The guidelines issued by the regulators in the last six months have contributed to the strengthening of Hong Kong financial services sector.

In this fifth edition of ‘PwC Regulatory Hot Issues’, we have discussed the following key developments:

**Interest Rate Benchmark Reform**

With the publication of the London Interbank Offered Rate (“LIBOR”) due to come to an end in 2021, the Hong Kong Monetary Authority (“HKMA”) is calling on institutions to ensure that they are adequately prepared for the transition to alternative reference rates. This approach reflects a global call to attention by regulators internationally, who have warned of potential disruptions for those who fail to be proactive.

A circular issued by the HKMA in March 2019 requested that Authorised Institutions (“AIs”) make preparations for the transition. This was followed by a second circular in October 2019, providing an update on the latest developments relating to interest rate reform and the HKMA's plans to conduct surveys to monitor AIs’ progress in preparing for the transition.

**Environmental, Social and Governance (“ESG”) Regulations**

ESG was a key focus of the September 2019 edition of our Regulatory Hot Issues, after a number of new regulatory initiatives were introduced during the year. This momentum has increased further over the past six months, with PwC being engaged as a consultant by the Securities and Futures Commission of Hong Kong (“SFC”) to conduct an industry-wide survey to understand how and to what extent licensed asset owners consider ESG risks. In addition:

- On 18 December 2019, the Hong Kong Exchanges and Clearing Limited published its consultation conclusions on the ‘Review of Environmental, Social and Governance Reporting Guide and Related Listing Rules’; and
- On 31 December 2019, the HKMA sought comments on the proposed Common Assessment Framework on Green and Sustainable Banking. The consultation seeks to gather information on six key elements to better understand the state of the industry on green and sustainable banking.
Banking Capital

Hong Kong has been one of the few jurisdictions actively employing the Countercyclical Capital Buffer (“CCyB”) as a macro-prudential instrument. Until October 2019 this was maintained at 2.5% (the maximum level), however the past six months have seen two reductions:

- In November 2019 the CCyB was reduced to 2% amid increasing economic risks; and
- On 16 March 2020 the CCyB was reduced to 1% based on the HKMA’s observation of the current economic situation.

The HKMA’s decision to lower the CCyB requirement constituted the first time it has been used to maintain sufficient credit supply, and to leverage the banking system as a buffer against economic downturns.

In addition on 27 March 2020, the oversight body for the Basel Committee on Banking Supervision (“BCBS”) announced an extension of the Basel III implementation timeline by one year to 1 January 2023. This deferral is intended to free up the resources of institutions to enable them to respond to the economic and operational impacts of Covid-19.

Governance, Culture and Accountability

As communicated in our September 2019 edition, culture and ethics continue to be a key focus for regulators both at home and abroad. Record fines were imposed on both financial institutions and individuals around the world in 2019. We expect this focus to continue in 2020, with a number of overseas regulators explicitly outlining their focus.

In Hong Kong, the HKMA has demonstrated this through culture self-assessments, hosting cultural dialogues with senior management and an increasing focus on culture and conduct during reviews.

Asset and Wealth Management

Regulatory developments continue to strive for more transparency and customer protection, while enhancing Hong Kong’s stature as an asset and wealth management centre globally.

Recent key regulatory developments concerning Hong Kong’s asset and wealth management sector include:

- The issuing of guidance to Licensed Corporations on the use of external electronic data storage;
- The issuing of licensing guidelines for family offices and private equity firms; and
- The launch of a consultation on enhancements to the open-ended fund companies (“OFC”) regime.
Insurance Regulatory Reforms
On 23 September 2019, the Hong Kong Insurance Authority ("IA") assumed regulatory supervision of the insurance intermediaries and focused its efforts on the fair treatment of customers along with the regulatory guidance for intermediaries. Most notably, the IA has recently issued a guideline on the carrying on of medical insurance business, and an explanatory note on the licensing requirements for the banking sector.

In addition on 13 January 2020, the IA issued their prescribed scenarios for general insurance business in relation to the guideline on Enterprise Risk Management. Pursuant to this, insurers are required to submit their first Own Risk and Solvency Assessment Report for the financial year ending on or after 31 December 2020.

