Relevant Clients" who have placed or propose to place (i) an on-exchange order or (ii) an off-exchange trade reportable to the Stock Exchange of Hong Kong (SEHK) under its rules, in securities listed or traded on SEHK's trading system (except for odd lots traded on SEHK's odd lot/special lot market)

Must ensure that up-to-date client identification data (CID) has been collected from each Relevant Client and is submitted along with the client's BCAN (by way of putting the BCAN and CID into a "BCAN-CID Mapping File") to a data repository to be maintained by SEHK by a prescribed time

Must ensure that the Relevant Client's BCAN has been included in the order information for each on-exchange order as well as each off-exchange order and included in all reporting of off-exchange trades to SEHK, and report any BCAN error of a matched and executed trade as soon as possible to SEHK by submitting a prescribed error notification form

Must adopt relevant data privacy and security measures to safeguard the data collected, transmitted and stored, including obtaining express consent from clients for the collection and handling of their personal data in compliance with data privacy laws

If the client consent cannot be obtained from any client which is a natural person, the relevant licensed or registered person should not submit any BCAN or CID of that client to SEHK and should only effect sell orders or trades in respect of existing holdings of a listed security (but not buy orders or trades) for that client

The SFC expects a number of specific tasks that the Relevant Regulated Intermediaries must complete as part of their preparation for the implementation of the HKIDR requirements, as outlined in the diagram below.

	Q3 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022
Seek appropriate client consent and update individual and corporate clients' CID.	✓	✓	✓		
Enhance order management systems in tandem with phase 2 of the SEHK's Cash Market Gateway (CMG) upgrade.	✓	✓			
Assign BCANs to relevant clients and prepare BCAN-CID mapping files.		✓	✓		
End-to-end testing and rehearsals.			✓	✓	
Submit BCAN-CID mapping files to SEHK's data repository and launch HKIDR.				✓	✓

Aug 2021

New SFC investor identification regime

Click **here** for more details on the SFC proposals on HKIDR and OTCR.

Update to the HKMA's Supervisory Policy in relation to share margin financing

On 22 October 2021, the HKMA wrote to the chief executives of all Authorized Institutions informing them of an update to the HKMA's supervisory policy in relation to share margin financing. The update relates to the HKMA's supervisory requirements contained in module CR-S-4 of the Supervisory Policy Manual which Authorized Institutions in Hong Kong must follow when granting loans to customers which are secured by share collateral (share margin financing).

Previous supervisory policy (CR-S-4)	Revised supervisory policy (22 October 2021 update)
<u>Maximum LTV ratio for each category of stocks</u> • Lending AIs may adopt different ratios depending on their level of expertise and proficiency in share margin financing. • However, they should exercise prudence in setting the ratios and have regard to the underlying financial strength, liquidity and price volatility of individual stocks. • If the maximum loan-to-value ratios adopted by a lending AI exceed the prevailing market norms , the AI should discuss the situation with the HKMA. • As a reference, the current market norms are: (i) around 50-60% for blue chips (with higher ratios of, say, 70% adopted by lending AIs which are specialised in share margin financing and have the expertise and sophisticated risk management systems to control the risks involved); and (ii) around 30-40% or below for selected second and third liners. • Lending AIs should note that such market norms may change from time to time according to market situations.	<u>Maximum LTV ratio for each category of stocks</u> • Considering the global nature of Hong Kong's wealth management and private banking business, and benchmarking against the latest supervisory practices in other major financial centres, the HKMA is of the view that continued enforcement of the requirement to observe market norms in the setting of maximum LTV ratios is no longer appropriate. Starting from 22 October 2021, AIs are no longer expected to fulfil this requirement. • AIs should continue to undertake share margin financing business in a prudent manner. In setting maximum LTV ratios for share collateral, AIs should give due regard to key factors such as their credit risk appetite, risk characteristics of individual stocks, and their expertise and proficiency in margin call management. • Other requirements in the SPM module will continue to apply. • **Going forward, the HKMA will proactively assess whether AIs are prudent in setting maximum LTV ratios by stepping up surveillance and collection of data.**

LTVs for Hong Kong Share Margin Financing are capped at 70% to comply with the HKMA's requirement on market norms.

→

The requirement to observe market norms in the setting of maximum LTV ratios no longer applies <u>but</u> maximum LTV ratios should be set with due regard to relevant factors including credit risk appetite, risk characteristics of individual stocks and expertise/proficiency in margin call management.

