Hong Kong Banking Outlook 2024

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Welcome to the 2024 edition of the Hong Kong Banking Outlook.

2023 saw mixed fortunes for the sector and the city more broadly. The removal of the final Covid-related restrictions in both the Hong Kong SAR and the Chinese Mainland in the first half of 2023 prompted many to predict a sharp rebound in economic activity. However, this did not materialise, and sentiment remains cautious across both Hong Kong and the Mainland. Hong Kong also continued to be affected by geopolitical tensions.

In this report, we discuss Hong Kong's prospects and make some predictions on key topics that will impact the banking sector in 2024. While the year ahead may not see significant growth for banks in Hong Kong, there will be still be some opportunities amid a changing landscape. Outside of Hong Kong, inflation being brought under control in many jurisdictions should provide more stability to the global economy.

On the other hand, corporate credit will remain challenged in the year ahead, amid credit stresses related to Chinese real estate and other areas.

In a situation where growth is hard to find, it is important that banks focus on improving operational efficiency and carefully managing risks so they are well positioned when sentiment improves and economic activity takes off. This report considers areas including protecting against consumer fraud, preparing for climate risk, and staying up to date on tax and regulatory developments.

Cross-border connectivity is also expected to continue to improve in the year ahead, with schemes like the Wealth Management Connect opening new markets and expand the potential customer base.

I hope you enjoy our thoughts on the outlook for 2024, and that our predictions are helpful as you plan your strategies for the year ahead. When discussing topics that are difficult to predict, it is expected that views within KPMG will vary. We will all be playing close attention to market developments in the year ahead.

Please get in touch with our team if you'd like to discuss any of these topics further.

Banks' Financial Performance

Paul McSheaffrey
Senior Banking Partner, Hong Kong

In looking at the financial performance of Hong Kong banks in 2024, I see three major trends.

1. The banking sector tends to follow the economy. In 2023 the economy has been challenging, which is likely to continue into 2024. This leads to lower loan growth, while lower activity in the financial markets will also impact the fees and commissions that banks earn.

2. Credit losses have been a big trend, in particular, exposure to Chinese Mainland real estate. But while many of those exposures are well provided, it will be in 2024 that many banks clean up their books and are ready to move forward.

3. Higher interest rates have generally been positive for banks, particularly those with a large current account and savings account base. Interest rates are unlikely to come down until the third quarter at the earliest, which should help banks' income in 2024.

Final prediction: 2024 will not be a year of growth. Instead, it is a time for banks to focus on operational efficiency and managing their risks, to be ready to reap the rewards when growth returns in 2025.

Hong Kong as an IFC

Jianing Song
Head of Banking and Capital Markets, Hong Kong

Hong Kong's position as a world-class city and IFC is stronger than ever. This is driven by three key ingredients:

1. Our unique position under One Country Two Systems and commitment to rule of law, including protection of business IP and our data and digital regulations. We should continue to emphasise and redefine our value under the Two Systems model, not just as an IFC for China, but also as a superconnector for the rest of the world.

2. More coordinated regulatory, government and private sector partnerships and policies, including in sustainable finance and fintech, particularly around virtual assets and tokenisation of financial infrastructure and products.

3. Hong Kong's world-class city standing. It's not only about the financial or business opportunities. It's truly a great place to live, with art, culture, sports and entertainment, where families and professionals can thrive.

Looking to 2024, there are some clouds on the horizon, including potential election outcomes globally. However, we remain cautiously optimistic given declining interest rates, tamed inflation, and generally a better macro outlook from a business standpoint.

Credit Risk Trends

Yi-Hsin Wang
Director, Financial Risk Management, Hong Kong

2024 will be a challenging year for banks as they prepare for the final Basel III reform, expected to be effective from January 2025.

Banks are facing multiple challenges in implementation. They need to estimate and manage possible increase in capital requirements. This will require upgrades to relevant data, systems, and internal and external reporting infrastructure to support more accurate risk measurement and regulatory compliance. Most importantly, banks need to have a strategy on balance sheet optimisation.

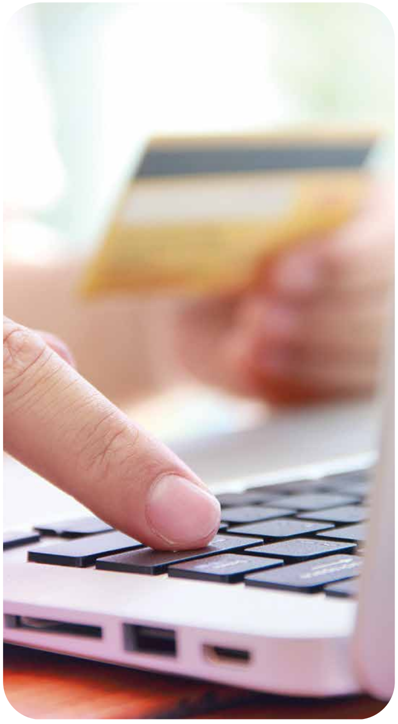
The other key issue is the recent global turmoil including the Chinese real estate crisis, higher interest rates, and financial institution failures in North America and Europe. Financial institutions face challenges in factoring these uncertainties into credit strategy and credit risk management. More and more banks are reviewing whether their methodology of stress testing and early warning mechanisms are prudent enough.

