Risk Management and Regulation Newsletter

June 2022

Welcome to the Risk Management and Regulation Newsletter

Welcome to this edition of KPMG's quarterly Risk Management and Regulation Newsletter for Hong Kong. This quarter we cover a number of key developments impacting regulated financial institutions.

Recent market disruption has extended into the crypto-currency and Virtual Asset market. Earlier this year both the HKMA and the Securities and Futures Commission (SFC) issued a joint circular which clarifies expectations for financial institutions in Hong Kong who wish to provide Virtual Asset-related services to their clients. We are seeing Private Banks in particular pay attention to the new requirements which apply to all Authorized Institutions and Licensed Corporations.

Another topic which is a key part of the global regulatory agenda is Climate Risk. In this quarter's newsletter we focus on the SFC's requirements for Asset Managers which have been incorporated into the SFC's Fund Manager Code of Conduct and which will be effective from August 2022.

The SFC-HKMA joint review on investment products has raised some important findings impacting areas including product due diligence, client suitability and pricing. We recommend all intermediaries engaged in the sale of investment products study the results of the review.

Moreover, the Hong Kong Monetary Authority's (HKMA) recently published the finalised paper on Operational Resilience. This topic is front of mind for regulators around the world given the impact of the COVID-19 Pandemic. All licensed banks in Hong Kong will be required to assess whether or not they are operationally resilient and perform regular testing to confirm this. Implementation of the new standard will require involvement by the Board of Directors as well as both business and supporting functions within the bank.

We also cover the topic of credit risk management and specifically the performance of Expected Credit Loss models which is also an area of focus for regulators given the economic impact of the pandemic and current macro-economic challenges.

Lastly we also include some updates on financial crime including recent guidance given by the HKMA on steps Authorised Institutions should take to mitigate the money laundering risks associated with customers engaging in Virtual Asset related activities through their bank accounts and banking relationships with Virtual Asset service providers.

As always, please contact us for further information and insights on any of these topics.

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New joint HKMA-SFC Circular on Intermediaries' Virtual Asset-related activities

On 28 January 2022, the Hong Kong Monetary Authority (HKMA) and Securities and Futures Commission (SFC) issued a joint circular on intermediaries' Virtual Asset-related activities to address an increasing number of enquiries from intermediaries about distributing Virtual Asset-related products to investors and so as to provide guidance on Virtual Asset-related activities.

Background

When the SFC formulated its regulatory approach for virtual assets (VAs) in 2018, it imposed an overarching "professional investors only" restriction on various types of activity, including the distribution of VA funds. Since then, the VA landscape has evolved rapidly and begun to expand into mainstream finance. A broader range and larger number of investment products are now available which provide investors, whether retail or professional, with exposure to VAs.

While VAs have exponentially increased in popularity in some locations, the HKMA and the SFC have concluded that the overall global regulatory landscape remains uneven. This in turn maintains a certain level of risk, already identified in the SFC's 2018 circular on the distribution of VA Funds. Some of the VA-related service providers may prove to either be unregulated, regulated only for AML/CFT, or subject to light-touch regulation. Hence VA-related service providers may not be subject to the same robust regulation as service providers on products in traditional financial markets, posing additional counterparty risks for VA-related products.

Aims of the Joint Circular

Given the aforementioned assessment of the global regulatory state for VAs, the HKMA and SFC consider that additional investor protection measures should be imposed to cover the risk specifically associated with these products. Further information on the classification of VAs can be found in the Bank of International Settlements' April 2021 Financial Stability Institute insight titled *Supervising crypto-assets for anti-money laundering*.