Oct 2021

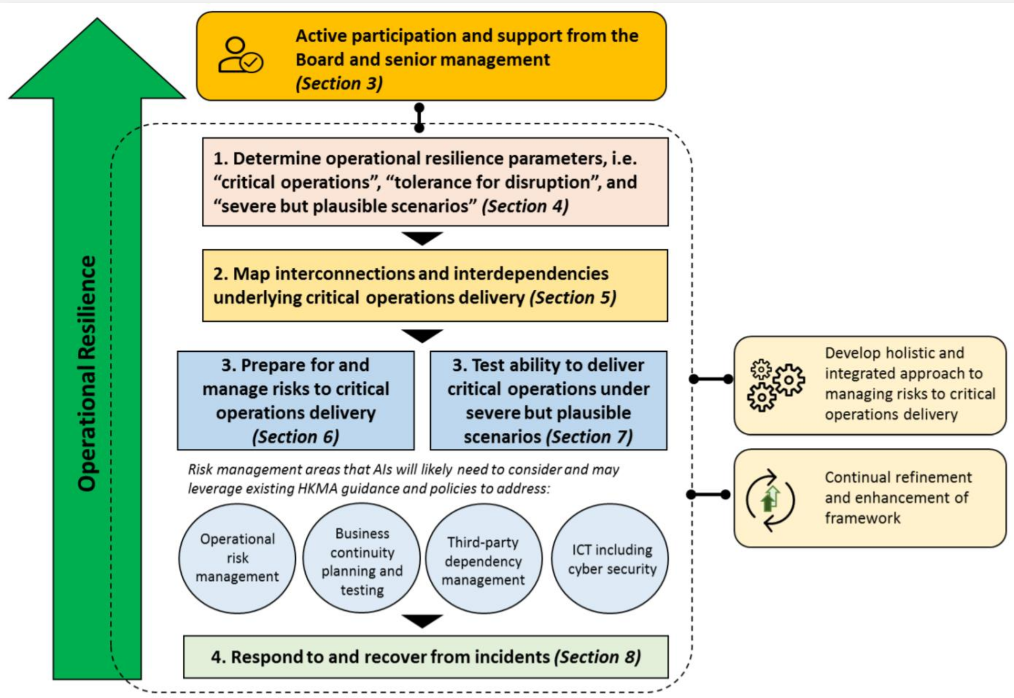
HKMA update to SPM CR-S-4 on share margin financing

Click **here** for the KPMG flyer for more details on the updates to the share margin financing requirements.

HKMA SPM OR-2 Consultation on Operational Resilience

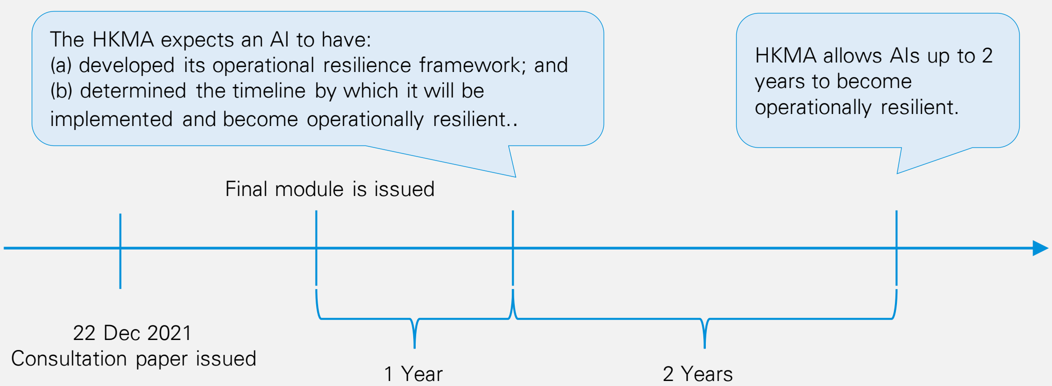
On 22 Dec 2021, the HKMA issued SPM OR-2 Operational Resilience setting out its supervisory approach to operational resilience and to provide guidance to AIs in relation to the general principles which they are expected to consider when developing their operational resilience framework. The SPM is issued as a non-statutory guideline as a guidance note to all AIs.

The diagram below summarises the key components that AIs must include within their operational resilience framework.



To establish an effective incident management programme, AIs can consider the following:

- Classification of an incident's severity based on predefined criteria.
- Incident response and recovery procedures.
- Communication plans for reporting incidents to stakeholders.
- Root cause analysis to prevent and minimise the risk of a recurrence.



Dec 2021

HKMA issued SPM OR-2 as a guidance note for all AIs

OR-2 Operational Resilience covers the following:

- Definition of operational resilience,
- Operational resilience framework,
- Role of the board and senior management,
- Determining operational resilience parameters,
- Mapping interconnections and interdependencies underlying critical operations,
- Preparing for and managing risks to critical operations delivery,
- Testing ability to deliver critical operations under severe but plausible scenarios,
- Responding to and recovering from incidents,
- Implementation of operational resilience requirements.