Bank should incorporate more forward-looking indices, such as real estate land prices and raw material prices, to make their early-warning mechanisms more comprehensive and effective.

In the next year, banks should ask themselves, are we forward-looking enough?

Consumer Fraud

Chad Olsen
Head of Forensic, Hong Kong



In an era where technological advancements have revolutionised how we conduct financial transactions, the need for robust consumer protection measures has become more significant than ever before.

Banks serve as pillars of the financial system, facilitating economic growth and financial stability. They are also targets for fraudulent activities. Asia is particularly vulnerable to various forms of identity fraud, from identity theft and phishing scams to credit card and online banking fraud. The threats are diverse and ever-evolving.

Consumer trust is the bedrock of any functioning banking system, and protecting consumers from fraud is essential to maintain that trust. The industry should collaborate with the regulatory authorities and law enforcement agencies. By sharing information, establishing strong partnerships and fostering a coordinated response, banks can collectively work towards minimising the impact of fraud on consumers.

The importance for banks of protecting consumers from fraud in Asia cannot be overstated. In 2024, we expect to see greater collaboration between regulators, law enforcement and the private sector, as safeguarding the interests of customers is a prerequisite for maintaining a secure and trustworthy financial ecosystem.

Wealth Management Connect 2.0

Edna Wong
Partner, Advisory, Hong Kong

The Wealth Management Connect scheme was launched in 2021, with the aim of allowing residents across the Greater Bay Area to invest in approved wealth management products in the Chinese Mainland, Hong Kong and Macau.

The regulators recently announced an upgrade to the scheme, noting that the reopening of the borders in 2023 provided a good opportunity to introduce version 2.0.

While Wealth Management Connect 1.0 was exclusive to banks, 2.0 includes eligible securities companies. It also includes a broader scope of investment products and an increased individual investor quota. Wealth Management Connect is seen by banks as a convenient and reliable platform for cross-border asset diversification and shows the demand for cross-border wealth management services. With the introduction of securities companies into WMC, we expect the market competition will be stronger.

Going in to 2024, we expect to see banks looking to capitalise on Wealth Management Connect 2.0 brushing up their digital wealth agenda and how they can ensure a seamless end-to-end customer journey, from onboarding to the selling of wealth management products, striking the right balance between risk, compliance and customer experience.

Tax Trends

Matthew Fenwick
Partner, Tax, Hong Kong

There is significant, fundamental change in the tax landscape for banks in Hong Kong at present.

1. The OECD's Base Erosion and Profits Shifting initiative. We currently have the OECD's generic rules, but will in 2024 move towards analysing Hong Kong's specific implementation regime. Banks must review the impact, from a technical and financial point of view, and consider how to fulfil the reporting and compliance obligations.

2. The EU's challenge of Hong Kong's territorial tax system. The foreign sourced income exemption won't apply to banks themselves, but will apply to non-banking entities and to the bank's customers. So we foresee some review, and possibly alteration, of banking arrangements in 2024.

3. Banks are also dealing with BAU, provisioning, compliance and customer tax reporting. Many banks are undertaking a significant review to better understand the processes they are required to deliver, and how to make better use of technology.

In 2024, we see both opportunity in the planning and optimisation of processes and challenge: by virtue of the significant weight of change and reform that will need to be analysed and understood.

Climate Risk

Gemini Yang
Partner, Financial Risk Management, Hong Kong

In 2023 the HKMA introduced the enhanced climate risk stress test (CRST), as part of its commitment to enhancing the resilience of the financial sector in the face of climate change.

It underscores the importance for banks to assess their climate-related risks and prepare for a range of potential scenarios.

Another significant step is the green classification framework, which categorises economic activities based on their sustainability, providing banks with a robust tool to identify and manage climate-related risks in their portfolios.

The HKMA also set forth a clear commitment to achieve net zero carbon emissions within the banking sector by 2050. These plans are important, not only for mitigating climate risk, but also for positioning banks as leaders in the sustainable finance landscape.

Furthermore, it is crucial that banks integrate climate considerations into their broader risk frameworks, and align their strategies with the evolving climate landscape to foster long term resilience.

Looking forward, collaboration will be key. By fostering partnerships, sharing data and developing common standards, the banking industry can collectively address climate risks, leverage green financing, and contribute to the broader sustainability agenda.

Deals Environment

Joan Wong
Partner, Deal Advisory, Hong Kong

China's contribution to Asia's financial wealth has increased significantly in the last 10 years and this is expected to continue to grow.