A concerted effort

The Joint Circular is part of a concerted effort from Hong Kong regulators to regulate the VA space. In parallel:

- The **HKMA** has come out with its own discussion paper on crypto-assets and stable-coins
- The **Insurance Authority** has released a piece on VAs titled *Regulatory Approaches of the Insurance Authority in Relation to Virtual Assets and Virtual Asset Service Providers*

Jan 2022

HKMA-SFC issued circular on Virtual Asset-related activities

The Circular outlines three main sections of focus:

1. Distribution of VA-related products

- Selling restrictions
- VA Knowledge Tests
- Net-worth requirements
- Caution in Financial Accommodation
- Disclosure

2. Distribution of VA Dealing services

- Restriction to deal with only SFC-licensed dealers
- Requirement to allow deposit and withdrawal of fiat currencies only
- For discretionary accounts, requirements specified in the Type 9 Regulated Activity (Asset Management) Terms and Conditions must be noted

3. Provision of VA Advisory services

- Compliance with advisory regulations, irrespective of the VA's nature
- Requirement to observe suitability obligations

Click **here** for the HKMA-SFC circular on VAs

SFC's Consultation on the Management and Disclosure of Climate-related Risks

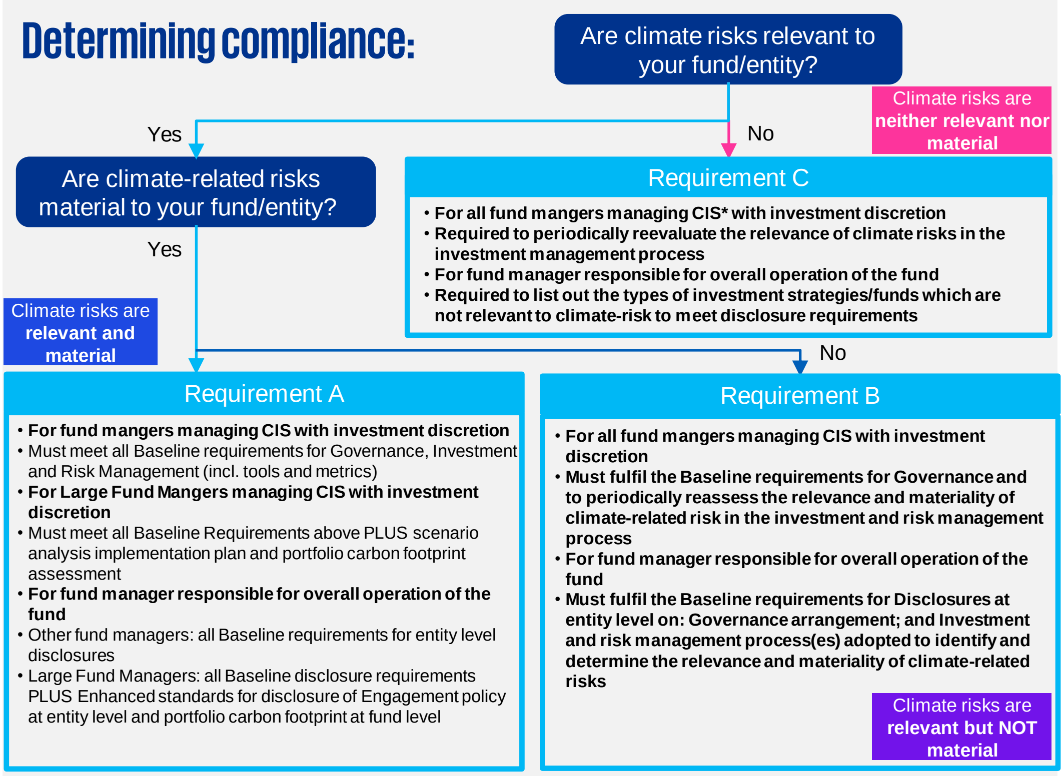
On 20 August 2021, the Hong Kong Securities and Futures Commission (SFC) issued the Consultation Conclusions on the Management and Disclosure of Climate-related Risks by Fund Managers. The resulting conclusion set out by the SFC is to implement the recommendations using a two-tiered approach; a baseline set of requirements which will apply to all fund managers managing collective investment schemes; and a set of "enhanced requirements" that will apply to fund managers with assets under management (AUM) that are equal to or in excess of HK$ 8 billion (excluding the AUM of discretionary accounts). The SFC proposed that the Fund Manager Code of Conduct (FMCC) be amended to provide high-level principles and that a circular be issued to set out expected standards for complying with the FMCC.