Technology
There have been a number of critical developments in the last six months concerning the use of technology in risk and regulation. In addition to the HKMA and PwC jointly-published whitepaper on artificial intelligence, the HKMA has refreshed and reissued their Supervisory Policy Manual TM-E-1 on ‘Risk Management of E-banking’ in October 2019, and conducted a holistic review of the Cybersecurity Fortification Initiative ("CFI").

Anti-Money Laundering Regulations
The HKMA hosted its first Anti-Money Laundering and Counter Financing of Terrorism ("AML/CFT") RegTech Forum in November 2019, attended by 400 industry stakeholders including regulators, institutions, experts from the RegTech sector, and other stakeholders. This serves as a reinforcement that the enablement of AML/CFT RegTech by AIs will be one of the HKMA’s key supervisory focuses in 2020. In other countries, we have seen similar initiatives to enable the use of technology to efficiently meet AML/CFT compliance objectives.

Tax: The Changing International Landscape
As we witness rapid developments in many tax rules internationally, Hong Kong is striking a delicate balance between the need to ensure the regime is defensible against international scrutiny and public pressure, while retaining its attractiveness as an international financial centre. In this edition, we discuss the following recent developments in Hong Kong’s tax environment:

• The proposed limited partnership for funds regime;
• Increased clarity and concessions on carried interest;
• Broadening of insurance incentives;
• Concessions for ship leasing businesses; and
• The Inland Revenue Department’s ("IRD") view on digital economy, e-commerce, and digital assets.
It can become difficult to keep track of regulatory updates when new regulations and guidelines are issued on a piecemeal basis almost everyday. “PwC Regulatory Hot Issues” aims to provide you with a recap on some of the most pertinent areas that are challenging financial institutions. This publication will be released periodically as a reminder of key regulatory updates impacting the financial services industry.

The 5th edition discusses a range of trending topics that the Hong Kong regulators are focused on for 2020, including interest rate benchmark reform, environmental, social and governance regulations, insurance regulatory reform, technology, governance and culture, amongst others.

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The growing impact of the Covid-19 pandemic crisis continues to drive volatility and uncertainty in the financial sector, and across the global economy. In response, we have seen governments together with supervisory authorities around the world introducing measures to provide relief and support to financial institutions as well as the wider economy. Recent measures taken by financial services regulators in Hong Kong have been summarised below:

**The HKMA**

- The countercyclical buffer (“CCyB”) has been reduced from 2% to 1% in response to the Covid-19 crisis.
- The HKMA has been holding small and medium enterprises (“SME”) lending roundtables since November 2019 where it encourages institutions to adopt a customer-focused attitude. With the Covid-19 crisis, these roundtables were supplemented by several public circulars that shared progress and best practices, one of them promoting a "sympathetic stance" in the treatment of customers facing difficulties.
- The regulator also clarified that changes to the repayment terms of loans do not necessarily lead to a "rescheduled" or "default" status as long as the new terms are deemed to be "commercial". This clarification grants institutions more flexibility in supporting customers in difficulties without causing a need for provisioning or higher capital requirements of such loans.
- Hong Kong Mortgage Corporation Insurance Limited (“HKMCI”), a Hong Kong public development institution, introduced a 90% SME loan guarantee scheme in December 2019. With the Covid-19 crisis, this scheme is now supplemented by a 100% SME guarantee programme for loans to SMEs for covering wages and rental expenses amid declining revenues. The regulator clarified that guarantees from this institution normally qualify as credit risk mitigation when calculating the capital requirements and are deductible for the calculation of large exposure limits.
- The HKMA announced on 30 March 2020 that Hong Kong will extend the timeline for the local implementation of the revised market risk and Pillar 3 requirements, in line with the finalised Basel III reforms, to 2023. This is in line with the announcement by the Group of Central Bank Governors and Heads of Supervision on 27 March 2020, in which they extended the implementation timeline by one year to 1 January 2023.
- Further actions have also been taken with respect to liquidity requirements and their inherent liquidity buffers. In a circular from 3 April 2020, the HKMA indicated the willingness to accept temporary non-compliance with the Liquidity Coverage Ratio (LCR) minimum requirements as well as temporary deviations from the minimum Liquidity Maintenance Ratio (LMR) as long as the minimum monthly average LMR is met.

