Hong Kong Banking Outlook 2023

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Welcome to the Hong Kong Banking Outlook 2023, where we review the key trends and discuss some of the developments that our experts expect to see in the year ahead.

There is no doubt that 2022 was a tough year for the sector amid global turbulence, with challenges set to continue into 2023 as the war in Ukraine and rising inflation seem unlikely to be resolved in the near future. The ending of the low-interest-rate environment has been a shock for many businesses and investors leading to increasing bad debts, exacerbated in Hong Kong (SAR) by the crisis in Chinese Mainland's real estate sector.

In a more positive development, the easing of certain Covid restrictions in the Chinese Mainland towards the end of 2022 was extremely welcome news. In particular, the lifting of quarantine for arrivals and an end to the ban on outbound travel, announced in December, were major steps on the path towards normality.

Here in Hong Kong, meanwhile, the increasing relaxation of pandemic-related restrictions in the second half of 2022 has been a major boost for the city. With the ending of virtually all travel and social-distancing measures in January, there is now a real sense of optimism that in 2023 we will truly be able to get back to business.

In this report, KPMG experts share their thoughts and opinions on some of the key issues for banks in the year ahead, including regulatory developments in Hong Kong and the Mainland, business transformation and digitalisation, as well as the rapidly evolving areas of ESG and virtual assets.

There are two key concerns that cut across the whole banking sector. The first is the need to reduce costs amid a cooler economic outlook. This will be particularly challenging in the year ahead as banks also have regulatory deadlines to meet as well as essential transformational projects to run. Tackling such demands on a tighter budget will not be easy.

The other issue is talent – a perennial issue for Hong Kong that has gone into overdrive in the past year, with many parts of the banking sector suffering acute shortages and high turnover. However, the tide may be turning, as large-scale lay-offs in major technology firms in recent months suggest that the exceptionally tight global jobs market may be easing. The Hong Kong SAR Government has also announced more funding to attract top talent, which should ease the bottleneck in the longer term.

I hope you enjoy our predictions for the sector in 2023 and that they serve as useful discussion points for you and your colleagues. Please get in touch if you would like to further discuss the outlook for the industry.

The Hong Kong market

Macro view and Hong Kong's role

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Hong Kong will be impacted by the global economic downturn but our standing as a global financial hub remains secure

Moving into 2023, Hong Kong will undoubtedly be affected by the global economy as concerns ranging from the conflict in Ukraine to rising inflation continue. A higher interest rate environment will affect fintech and other start-ups most acutely, but traditional banks will also have to deal with issues including rising credit risk.

But banks can also separate themselves from the herd during times of volatility, and digital innovation is one way that traditional banks can stand out. The year ahead could provide opportunities for big financial players to acquire interesting assets on the fintech side, helping them to improve their own digital offerings while also ensuring that the most exciting fintech innovations reach the market.

Closer to home, the major easing of Covid controls in the Chinese Mainland announced as 2022 drew to a close will have a significant impact on Hong Kong's own recovery. Looking beyond Covid, we see a number of positive developments. At the 20th Party Congress in October, it was made clear that China will continue to be open for business, and will continue its reforms of the financial system. This will further open the Mainland market for international banks. The Central Government has also emphasised Hong Kong's role as a financial hub for the nation, with concrete policies like the Connect schemes enhancing our role as superconnector.

As a global financial centre, not many cities in the world have been blessed with the inherent advantages that Hong Kong enjoys. We have served as the gateway throughout China's opening up over the last 40 years, and that role will continue.

Hong Kong is also a world-class city with a unique culture and a deep talent pool. Comparisons with Singapore are inevitable, but the two cities offer different value propositions, and the Asia Pacific region is big enough for two IFCs. While the year ahead will be challenging for the banking sector, Hong Kong's standing as an international financial hub will not diminish.

Banking performance

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Subdued outlook as banks deal with the impact of an under-par local economy and ongoing China real estate concerns

The outlook for the Hong Kong banking sector performance is likely to be muted in the year ahead, as global and local headwinds put a brake on growth. But within that forecast there are a number of competing aspects, including some positive developments.