The asset management industry has been under pressure to manage its climate risk exposure. The consultation conclusion is a sign of convergence between institutional investor demands and the regulatory agenda.

When will the rules come into effect?

Manager Profile	Large Fund Managers	All Other Managers
Baseline Requirements	20 August 2022	20 November 2022
Enhanced Requirements	20 November 2022; quantitative disclosures due in 2023	Not applicable

Determining compliance:



*Collective Investment Scheme (CIS)

Mar 2022

SFC issued Consultation Conclusions on the Management and Disclosure of Climate-related risks

Regulatory Requirements

Governance – Board of Directors:
Maintain oversight of climate risk issues through defining roles and overseeing progress against goals

Governance – Management:
Supervision and integration monitoring of climate risk into investment and risk management processes

Investment Management:
Identify material physical and transitional risks, and factor in material climate-related risks into the investment process

Portfolio Risk, Management and Operations:
Incorporate climate-related risks into portfolio risk management through developing tools and metrics

Investor Reporting and Disclosures:
Review and update disclosures at least annually, and inform fund investors of any material changes

Click here for the KPMG flyer for more details on the SFC's consultation

SFC-HKMA's thematic review of the distribution of non-exchange traded investment products

On 1st March 2022, the SFC and HKMA jointly issued a circular announcing the commencement of a thematic review on the distribution of non-exchange traded investment products by intermediaries. This thematic review leads on from their previous joint product study from October 2021.

Key focus areas for Registered Institutions (RIs)/Licensed Corporations (LCs)

Product due diligence

The suitability obligations in paragraph 5.2 of the Code of Conduct of SFC require:

- Due diligence on the current approved product list be conducted on a continuous basis
- Frequency of due diligence take into consideration the natures, features and risks of investment products.
- Recent considerations of risk factors: Deterioration in credit quality or liquidity, market and industry risks related to the COVID-19 outbreak.

Conducting suitability assessments

- RIs/LCs should develop their own process for performing suitability assessments
- The suitability assessment should consider: the type of investment product (including its complexity and risks), and the services provided by the licensed or registered person, etc.
- Assessment should be performed on investors that do not possess knowledge or experience to ensure the investment products are suitable for them.

Disclosure of product information

- When distributing a complex product, RIs/LCs should disclose product information and provide warning statements for key features and risks.
- Disclosures may vary on particular circumstances depending on requisite level of knowledge
- Proper records of the assessment of sophistications should be maintained.

Product risk rating model

RIs/LCs should ensure sufficient consideration is made when assessing PRR. This may include incorporating risk rating adjustment for products with particular features.

Monetary Benefit (MB) disclosure

RIs/LCs should assess:

- details of MB disclosure, like use of specific and generic monetary benefit disclosure.
- all forms of MB receivable, including spread, trailer fees, retrocessions and rebates, to ensure correct and transparent disclosures.

Product pricing

- RIs/LCs should perform a detailed assessment of compliance of non-Exchange Traded products against the requirements of the latest October joint-circular, including treatment of bilateral pricing agreements, as well as policies and controls in place for the treatment of price improvement.

Mar 2022

Thematic Review of the distribution of non-exchange trades investment products

Key observations from previous Product Survey

Popularity of structured products

Most common type of product sold was structured products (including equity accumulators/ decumulators), representing 48% of all non-exchange traded investment products sold.

Increasing popularity of online distribution channels

58 firms reported that they used online platforms to distribute products to investors.