**The SFC**

- The SFC and The Stock Exchange of Hong Kong Limited (“SEHK”) issued a Joint Statement on 4 February 2020 and a set of Frequently Asked Questions (“FAQs”) on 28 February 2020 to provide guidance on the publication of preliminary results announcements due on 31 March 2020. The Joint Statement encouraged listed issuers to consult with the SEHK on the financial information that an issuer may publish if it is unable to obtain agreement from its auditors on its preliminary results, with a view to minimising disruptions to trading while ensuring that the investing public continues to receive sufficient information to make informed investment decisions.
• The SFC and the SEHK issued further guidance on 16 March 2020, wherein they clarified that an issuer may defer the publication of its annual report initially for up to 60 days from the date of this statement if the issuer has published, on or before 31 March 2020:
  I. its preliminary results with its auditors’ agreement in compliance with Main Board Rule 13.49 or GEM Rule 18.49 (as applicable);
  II. its preliminary results without its auditors’ agreement pursuant to the Joint Statement;
  III. its management accounts; or
  IV. Material Financial Information.

• The SEHK will consider applications for a further extension solely on a case-by-case basis having regard to the individual circumstances of the issuer.

• Also, the SFC has extended the deadlines for implementation of the following regulatory expectations by six months
  I. Use of external electronic data storage (“EDSP”) – Deadline extended from 30 June 2020 to 31 December 2020
  II. New measure to protect client assets – Deadline extended from 31 July 2020 to 31 January 2021
  III. Data standards for order life cycles – Deadline extended from 31 October 2020 to 30 April 2021

The Insurance Authority

• On 21 February 2020, the IA introduced temporary measures on supervisory requirements to facilitate non-Face-to-Face (“F2F”) distribution methods for the Qualifying Deferred Annuity Policy (“QDAP”) and Voluntary Health Insurance Scheme (“VHIS”) as a matter of priority.

• Insurers and intermediaries can dispense with the need to conduct the Financial Needs Analysis (“FNA”) for QDAP and VHIS products after implementing the compensating measures of upfront disclosure and extended cooling-off period to achieve the fair treatment of customers.

• To allow sufficient time for policy documents to reach the policyholders through mail, as well as time for policyholders to seek independent professional advice where necessary, insurers should extend the cooling-off period to no less than 30 calendar days for policies sold with the variations under non-F2F distribution adopted.

• For the signature requirement, insurers and intermediaries can put into place appropriate measures such as electronic signature, onsite recording, personal identification number (“PIN”) verification, sign-and-return-mail, and one-time-password in lieu of wet signature by the customers.

• In addition as a one-off facilitative measure, the IA has decided that for the purpose of fulfilling the Continuing Professional Development (“CPD”) hour requirements in the first CPD Assessment Period, individual licensees will be considered as CPD-compliant if they can earn the CPD hours required for the first Assessment Period on or before 31 October 2020 (instead of 31 July 2020). They must then report their CPD compliance to the IA no later than 31 December 2020.

• The second phase of measures announced on 27 March 2020 also cover additional protection type products, including term policies, and certain refundable or renewable policies that provide insurance protection (such as hospital cash, medical, critical illness, personal accident, disability or long-term care cover).

• With immediate effect until 30 June 2020, insurers and intermediaries are allowed to distribute those life insurance products through non-F2F methods.

Looking Ahead


Interest Rate Benchmark Reform - LIBOR ends in 2021, but you should act now

Publication of the LIBOR will likely cease after 2021. The shift away from the most widely used interest rate benchmark is an immense change to global finance that will have far-reaching impacts.

New alternative reference rates ("ARRs") are being developed in key markets to replace current LIBOR currency rates, namely the US dollar, Euro, British pound, Japanese yen, and Swiss franc. In the US, the Alternative Reference Rates Committee ("ARRC") selected the Secured Overnight Financing Rate ("SOFR") as the preferred alternative reference rate to US dollar LIBOR.

ARRs are structured differently than LIBOR rates, which will increase complexity for impacted companies. For example, US dollar LIBOR is a forward-looking rate for seven tenors, from overnight to one year that includes bank credit risk. SOFR is a backward-looking overnight rate and, as a repo rate, is secured by collateral.

In our previous edition (September 2019), we discussed the key challenges for the LIBOR transition arising from the combined impacts of risk, ambiguity and complexity, and how market participants should prepare themselves.