Click **here** for the OR-2 SPM on Operational Resilience issued by the HKMA.

Climate risk management

On 30 December 2021, the Hong Kong Monetary Authority (HKMA) released a Supervisory Policy Manual module on climate risk management (GS-1). The aim of GS-1 is to provide guidance to AIs on the key elements of climate related risk management as well as to set out the HKMA's approach to, and expectations in, reviewing AIs' climate related risk management.

The following four pillars were developed to guide to AIs on the key elements of climate-related risk management:

GS-1

1 ***Governance and overview***
- Define responsibilities of the board and senior management.
- Set the risk appetite statement (RAS), climate goals and actions.

2 ***Strategy***
- Perform Strategic assessment on internal and external factors.
- Formulate strategy along with stakeholder engagement.
- Strategy Implementation: Potent use of resources by implementing robust polices and organisational structure.

3 ***Risk management***
- Conduct risk identification and measurement at a portfolio and counterparty level.
- Develop climate-focused scenario analysis including stress testing.
- Monitoring and report climate risk.

4 ***Disclosure***
- Disclose information aligned with the TCFD recommendations.
- **Prepare the first climate-related disclosures no later than mid-2023.**
- Make disclosure at least on an annual basis under a "comply-or explain" approach.

The timeline below illustrates the regulatory focus on climate risk management:

- **CBIRC Promoting the High-quality Development of the Banking and Insurance Industry** — *January 2020*
- **HKMA White Paper on Green & Sustainable Banking** — *June 2020*
- **PBOC Pilot Climate Stress Test** — *2021*
- **HKMA Pilot Climate Risk Stress Test** — *2021*
- **GS-1 Climate Risk Management** — *July 2021 (consultation)*
- **GS-1 Climate Risk Management** — *Dec 2021*

Dec 2021

HKMA released final SPM on Climate Risk Management

Task Force on Climate-Related Financial Disclosures

Its recommendations focus specifically on:

Governance: Companies should disclose its governance structures, oversight and management processes.

Strategy: Companies should disclose the actual and potential risks, and opportunities, of climate change on its business, strategy and financial planning.

Risk Management: Companies should disclose how they identify, assess and manage climate-related financial risks.

Metrics and targets: Companies should disclose the metrics and targets used when assessing and managing climate-related financial risks and opportunities.

Click here for KPMG's flyer with further information on Climate Risk Management.

Click here for the final GS-1 SPM on Climate Risk Management issued by the HKMA.

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

Hong Kong Monetary Authority Regtech initiatives

The HKMA hosted its flagship regtech event – "Unlocking the Power of Regtech" on 30 June 2021. The event was attended by over 4,000 participants, involved global Regtech representatives sharing their experiences and insights into the potential of Regtech, and announced the winners of the HKMA's Global Regtech Challenge. Eddie Yue, Chief Executive of the HKMA, emphasised in his opening remarks that Regtech constitutes an important driver of the HKMA's 'Fintech 2025' strategy and set out four actions to transform bank attitudes and practices towards Regtech: (i) understand the Regtech landscape evolution; (ii) raise Regtech awareness; (iii) encourage new Regtech solutions; and (iv) expand the Regtech ecosystem, particularly the nurturing of talents.

To achieve these actions, the HKMA commissioned KPMG to write the "Transforming Risk Management and Compliance: Harnessing the Power of Regtech" white paper published on 3 November 2020 and the Regtech Adoption Index 2020 ("RAI") published on 30 June 2021. The RAI describes the current level of Regtech adoption among banks in Hong Kong as well as their preparedness and intent to adopt. It indicated that 56% of the surveyed banks have applied Regtech to at least two regulatory themes identified in the 3 November 2020 white paper, particularly in financial crime. The RAI provides three key actions for banks to further Regtech adoption: (i) develop a Regtech strategy and assign/establish Regtech leadership roles; (ii) foster Regtech expertise, and; (iii) engage with the Regtech ecosystem.

In addition, HKMA also launched the Regtech Adoption Practice Guide ("Regtech APG") series to provide banks with detailed practical guidance on the implementation of Regtech solutions. Four issues of the Regtech APG have been issued, covering cloud-based Regtech solutions, AML/CFT, governance, risk and compliance, and regulatory reporting and stress testing.

Implications on recently published HKMA Regtech initiatives

- Banks to adopt Regtech as part of 'Fintech 2025' strategy.
- RAI provides an outlook of the Regtech environment among banks.
- Regtech APG provides detailed guidance to help banks implement Regtech solutions.

AML/CFT legislation public consultation conclusions

In May 2021, the Financial Services and Treasury Bureau published consultation conclusions on enhancing the AML/CFT regulations in Hong Kong, particularly in relation to the licensing of virtual asset services providers ("VASPs"), dealers in precious metals and stones ("DPMS") registration regime, and other amendments in respect of the AML Ordinance (Cap. 615).