Most obviously now that interest rates are rising after many years of low margins, we expect margins to widen, which will benefit banks.

However, Hong Kong's economic slowdown will impact the amount of fee income that banks earn from wealth management and other fund raising and general spending activities by their customers. In addition, loan activity – both in Hong Kong itself and also the cross-border transactions and other investment into China – will be constrained until the economy starts growing again. The recently announced easing of restrictions for travel into Hong Kong is perhaps the most important factor and will help the city to truly recover.

One thing that will weigh negatively on performance in the year ahead is credit costs and loan impairment charges. In particular, many banks that have exposure to the China real estate market, or to real estate more generally, are going to continue to find that is going to weigh negatively on their earnings.

A major prediction for 2023 is that China real estate and the associated loan impairment charge will continue to be a big story in 2023. The Central Government has rolled out a number of support measures -- including a 16-point plan released in November to ensure banks continue lending to real estate companies -- which offered immediate relief to the struggling sector. However, the problem is not completely solved, and we expect that banks will continue to have to deal with the impact in 2023.

Regulatory change

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Besides Basel III and new regulations, banks should also expect more sophisticated use of SupTech by regulators in the year ahead

Implementation of the final Basel III reform package is nearing its conclusion in Hong Kong, marking the end of this massive global reform programme to the banking sector.

The final stages of the process have not been without challenges. International banks operating in Hong Kong have been able to leverage what their groups are doing globally during the multi-year Basel project. However, Hong Kong's timeline for implementation was earlier than some major overseas jurisdictions, meaning that some banks have had to complete local implementation before their head office -- although the HKMA has aligned to some global timelines in providing an extension on certain elements. In general though, implementation is well under way for most banks in Hong Kong.

One of the biggest regulatory developments in 2023 will be the introduction of a licensing regime for virtual assets service providers. Regulators in Hong Kong have consistently adopted a "same activity, same risks, same regulation" approach to virtual assets, resulting in a robust framework which is among the most comprehensive globally, which will attract investors looking for well-regulated venues.

Other major regulatory changes currently under implementation are in the areas of climate risk management and operational resilience (read more on pp 21 and 24).

The commercial data interchange (CDI) initiative from HKMA could have an impact on banks and the future of credit and lending in the city. Under the CDI proposal, SMEs will have the choice to share their business data to a common platform and build up their credit rating, which banks can then use to assess their suitability and grant loans much more quickly. No doubt, banks will be looking deeper into automated credit approval processes and models on the back of the CDI.

A key trend that we will see in 2023 is regulators making more use of market surveillance. The development of SupTech -- supervisory technology – is giving regulators a lot more data that they can use in a more sophisticated way to ensure that banks and other financial operators are avoiding exposure to risks.

Virtual assets

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Fallout from FTX will weigh on virtual assets but blockchain technology can help drive market development in other sectors

The end of 2022 was a massively tumultuous quarter for the virtual assets sector as FTX, one of the biggest cryptocurrency exchanges globally, collapsed. Market volatility and prices have been negatively impacted by the demise of FTX, while revelations about the company's operations have thrown up a massive challenge to the level of trust in virtual assets more generally.

However, this upheaval could play into Hong Kong's favour, as the authorities are rolling out policies to regulate the industry, with the aim of making the city a virtual assets hub. Investors around the world are still interested in virtual assets, and they will want to invest in a jurisdiction where trading in such assets is well regulated. KPMG's Investing in Digital Assets report, released in October, found strong appetite among family offices and HNWIs in virtual assets, particularly Bitcoin.

With more regulation, and with customers prioritising security, there could be a structural change in the competitive dynamics of the crypto industry, with ultimately far fewer exchanges in operation globally.

There are two visions of the direction in the year ahead. Decentralised finance, which is more transparent than other virtual assets, could come to the fore. On the other hand, traditional finance may benefit as investors revert to institutions they can trust. We will see which vision proved correct at the end of 2023.

Despite the current turmoil, the underlying blockchain technology is still extremely powerful. It will continue to be used in areas including Central Bank Digital Currency development and trade finance, and other sectors will increasingly make use of the technology.