In this issue we will cover the recent regulatory developments which further increase the need for financial institutions to act quickly, highlighting key components institutions and other market participants should consider in their transition program. We will also take a look at some of the key developments for 2020.

Regulatory expectations in Hong Kong – it is important that institutions and other market participants in Hong Kong are getting prepared for the transition

Locally, the HKMA has continued to raise awareness and remind institutions to make required preparations. They have done so through a series of circulars released over the past year. The initial circular, published in March last year, requested institutions to make preparations for the transition associated with the interest rate benchmark reform.

This was followed by a second circular issued by the HKMA in October 2019 which provided an update on the latest developments relating to the reform of interest rate benchmarks. This second circular also highlighted HKMA’s plans to conduct surveys on institutions to monitor their progress in preparing for the transition from interbank offered rates ("IBORs") to ARRs. The first survey took place at the end of 2019. This is similar to actions taken by other overseas regulators, such as the UK’s Financial Conduct Authority ("FCA") and the issuance of their ‘Dear CEO’ Letter. It is expected that the HKMA will conduct the survey on a semi-annual basis and therefore, expect institutions to show notable progress in their preparations for the transition.

Why you should act now?

Apart from the HKMA’s local efforts, other regulators around the globe have warned of potential market disruptions for those that do not proactively transition away from LIBOR. While banking regulators have been at the forefront in reminding institutions to take action, recent months have seen an increased focus on other market stakeholders, including asset managers and buy-side participants. The publication of practical guidelines and renewed warnings issued by the regulators also highlight the wider market implications of the LIBOR transition.
For example, in January 2020 the ARRC, a US working group, published a buy-side practical implementation checklist to which PwC contributed. The checklist addresses specific topics relevant to buy-side firms such as portfolio strategy, investment and client accounting. Further, the FCA published a ‘Dear CEO’ letter on 27 February 2020 outlining the regulator’s expectations from asset managers as they prepare for the end of LIBOR. All asset management firms are in scope (MiFID, AIFM and UCITS), and it is clear that the FCA expects firms to take immediate action towards ending their dependence on LIBOR, as well as calling out the need to be operationally ready and resource the transition programme adequately.

On the local corporate side, many corporates noted increasing awareness of the LIBOR transition but have not been approached by their bankers yet. Some larger corporations are beginning to initiate their treasury LIBOR impact assessment or assemble project teams. Some of these corporations see LIBOR reform as an opportunity to digitalise and centralise control of contracts life cycle management, understanding the need for remediation of legal contracts.

All companies – regardless of the size of their LIBOR exposure or industry – need to act now. Here’s why:

**Amending contracts is a time-intensive process that requires coordination across departments (for example treasury, procurement, legal) and agreement with borrowers and other counterparties.**

LIBOR exists as a reference rate in a variety of contracts, and preparing a comprehensive inventory can be challenging. Planning now for how and when to negotiate with borrowers and other counterparties can facilitate an orderly and timely transition.

**Differences between ARRs and LIBOR may necessitate business changes.**

For example, companies may need to change how interest and cash flow is managed because interest payments on some ARR debt issuances are not set until the end of the period while most LIBOR interest payments are known at the beginning of the period.

“During the course of this year, banks should expect greater supervisory scrutiny of their preparations and contingency planning.”

*(BCBS – Newsletter: Benchmark rate reforms 27 Feb 2020)*

**Impact on IT, data, and models can be significant.**

Acting early can help companies understand the requirements to implement vendor/IT solutions and reduce costly, last minute operational problems.

**Early communication to stakeholders is critical**

Proactive communication to internal and external stakeholders will provide transparency. Early communication with lenders and investors will give companies a sense of what their concerns are and how best to interact with them to modify contracts.

The Basel Committee on Banking Supervision (“BCBS”) in its recent newsletter on benchmark reform has also reiterated that during the course of this year, institutions should consider the effects of benchmark rate reform on their businesses and make the necessary preparations for the transition to ARRs.

Other than the above implication areas, it also noted the considerations for capital instruments as regulatory capital in some jurisdictions, but clarified that amendments to capital instruments due to benchmark reform should not affect their eligibility for transitional arrangements of Basel III. Further considerations for adjustments to risk management frameworks were highlighted and it was reiterated that during the course of this year institutions should expect greater supervisory scrutiny of their preparations and contingency planning.