Chapter 2 of the publication consolidated the proposed requirements on the licensing regime for VASPs in Hong Kong. Chapter 3 of the publication proposed a two-tier registration regime for DPMS based on a risk-based approach. Chapter 4 of the publication proposed miscellaneous amendments on AMLO to address technical issues identified in the FATF's Mutual Evaluation Report on Hong Kong, including but not limited to the definition of "politically exposed person" in accordance with the FATF requirement, aligning the definition of "beneficial owner" in relation to a trust, and allowing digital identification systems to conduct customer due diligence processes.

Takeaways from FSTB consultation conclusion:

- Licensing regime requirements proposed for VASPs.
- Two-Tier Registration Regime for DPMS.
- Miscellaneous amendments to AMLO to address FATF findings.

Key Upcoming Regulatory Changes - HKMA and SFC

Body	Priority	Impacted	Required actions	Deadline
HKMA	*Guidance on sharing customer data for direct marketing by third parties*	Any AIs which share their customers' personal data with third parties	• Update data governance framework, policies and procedures. • Identify current arrangements where personal data is shared with third parties and ensure compliance with new requirements. • Adopt appropriate approach outlined by the HKMA for sharing customers' personal data collected through online channels to third parties for the purpose of direct marketing by the third parties.	30/6/22
	Guidance on non-F2F distribution of investment and insurance products	All AIs which distribute investment/ insurance products via non-F2F channels	Review existing online platform set-up and related policies, procedures for compliance with the new guidance on appropriateness of non-face-to-face service modes for certain customers, assessment for vulnerable customers and handling of their transactions, and selling/suitability process.	24/9/22
	GS-1 Climate Risk Management	All AIs	• Develop and implement strategy for addressing climate-related issues. • Conduct scenario analysis and stress testing, implement monitoring, reporting, controls and mitigation. • Develop an appropriate approach to disclosing climate-related information (at minimum implement TCFD recommendations).	31/12/22
	Next phase of Granular Data Reporting	Impacted AIs to be notified by HKMA	Review and update regulatory reporting process, ensure all data required for granular reporting are available.	End of 2022
	Basel 3 Go-live	All locally incorporated AIs	Implement new Basel revised frameworks on credit risk, market and CVA risk, operational risk, output floor and leverage ratio .	1/7/23
SFC	*Revised FRR return*	All licensed corporations	Review and update regulatory reporting process, ensure all data required for reporting is available.	24/1/22
	Requirements for Cross-Border Correspondent Relationships	All licensed corporations	Establish and maintain effective procedures for mitigating the risks associated with cross-border correspondent relationships.	30/3/22
	Conduct Standards in Capital Market Transactions	LCs and RIs with DCM/ECM activities	Review and update internal procedures and controls to ensure compliance with the new requirements for bookbuilding, pricing, allocation and placing activities.	6 months after gazettal
	HKIDR	Licensed/registered persons which: arrange/submit an on-exchange order; carry out an off-exchange order; or conduct OE Trade Reporting	• Obtained explicit client consent from the client indicating his/her agreement to the purposes of use and transfer of his/her personal data. • Prepare for assigning the Broker-to-Client Assigned Number (BCAN), collecting CID, preparing the BCAN-CID Mapping File, and submitting the BCAN-CID Mapping File to SEHK.	Second half of 2022
	FMCC Climate Risk Requirements	LCs with discretion over investment management processes for CIS	Take climate-related risks into consideration in investment and risk management processes for collective investment schemes and make appropriate disclosures.	20/8/22 & 20/11/22
	OTCR	LCs and RIs conducting off exchange trades subject to stamp or involving physical share certificates	• Obtain written or other express consent from their clients for the transfer of their personal data to the SFC under the proposed OTCR regime. • Prepare for reporting to SFC under specific circumstances.	First half of 2023

Upcoming deadlines in 2022 and 2023

Key priorities for HKMA and SFC:

- Fairness & Inclusion
- Climate & Sustainability
- Tech & Resiliency
- Fraud & Financial Crimes
- Cyber & Data

Key areas of recent supervisory focus for intermediaries:

- AML
- Implementation of DS-OL
- Trade execution
- Alternative liquidity pools
- Conflicts of interest
- Asset management

Regulatory changes with deadlines to be confirmed:

- *OR-2 Operational Resilience* (HKMA)
- *TB-1 Trust Business* (HKMA)
- *New Type 11 and Type 12 Regulated Activities* (SFC)
- *New Type 13 Regulated Activity* (SFC)

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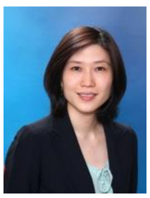

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