One sector where blockchain could have a significant impact is secure token offerings around real assets – in particular real estate. In the next year, we could see the first mass offering to consumers of a real estate secure token. This will be an exciting development that could pave the way for opening more sectors to retail investors.

Building a House of Wealth

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Innovative propositions, digital solutions and a 'connected enterprise' approach will be key to success for wealth managers in 2023

Wealth managers in Asia are facing significant headwinds. Macroeconomic and geopolitical pressures coupled with ongoing cross-border travel restrictions have put pressure on AUM, net inflows and revenues, while inflation and increased regulatory requirements are driving costs higher.

Notwithstanding these headwinds, wealth managers remain steadfast in their commitment to Asia and anticipate growth, particularly in the Chinese Mainland. KPMG's recent Hong Kong Private Wealth Management Report 2022 highlights that the top two priorities for driving growth are further penetration of China and targeting second- and third-generation clients.

To achieve these goals, having innovative propositions that attract clients and AUM, and the development of digital solutions that are compatible with multi-channel delivery, will be key.

Such initiatives should not be siloed or have a short-term focus. Instead, a "connected enterprise" approach that is front-to-back (ie where the customer experience, service model and infrastructure are designed as a fully integrated solution), that are multi-disciplinary and multi-jurisdiction, is required.

The different components of a wealth manager, when layered in a logical architecture, can be thought of as a House of Wealth, comprising:

- client proposition including products, services, value proposition and channels;
- technology, tools and data that support delivery of the client experience and drive better decision making;
- operating model including organization structure, partnerships, core processes, controls and governance; and
- leadership, talent and culture – which are key to successful execution.

As we move into 2023, strategic agenda items for wealth managers in Asia include market expansion, new product development, digital transformation, cost rationalization and dealing with regulatory changes.

In addressing these challenges, a narrow focus on a limited range of elements in the House of Wealth will produce sub-optimal results. Adopting a connected enterprise approach that is customer-centric and is delivered in a collaborative and agile manner will ensure wealth managers are best positioned to meet their growth aspirations in Asia.

Perspectives on China

Regulatory outlook

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Regulatory changes are opening the Chinese market further but international banks will take diverging paths, with some reducing investment while others seek growth

The market for international banks in China is continuing to open up as regulatory changes over the past few years take effect, in areas including data governance, cybersecurity and the expected credit loss (ECL) model. The range of products that foreign banks in China can offer, such as local public custody licences, has increased. Citi and Standard Chartered are among the foreign banks that have been granted this licence to date.

There have also been moves to enable international financial groups to offer services in other sectors. In addition, many licencing procedures have been simplified.

However, banks are also facing a more intense regulatory environment. Although this affects all banks in China, the impact is more keenly felt by international players. As they are relatively small, foreign banks face proportionally higher compliance costs, and they must also deal with their group demands as well as local ones.

These rising compliance costs will add to the challenges for foreign banks in maintaining profitability and growth momentum. Looking at their near-term plans, international banks will take diverging paths in 2023 that will reshape the landscape to a certain extent. Some are considering reducing their investment in China, including cutting some business lines, while others are ramping up their plans to grow and are introducing more products. A number of banks that previously did not have a big presence are also looking to open new branches and set up subsidiaries.

There is a broad trend where European and US banks are more prudent on growth, while banks from Japan, Korea and Singapore are ready to move in and take over subsectors where their competitors have exited. However, this division is not clear-cut, and banks from the Western hemisphere are among those with the most ambitious growth plans.

Deal making and partnerships

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Fast-growing market and further opening up lay the foundation for more wealth management deals in the year ahead

Wealth management is the area likely to see the most activity in deals and partnerships involving international banks in the Chinese Mainland in 2023.

Interest in wealth management has been boosted by regulatory changes in recent years to open up the financial services sector. In particular, the rule introduced in 2018 allowing banks to operate their own wealth management subsidiaries has been welcomed not only by local players, but also by international banks, who have taken up the opportunity to team up with Chinese banks.