**Setting up your IBOR program**

As we move closer to the expected LIBOR cessation by the end of 2021, time is of the essence and institutions in Hong Kong need to set up a comprehensive IBOR transition programme and strategy. Any further delay may only increase the multidimensional risks, including conduct, operational, contract, reputational risk and cost implications, as well as the risk of falling behind their peers in other parts of the world.

By now institutions should have completed their assessments or at least be in the process of executing them and should have established or be in the process of establishing a program management office or governance structure to deal with the IBOR transition.
Major developments in the adoption of ARRs in 2020

With the expected transition from LIBOR and other IBORs to ARRs less than two years away, transition efforts globally continue to take shape. A number of these developments are taking place in 2020 to promote and further facilitate the adoption of the new ARRs. These developments include:

- The change of the market convention for Sterling interest rate swaps from Sterling LIBOR to Sterling Overnight Index Average ("SONIA") in March 2020. This happens as the Bank of England ("BOE") also announced that it will impose increasing haircuts on LIBOR-linked collaterals. The BOE has further announced that, starting July 2020, it will publish a compounded index for SONIA;

- The calculation and publication by Bloomberg of IBOR fallback rates based on adjusted ARRs for key IBORs in the first half of 2020. This takes place as the International Swaps and Derivatives Association’s ("ISDA") published adjusted fallback arrangements are incorporated in the 2006 ISDA Definitions and ISDA will also publish a protocol for the adoption of these fallbacks in legacy IBOR contracts;

- The change of discounting and price alignment interest ("PAI") by central counterparty clearing houses around the world, including the US, Europe and locally in Hong Kong; and

- Expected increase in ARR-based cash products issuance that will further drive demand for ARR-based derivative products, which may be supported by the other changes above.

Key components of a LIBOR transition program

Program structure and governance

- Establish a program governance structure with appropriate executive leadership and board oversight, including stakeholders from all impacted businesses and functions across the organisation.
- Manage and monitor transition progress.

Impact assessment

- Conduct a comprehensive assessment to identify the company’s exposure to contracts that reference LIBOR.
- Understand transition impacts and develop a strategy for remediation activities.

New benchmark markets and strategy

- Monitor and assess ARR market developments.
- Develop a plan for entering into and managing new ARR contracts.

Contact remediation

- Remediate contracts with counterparties that reference LIBOR.
- Establish clear protocols on the type and nature of amendments that will be made.
- Periodically revalidate the exposure population to ensure all remediation will be complete before the end of 2021.

Outreach and communication

- Develop a communication strategy for regulators, investors, and company personnel that outlines the company’s transition plan and status.
- For companies that offer LIBOR-linked financing to customers, develop a plan to manage customer outreach and contract remediation so customers are treated equitably.
- For companies that use LIBOR-linked funding (for example, issued debt or preferred securities), develop a plan to manage lender and investor outreach for contract remediation.

Data, systems and process changes

- Develop a plan to address operational, data, and technological readiness.
- Communicate with internal and external stakeholders who are responsible for affected systems, models, and processes.

Risk and valuation models

- Remediate pricing and risk management models that reference LIBOR.
- Validate and approve changes to models.

Accounting and tax

- Plan for accounting, tax, and reporting impacts by understanding the available relief proposed and coordinating contract remediation activities to take advantage of relief provided when possible.
- Consider necessary disclosure changes.
The last six months have witnessed an increased momentum in integrating ESG factors in the financial services industry in Hong Kong. To align with the global developments as well as to address the growing investor demand, financial regulators in Hong Kong have taken the following steps focused on green finance:

**Environmental, Social and Governance Regulations**

The SFC survey on integrating ESG factors and climate risks in asset management

In 2019, PwC was engaged as a consultant by the SFC to conduct an industry-wide survey and analyse the findings to understand how and to what extent licensed asset management firms as well as leading institutional asset owners consider ESG risks, particularly those relating to climate change. The SFC issued a report in December 2019 to present the key findings and discuss the way forward.

Key survey findings have been summarised below:

1) **Consideration of ESG factors**, including climate change. Of the firms surveyed, 83% (660) of those actively involved in asset management considered at least one ESG factor in order to understand a company’s investment potential, and facilitate better investment decisions and risk management.