Sales to non-professional investors (non-PI)

88% of the clients that completed at least one transaction in investment products during the reporting period were non-PI clients

Concentrated market shares of top sellers

Top 20 sellers of structured products accounted for 92% of the transaction amount for all structured products

HKMA Issues Operational Resilience Guideline

The Hong Kong Monetary Authority (HKMA) issued the final SPM module OR-2 Operational Resilience in May 2022**.** Operational Resilience is the ability of a bank to deliver critical operations through disruption. It enables a bank to identify and protect itself from threats and potential failures, respond and adapt to, as well as recover and learn from disruptive events in order to minimise their impact on the delivery of critical operations. The final standard has clarified timelines, responsibilities and integration with other frameworks.

1+3 Years Timeline	31st May 2022 — **Planning (1 year)**: Develop OR framework — 31st May 2023 — **Implementation (3 years)**: Become operationally resilient — 31st May 2026 ▲ We are here • Implementation period of the framework has been extended from 2 to 3 years
Board Responsibility	• The finalised OR-2 has shifted the active role of the Board to senior management. Rather than taking direct action, the Board is now only required to review and oversee the OR framework • AIs would also need to start considering how to properly allocate the workload without affecting the daily operations
Development of Operational Resilience Framework	• With HKMA's consent, AIs can now leverage on their group's existing operational resilience frameworks, where appropriate • The Incident Management Programme under OR-2 can be constructed on top of the Bank's BCP Recovery Strategy

May 2022

HKMA issued final SPM module OR-2 Operational Resilience

What will you need to do as an Authorised Institution:

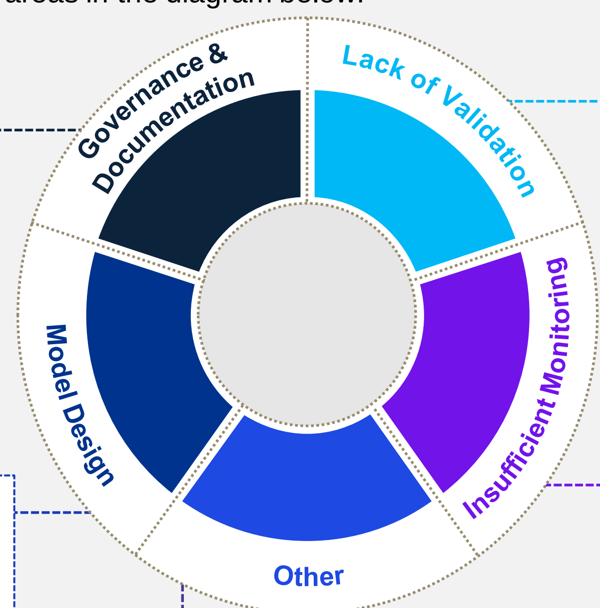
- Identify scenarios
- Set tolerance
- Map resources
- Implement incident management
- Test

Click here for the OR-2 SPM issued by the HKMA

Click here for KPMG's flyer with further information on the OR-2 SPM

Key IFRS 9 ECL Model Challenges Observed in the Hong Kong Market

KPMG performs annual reviews on the IFRS 9 Expected Credit Loss (ECL) models of banks, insurance and securities firms, and money lenders. Based on the latest year-end reviews, KPMG has noted several challenges that were faced, captured in five key areas in the diagram below:



Governance & Documentation

- Documentation does not allow model replication, with details often in working files.
- Insufficient or missing documentation, e.g.:
  - Model selection process, weaknesses and limitations.
  - Model development e.g.: build samples and data periods used for development and testing, validation tests that were performed, data sources and accuracy, etc.
  - Model monitoring, performance thresholds, and governance & review of monitoring process.

Lack of Validation

- Not performing regular independent model validation.
- The design, performance and accuracy of core IFRS 9 models should be subject to regular independent testing, such as calibration tests, tests of discrimination, stability tests, etc.

Insufficient Monitoring

- A lack of model monitoring throughout the year meant some FIs were slow to react when models began to give non-intuitive results.
- This has resulted in FIs implementing overlays/underlays to correct model errors due to COVID-19. These are often not supported by sufficient analysis and justification, or there is little or no evidence of challenge/ comments from management.