As of August 2022, 29 wealth management subsidiaries had been approved by the regulator, five of which involved foreign investors, including JPMorgan's 10% stake in a subsidiary of China Merchant Bank. Joint ventures are another option for international banks to access the market, as seen in the joint venture between Goldman Sachs and ICBC Wealth Management that received approval in 2021.

Working with local banks provides advantages to both sides. Chinese banks benefit from their foreign partner's capabilities and expertise, including products, risk management, diversification and know-how. They are then able to offer their clients a broader range of products, including access to international offerings.

Foreign institutions, meanwhile, enjoy access to the huge customer base of the domestic banks. The growing numbers of HNWIs and swelling ranks of the middle class in China means that there is a huge potential market for a variety of products.

In addition, the wealth management industry in China is still at an early stage of development with vast opportunities and growth potential. So we anticipate further deals and partnerships between Mainland banks and foreign financial institutions in the years ahead to serve this rapidly growing market.

Cybersecurity and data

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Staying alert for proliferating cyberattacks will be key for foreign banks in China as they also navigate a shifting regulatory landscape

Cybersecurity will be one of the crucial areas for all banks globally as we move into 2023. We predict that different types of cyberattacks will continue to grow in both volume and complexity, a trend that has been seen in recent years. Hacking techniques are becoming more sophisticated, and are also proliferating as hackers learn and share their methods across different platforms around the world.

The talent crunch across the whole banking sector is adding to the issue, as manpower shortages in cybersecurity increases financial institutions' vulnerability to attack amid the shifting security landscape. So it is crucial that banks make it a priority to develop and invest in cybersecurity talent and teams as they implement robust and appropriate programmes to ensure resilience in the year ahead.

At the same time, foreign banks in China are also navigating a shifting regulatory landscape around data and cybersecurity. The Personal Information Protection Law of the People's Republic of China (PIPL), which came into force just over a year ago, is the biggest of these developments in recent years. It has had an immediate and ongoing impact on banks operating in China, as they have had to review and assess their data, and, in particular, to establish processes and frameworks around cross-border transfer of customer information.

International banks in China have also been assessing what the introduction of PIPL says about the operating environment. Some commentators have raised concerns that PIPL could be a first step, and that the Central Government may continue to tighten regulations to the point where no data can be transferred out of China. This would ultimately make operations almost impossible for foreign banks.

However, this is currently speculation. If foreign banks are overly cautious, and rein in their growth plans due to concern about further tightening that does not actually happen, they could miss out on the emerging opportunities as the banking sector continues to open up.

Transforming operations

Outsourcing - better, cheaper, faster, safer

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The year ahead could see a boom in outsourcing as banks shift non-core areas to external service providers to focus more strategically

In the next five to 10 years, the outsourcing industry in Hong Kong has the potential to go through the roof. In the shorter term, banks that make use of outsourcing sooner rather than later could reap the benefits of lower costs and improved efficiency that enable them to deliver a better and more secure customer experience.

In recent years, many Hong Kong banks have struggled to effectively roll out digitisation programmes. For extremely large and complex organizations like banks, it can be difficult to manage such transformation programmes in-house. Using external providers instead would give banks access to the dedicated tech talent and innovation available at digital specialists.

As part of their cost optimisation considerations, banks should decide which areas are non-core – which could include tax, finance and HR – and consider outsourcing these, enabling them to focus on the strategic elements of the business.

Another issue is manpower. Hong Kong's current talent shortage has been particularly acute in areas including AML and KYC, financial risk management, and actuarial. Again, outsourcing could be a solution in these segments, and it is worth noting that outsourcing firms have not experienced the severe staff churn issue seen at banks in recent years.

Banks should also consider the "safer" part of the outsourcing equation. As outsourcing firms are often focused on specific services, they will likely have passed all the relevant legal requirements and audits. Being more nimble, external providers can also more easily adapt to shifting regulatory demands and other external pressures.

Banks will face a difficult macro environment in the year ahead, with rising inflation and a slowing global economy in addition to the internal pressures to reduce costs, need for digital transformation and talent shortages. In a recession, business that do well are often the ones that have focused on restructuring, transformation and outsourcing. A successful and timely outsourcing programme can have a phenomenal impact on improving business operations.