2) **Governance and oversight**: To improve the financial performance of investment portfolios and satisfy client demand, 35% of the 660 asset management firms which considered ESG factors have implemented a consistent approach to systemically integrate ESG factors in their investment and risk management processes, rather than doing so on an ad-hoc basis.

3) **Investment management**: Asset management firms which systemically integrate ESG factors most often use investment strategies such as negative and exclusionary screening, corporate engagement, shareholder action and ESG integration.

4) **Disclosure**: Although 660 asset management firms reported giving general consideration to ESG factors, a majority (68%) indicated that information about their own ESG practices was not available.

5) **Risk management**: Those asset management firms which systemically integrate ESG factors have put in place risk management controls, such as incident monitoring mechanisms to flag major ESG incidents, so that portfolio managers can adjust investment portfolios as appropriate.

6) **Market trends**: Survey results also show that asset management firms of various sizes, including small firms in terms of assets under management have ESG investment processes relating to research and portfolio management.

To increase the visibility of SFC-authorised green funds, a central database of these funds has been made available on the SFC’s website.

The list is compiled based on confirmations and representations provided by the respective management companies that these SFC-authorised funds comply with the requirements set out in the ‘Circular to management companies of SFC-authorised unit trusts and mutual funds - Green or ESG funds’.
HKMA consultation on proposed common assessment framework on green and sustainable banking

On 31 December 2019, the HKMA issued a letter to the Hong Kong Association of Banks and the Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies to seek comments on the proposed Common Assessment Framework on Green and Sustainable Banking (“Framework”).

The Framework assesses an institution’s readiness and preparedness in managing climate and environment related risks.

The Framework collects information on the following six elements to enable the HKMA to better understand the state of the industry on green and sustainable banking. The Framework is a self-assessment to be conducted by the institutions, wherein each institution will assign a rating to all questions along with an explanation.

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<td>2) Corporate planning and tools</td>
<td>5) Performance and resources</td>
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<td>3) Risk management process</td>
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These six elements are further split into 21 sub-elements representing the focus areas of an institution in managing climate and environment-related risks, and which are usually found in those standards / recommendations from international bodies and regulators in other jurisdictions.

The consultation for comments on the Framework closed on 21 January 2020.

The Hong Kong Exchanges and Clearing Limited’s consultation conclusions on review of the ESG reporting guide and related listing rules


The proposed changes to the ESG Guide and Related Listing Rules will apply to issuers’ ESG reports for financial years commencing on or after 1 July 2020.

Key changes to the ESG Guide and Related Listing Rules include:

• Introducing mandatory disclosure requirements including:
  • a board statement setting out the board’s consideration of ESG matters;
  • application of Reporting Principles “materiality”, “quantitative” and “consistency”; and
  • explanation of reporting boundaries of ESG reports.

• Requiring disclosure of significant climate-related issues which have impacted and may impact the issuer.

• Amending the “Environmental” key performance indicators to require disclosure of relevant targets.

• Upgrading the disclosure obligation of all “Social” key performance indicators to “comply or explain”.

• Shortening the deadline for publication of ESG reports to within five months after the financial year-end.
Looking Ahead

There is a clear regulatory focus on ESG and green finance, and we expect the HKMA and the SFC to issue more guidelines in this area.

The SFC intends to deliver three outcomes in the near term to help firms move forward and to align the regulatory regime with the global standards:

1. To set expectations of asset management firms in areas such as governance and oversight, investment management, risk management and disclosure, focusing on environmental risks with an emphasis on climate change;

2. To provide practical guidance, best practices and training in collaboration with the industry and relevant stakeholders to enhance the capability of asset management firms to meet the SFC’s expectations; and

3. To establish an industry group to exchange views amongst the SFC and experts in environmental and climate risks, as well as sustainable finance.

In 2019, the UK’s Prudential Regulation Authority and the German Federal Financial Supervisory Authority required that banking institutions should manage climate-related risks. Specific requirements included incorporating climate-related risks into the institutions’ scenario analyses and including material exposures to climate risks within the Internal Capital Adequacy Assessment Process.

Going forward, the HKMA is likely to adopt similar standards as both the UK and German regulators. Institutions in Hong Kong will likely be expected to incorporate environmental and climate-related risks into their governance and risk management frameworks.