Model Design

- Simplified models were developed on small samples, due to a lack of available data.
- However, these models should be regularly updated with new data to strengthen their statistical inference.
- SICR is still reliant on the backstop and is not forward looking enough.
- Lack of forward looking adjustments on LGD.

Other

- Latest available internal or external benchmark data is not used,
- Assuming 100% PD for stage 2.
- No scenario weighting applied on the IFRS 9 ECL, or lack of justification of probability weights selected, with minimal management oversight.

Next generation Anti-Money Laundering and Regtech

In her keynote address at the Association of Certified Anti-Money Laundering Specialists (ACAMS) 13th Annual AML & Anti-Financial Crime Conference, Carmen Chu, Executive Director of the HKMA highlighted three areas of innovation to sustainably address Hong Kong's AML risks and accelerate the move to next generation approaches to AML: "Analytics" – using data and technology, e.g. network analytics, to provide actionable information to disrupt fraud and financial crime; "monitoring" – extracting the best from rules-based monitoring systems and implementing next-generation transaction monitoring systems; and "link-up" – establishing collaborative public-private partnerships, such as the Fraud and Money Laundering Intelligence Taskforce (FMLIT), to strength Hong Kong's AML ecosystem response to fraud and financial crime. AIs are encouraged to continue to innovate and adapt their approaches to implement the aforementioned innovative approaches for AML.

In conjunction with the above message, KPMG has been actively supporting the HKMA to promote the adoption of Regtech. With KPMG's support, HKMA has recently launched the Regtech Knowledge Hub – a central repository of Regtech-related information produced by the HKMA and the Regtech community – including the Flagship Regtech Event and Global Regtech Challenge that KPMG helped to organise previously. The sixth issue of the Regtech Adoption Practice Guide, which focuses on Artificial Intelligence-based (AI-based) Regtech solutions, was also issued by KPMG in collaboration with HKMA to help banks stablish data and AI frameworks to address the challenges and barriers associated with AI usage.

Regulatory approaches to Virtual Asset Service Providers (VASPs) and Virtual Assets (VAs)

The HKMA provided Authorized Institutions (AIs) with regulatory guidance in January 2022 in response to enquiries regarding AIs' intentions to engage in certain activities related to VAs, focusing on (i) prudential supervision, (ii) AML/CFT and financial crime risk and (iii) investor protection.

In respect of (ii) AML/CFT and financial rime risk, the HKMA shared guidance to mitigate the ML/TF risks associated with (a) customers engaging in VA-related activities through their bank accounts and (b) banking relationships with VASPs. AIs were reminded to pay extra attention when they become suspicious of customers engaging in VA related activities in their ongoing monitoring processes. When establishing business relationships with VASPs, AIs should recognise that there is no "one-size-fits-all" approach and undertake appropriate ML/TF risk assessments and additional customer due diligence measures similar to those for offering correspondent banking or similar services.

Meanwhile, on the topic of VAs and blockchain technology, the HKMA issued a discussion paper on crypto-assets and stablecoins in January 2022, which outlined HKMA's consideration of establishing a risk-based stablecoin regulatory regime by 2023/24. In April 2022, the HKMA also invited the public to provide feedback on the key policy and design issues for introducing a retail central bank digital currency (rCBDC), i.e. e-HKD, in Hong Kong

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

Next generation AML and Regtech

- AIs should adopt innovative approaches to sustainably tackle AML risks
- HKMA has set up the Regtech Knowledge Hub and issued Regtech Adoption Practice Guides to promote Regtech adoption

VAs and VASPs updated approach

- AIs are expected to encounter increasing number of VA-related activities and VASP clients
- HKMA provided suggestions and recommendations for AIs to mitigate AML/CFT and financial crime risks
- HKMA to consider the establishment on a risk-based stable coin regulatory regime by 2023/2024
- HKMA discussed the establishment of e-HKD from a policy and design perspective

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