Tax transformation

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Banks and their customers will need to navigate a new landscape as fundamental global and local tax reform starts to take effect

Transformational changes to global and local tax regimes are creating a new environment for banks in Hong Kong. Globally, the biggest development is BEPS 2.0, which is expected to be implemented for Hong Kong from 2024. This OECD initiative aims to ensure that large corporate groups are paying the right amount of tax in the right places, including a global minimum corporate tax rate of 15%.

We predict that some banks in Hong Kong – as well as many of their biggest customers – will see a significant top-up on what they are currently paying.

Locally, a key development is the Foreign Sourced Income Exemption (FSIE) regime for certain passive income streams that are not currently subject to tax here. The new rules do not apply directly to banks, but may well affect their non-regulated subsidiaries.

This is also likely to affect customer behaviour. For example, under FSIE, if a corporate was to receive interest in Hong Kong it must have sufficient substance here to qualify for exemption. For dividends or equity disposal gains received in Hong Kong, the corporate may rely on the participation exemption where it does not have sufficient substance. Separately, affected corporates receiving income or gains outside Hong Kong, will change the liquidity profile of banks.

Amid such fundamental changes to the tax landscape, banks will also need to consider the operational implications. The new regimes will increase the compliance burden, at a time when banks are already under pressure to reduce costs and facing a talent shortage. This increases the urgency for financial institutions to accelerate the automation of the collection and processing of relevant information.

Looking more broadly at fiscal concerns in the year ahead, governments globally will be trying to rebuild their reserves after Covid. Expanded tax bases and enhanced audit activity are options – with the latter more likely than the former in the short term in Hong Kong. On the other side of the coin, the application of tax incentives to encourage economic activity should be revisited, acknowledging their interplay with minimum tax requirements.

Cost and optimisation

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Banks that target cost reductions in the right areas to address shorter term challenges and build for the longer term will be best-placed to weather the challenges ahead

While banks are benefiting from a revenue uplift attributed to increased margins, we expect increasing focus on cost reduction in the year ahead to deliver a lower sustainable cost-income ratio, and enhanced profitability, as we move into a recessionary environment.

To achieve these aims, banks will need to ensure that they choose the strategies that best suit their needs, and that they fully understand the process and impact. Otherwise, the results may not be as expected.

Tactically, we expect that banks with higher cost-income ratios will cut spending through delayering and outsourcing of operations in an accelerated manner. Staff costs rose by over 8% on average in 2021, according to KPMG's Hong Kong Banking Report 2022.

Reducing headcount is often seen as a quick solution, but may have repercussions if banks later face regulatory scrutiny or business disruption and do not have the skilled manpower on hand to handle the issues. Cost savings will also evaporate if they end up needing to backfill roles rapidly, typically using more expensive resources.

Cuts in spending will need to be balanced with increased need for investment in technology to service the digital economy and pursue high growth opportunities within a new era of banking, as well as addressing the increasing operational risks, in particular cyber risk. Careful management of these programmes will be required to ensure legacy systems are decommissioned and costs are not unnecessarily duplicated.

As banking services are offered increasingly through digital channels, a question mark remains over whether banks will look to reduce their branch footprint.

We predict that the banks that do well during these recessionary times will be the ones that are thinking of a three- to five-year strategy, and have a view on how they want to position their business on the other side. It is important for banks to have a clear strategy for cost reduction, rather than rushing into a lot of ad-hoc initiatives. History suggests that those that do not take a well-thought-out approach will not generate the same level of value than those who carefully plan their cost optimisation strategies.

Cloud adoption

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Banks should pay close attention to their cloud adoption programmes to avoid costs and complexity spiralling

The snowball of cloud adoption by banks is getting bigger and bigger. And while moving to the cloud offers many benefits, there are also potential risks lingering under the surface.

As banks have moved towards using the cloud, they have also continued to operate their on-premises systems. The complexity will start to build as they adopt a multi-cloud hybrid digital environment for the business, which will create issues in a number of areas.