The Greater Bay Area is a unique private banking and wealth management opportunity with a growing population and economy, and initiatives such as the Wealth Management Connect schemes.

We continue to see M&A transactions taking place in the financial services sector. For example, a few months ago, HSBC announced that it had signed an agreement to acquire Citi's retail wealth management portfolio in China. We expect to see more deals in the wealth management sector.

The banking sector continues to digitise. Although many banks have in-house initiatives and business units dedicated to this area, we anticipate potential for inorganic growth through acquisitions that enhance banks' digital offerings and align with their overall strategies for digitalisation.

Another observation is that a few fintech companies are trying to raise funds, although the current fund-raising and IPO market is challenging.

In the years ahead, we expect to see more deals in the areas of wealth management and private banking.

Regulatory Reporting

Aroopkumar Lalla
Director, Advisory, Hong Kong

To mitigate risks to financial stability, regulators in Hong Kong are now focusing on four key aspects:

Increased transparency: Initiatives include Granular Data Reporting (GDR). Regulators need high quality data to help them assess systemic risk, perform market surveillance, and conduct enforcement.

Aligning reporting standards: With measures like IFRS and Basel III reforms, there is a push towards harmonising data reporting.

Non-financial reporting disclosures: These include ESG, carbon credits and sustainability reporting.

Anomaly detection: Regulators are questioning if data reported is inconsistent across different reporting data sets.

To ensure that they are complaint with regulatory developments, banks in Hong Kong will need to:

- Conduct compliance testing to ensure data quality
- Start running GDR programmes by designing robust data models
- Implement technology-supported reporting engines to reduce human error and streamline regulatory reporting processes

If I had to prioritise one thing for 2024, it would be Granular Data Reporting. The time to implement a robust, scalable and cost-effective solution is now, rather than waiting for regulators to knock on your door.

Cross-border Data Interchange

Lanis Lam
Partner, Technology Risk, Hong Kong

Data connectivity is an important topic in the digital age, and many organisations are talking about this, including cross-border data transfer between Hong Kong and the Chinese Mainland.

In recent years, the Chinese Government has issued regulations regarding cross-border data transfer. Several regulations have also been released in the past few months, which provide additional information in areas such as the relaxation of certain reporting requirements. Additionally, both the Hong Kong Government and the Guangdong authorities have released implementation details on data exchange within the GBA region.

We understand that data flow is a complex matter. It requires the right management procedures and technical set-up. These include, for example, setting up the cross-border data inventories, establishing data governance controls, formalising agreements between data senders and recipients, and most importantly, embedding the overall control frameworks into banks' BAU environment.

Looking ahead in 2024, we expect to see further developments on this topic. It is critical that banks ensure that they consider cross-border data flow when developing their upcoming business strategies.

Corporate Credit

Guy Isherwood
Senior Advisor, Hong Kong

Corporate credit in 2023 was tough:

- Covid pandemic forbearance support rolled back
- Global supply chains began to de-risk, trade volumes fell
- Global inflation leapt, hitting demand
- Ultra-low borrowing costs ended as interest rates soared
- China's growth slowed due to stressed real estate and non-bank financial sectors

These all took their toll on corporate credit portfolios, and bank performances suffered from falling lending volumes and rising impairment. In 2024, global inflation will stay above policy targets, so interest rates will only taper in the second half, and will remain comparatively high.

Mainland and Hong Kong economies are unlikely to rebound strongly, unless there is unexpectedly high government stimulus. Trade tensions will remain, and are challenged by geopolitics. Expected Credit Losses will remain elevated as credit stresses emerge beyond Mainland real estate.

However, US economic resilience will provide some global trade tailwind, which will mitigate some of these issues.

Corporate credit will remain challenged in 2024, with the quality and scale of corporate loan growth under pressure. We see rising non-Mainland real estate impairment charges, although reported NPL ratios should moderate as banks actively write down their non-performing loans.

Virtual Assets

Robert Zhan
Director, Risk Consulting, Hong Kong

2023 has been an exciting year for blockchain and virtual assets.

With the increased focus on regulation -- such as the implementation of the virtual asset service provider regime in Hong Kong, which will move the trading of virtual assets from an unregulated space into a regulated space -- we expect this to bring about more stability, certainty and investor protection for a sector that has had more than its fair share of bad news in recent years.

We also continue to see increasing interest and adoption from the traditional finance sector. Financial institutions exploring distributed ledger technology (DLT) have seen promising results, particularly around security tokenisation and smart contract capabilities.

In 2024, the focus will continue to be the integration of DLT and virtual assets to the real economy. How financial institutions can innovate to develop products with new features using this new technology, or how they can leverage this new technology to save costs for customers and increase the bottom line, will be the key driver for innovation and differentiation in 2024 and beyond.

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