Disaster recovery is impacted. In a multi-cloud hybrid environment, with different cloud services plus on-prem application, the complexity in performing disaster recovery is increased and more drills will be required. In a multi-cloud hybrid environment, data must be transferred between cloud and on-prem, making it more challenging to manage data security, availability as well as application performance.

Another issue is cost. As it is easier to request resources from the cloud, it is becoming more challenging for banks to control the number of requests and keep track of the source of demand. As a result, costs will continue to spiral which will become a significant burden to operating cost.

Last but not least, maintaining expertise to keep up with the latest cloud technologies as well as for on-prem technology is also challenging, as not all on-prem applications can be migrated to cloud easily.

These issues have not yet become apparent at banks. But we predict that they will soon face challenges in cost, data, performance, disaster recovery and talent, as was the case with the insurance sector, which was an early adopter of cloud services and has already experienced these issues. As we move into 2023, some banks will start to taste the challenges ahead. But in 2024 and beyond, as banks become more cloud-dependent, these problems may grow from a snowball into an avalanche.

To prevent this scenario developing, banks should be aware of the potential issues before they become acute, have rigorous governance in place, and ensure they have the capabilities, either in-house or externally, to deal with issues that may arise.

Operational resilience

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As the first milestone for OR-2 compliance approaches, the question for banks in 2023 is whether they can meet the ongoing implementation deadlines

With the first deadline for the HKMA's Operational Resilience standard (OR-2) fast approaching, operational resilience should be on all board agendas for 2023. The standard was launched in May 2022, giving banks only one year to put their frameworks in place, followed by three years to demonstrate resilience.

OR-2 introduces a fundamental change to how banks manage risk and is not a one-off exercise. There are ongoing compliance requirements, enhanced testing and supervision, with new accountability demands for the board and senior management. Operational resilience cuts across all areas of banking, so boards and senior management will play a critical role in driving a holistic approach in their design, implementation, remediation and governance of this framework.

Banks need to demonstrate business resiliency and show they can quickly restore services in the event of disruption – such as outages in internet banking or cash access, and ensure they understand what events might push them outside their defined risk appetite and tolerances for disruption. They must also identify and protect themselves against more severe threats, and minimise the impact of disruptive events on their delivery of critical operations. The identification of such operations should be commensurate with the size and complexity of the bank's role in Hong Kong.

Despite the time pressure, it is expected that banks in Hong Kong will meet the first OR-2 milestone. However, this is only the first step. We expect that some banks will find bigger-than-expected challenges ahead in the implementation phase, given the vast amount of data and coordination required. Considerations to invest in data management, technology enablement and tooling should be made to relieve the information burden.

Regulators worldwide increasingly expect firms, especially those whose failure could cascade into a financial crisis, to reasonably maintain continuity of services through disruptions. Banks will need to focus on communication with employees to embed operational resilience into the fabric of a bank's culture.

Banks should be taking action now, to meet the tight HKMA deadlines, and also be prepared for a dynamic environment where disruption is the new norm.

ESG

Sustainable finance

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Sustainability related products are expected to go beyond green loans in the year ahead as banks take the opportunity to accelerate transition through managed phaseout and portfolio restructuring

ESG is undoubtedly a hot topic in the banking sector. Many banks in Hong Kong are already successful green finance operators, offering a range of loans and other sustainability-linked products.

However, green loans remain a small proportion of the overall finance landscape in Hong Kong, so there is considerable scope for banks to grow this by broadening access to loans. For example, green loans have generally only been available to global clients, while the banks' huge customer base of SMEs has remained relatively untapped (read more about SME lending on p 25).

There are other ways that banks can extend their green finance offerings. Sustainable lending does not have to be restricted to newly launched projects. There is also the potential for banks to help clients transform their brown assets, and for large conglomerates to rebalance their portfolios so they can access green finance.

To date, there have been relatively few deals for transition loans to upgrade brown assets. Lending to such projects carries a higher risk, as the green aspiration will only be met several years down the line. There are other hurdles, such as administrative demands. The corporates need to create a detailed and credible transition plan before they apply for a loan, while banks must conduct due diligence. However, both sides are interested and will benefit if this gap can be bridged.

Banks could also help -- through lending or equity/debt issuing -- large conglomerates review and restructure their portfolios, which often contain a mix of green and brown assets. If the different types of assets are grouped together, the sustainable side of the company can get the benefit of access to green and sustainability-linked loans, while the brown assets can either be put into a transition process, or a managed phaseout if necessary.

Amid growing pressure from regulators and investors for more sustainable practices, there will be significant opportunities for banks to support businesses in this complex but urgent transition in the near future.

Climate risk management

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Climate risk regulation is creating compliance demands for banks but also puts them in prime position to seize the opportunities from our standing as an ESG finance hub

Climate risk management has been evolving rapidly and must now be considered by banks and their clients across all areas of business. In Hong Kong, the regulator has released climate-related guidance (HKMA SPM GS-1), and in some cases, conducted pilot climate risk stress tests. It continues to promote the adoption of effective climate risk management tools such as scenario analysis and stress testing.

In addition, the first submissions under the new Task Force on Climate-related Financial Disclosures (TCFD) regime are due by mid-2023. Despite the tight timeline, local banks have made good progress. Although the enhanced regulations create compliance burdens, we predict that they will further cement Hong Kong's standing as a global green finance hub in the year ahead.

More broadly, banks are implementing measures to systematically manage climate-related risks including developing quantitative analytical models and releasing climate risk disclosures. Some of the bigger banks have been adopting more advanced initiatives to further embed climate risk into their risk management frameworks as well as business processes. These include profiling the climate risk of their clients, embedding climate risk considerations throughout the credit approval process, and rolling out pragmatic green transition plans.

At the same time, there are headwinds to the low-carbon transition. Hong Kong banks have reported challenges in areas including capability building, technology, bridging data gaps and customer readiness. Across the region, there are pockets of resistance as some economies deal with the post-pandemic recovery by focusing on resource-heavy economic growth. Banks are presented with the challenge of balancing risk appetite frameworks between prioritising growth versus climate resilience.

Looking ahead to 2023, Hong Kong is in a strong position in climate risk management. The government is supporting banks to build financial resistance against climate change as part of its commitment to making the city a global hub for green finance. Meanwhile, regulatory action is boosting the city's role as the ESG leader in the Asian market. Hong Kong banks will therefore be in prime position to seize the opportunities as they emerge.

SME lending

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Forward-looking banks that work to solve ESG financing issues for SMEs will capture a huge market segment that forms the backbone of the global economy

One of the big issues keeping banks awake at night is how to serve their SME customers in their sustainability transition. SMEs are losing sleep too: to remain relevant to their largest customers and competitive in a global market, they must address sustainability. Yet access to relevant industry guidance and financial support is still a challenge.

As the primary financial partner for most SMEs, banks are uniquely placed to help SMEs access the sustainability support they need. The dilemma for banks is that they do not have the resources to provide the kind of tailored support SMEs need on a one-on-one basis to hundreds of thousands of small businesses. Availability of data is another crucial challenge.

Now, the rapidly changing regulatory environment is making the topic more urgent: reporting on scope 3 emissions will become part of the required company disclosures under the new ISSB Standards. Disclosure is also becoming mandatory in many jurisdictions. This means that banks with net zero commitments are expected to pivot their focus from reducing their own emissions to also financing emission reduction in the real economy – where around 90% of businesses are SMEs.

Forward-looking banks will grab this opportunity to capture business from a relatively untapped customer segment, scale up sustainable financing to SMEs and address the data challenge.

The answer could be in an ecosystem that brings together data, technology, advisory and finance, to deliver actionable and sector-specific ESG guidance and financing solutions at scale to SMEs. Underpinned by a data infrastructure that collects, uses and consolidates key data from multiple sources, including SMEs themselves, and with the services of a digital relationship manager, such a solution would help SMEs to progress towards net zero, which banks could leverage to provide transition financing.

Zooming out from these challenges, we might see that it may be necessary to further disrupt the way we operate to bring us forward in the transition to net zero. To solve such a huge planetary problem such as climate change will be for the benefit of us all – banks, SMEs, their customers, and the communities they serve.

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