Regulators recognise that this transformation is a journey and there is no existing prescribed standard with which institutions are expected to comply. However, the magnitude of change required, both operationally and culturally, means that institutions need to start taking action now.
Fighting procyclicality during a downturn – HKMA reduces CCyB requirement to 1%

On 16 March 2020, the HKMA reduced the CCyB requirement for Hong Kong exposures for the second time in less than 6 months to now 1%. With this step, the HKMA is further applying and exploring the macro-prudential instruments introduced under Basel III according to their design objectives.

The rationale for the worldwide introduction of CCyBs was to address the procyclical capital management and business behaviour of institutions that had been observed during the financial crisis in 2008 and subsequent years.

Inflexible capital requirements, coupled with risk management models that relied heavily on historic data, were seen as having procyclical effects on both the real economy and the financial system. But when the tide turns and bad data starts to fit into models, institutions could be subject to pressures from different fronts, namely actual credit losses, increased risk weights, and above all a risk-off market sentiment with weakened confidence in institutions. As an inherently procyclical behaviour, during downturns institutions would be eager to sustain market confidence in them and try to maintain their capital adequacy ratio by cutting back their lending activities to reduce capital utilisation. This, as we learnt from the global financial crisis, could create a vicious cycle that in extreme cases might lead to a systemic “credit crunch”.

Addressing these observations, the buffer concept was introduced in Basel III. Buffers should be built up during good times and be consumed in downturn cycles. Thus, the banking system will not unnecessarily exacerbate the impact on the real economies. More importantly, by allowing the use of buffers there is a better chance of preventing a credit crunch which in turn would lead to increasing default rates that further impact institutions’ capital.

Hong Kong has been one of the few jurisdictions that have implemented and used the CCyB actively as a macro-prudential instrument. It was raised to the maximum level of up to 2.5% (which was maintained until October 2019) to address the potential risks of an overheating economy.

Amid increasing economic risks, the HKMA was also among the first regulators in the world to lower the CCyB requirement to 2% in November 2019, and subsequently to 1% on 16 March 2020.

The HKMA based its decision on both macroeconomic and statistical data as well as expert adjustments that are not only informed by historical information, but also on what seemed appropriate based on their observation of the current situation.

The HKMA’s decision to lower the CCyB requirement was the first time it had been utilised aiming to maintain a sufficient credit supply, in particular for SMEs, and leverage on the banking system as a buffer against economic downturns.
**Actions and considerations for institutions**

To achieve the results as designed under Basel III, institutions may want to approach economic and regulatory capital management with a more dynamic understanding compared to the relative inflexibility of capital ratios some years ago.

Thanks to the CCyB and other buffer types, institutions are able to maintain a healthy risk appetite even during adverse times and thus serve their customers better and reduce the risk of contagious economic stress in the real economy.

In addition, institutions should consider the following:

- Institutions should conduct timely re-assessments of their capital resilience and pro-actively articulate their resilience, of which the capital buffers are a relevant part, to shareholders, the HKMA and other stakeholders (such as their customers) if necessary;

- Institutions and their stakeholders should be aware that capital buffers are meant to be utilised in economic downturns, thus a decrease of capital ratios of institutions during these times should be expected and not be seen as a weakness or risk;

- Institutions should demonstrate good culture and strong discipline by allocating their freed-up capital wisely to support the real economies; and

- While institutions will need to continue to conduct stress testing for capital management purposes, they may want to take the current state of the market conditions into account, which may have already been interpreted as a part of an adverse development, and evaluate the need for adjusting their stress scenario accordingly.

**Basel III implementation timeline extension**

On 27 March 2020, the Group of Central Bank Governors and Heads of Supervision (“GHOS”), the oversight body for the BCBS, announced an extension of the Basel III implementation timeline by one year. Thus, the finalised Basel III reforms are now expected to be implemented by member jurisdictions by 1 January 2023. The phase-in time of the output floor will remain at five years and therefore be extended to 2028.

The implementation of the revised market risk and Pillar 3 requirements will also be deferred to 2023.

According to the GHOS, this deferral is intended to free up resources of institutions, which will enable them to respond to the economic and operational impact of Covid-19.

The HKMA announced on 30 March 2020 that Hong Kong will follow the revised timeline and postpone the local implementation of the finalised Basel III framework by one year to 2023.

In the short run, this will allow institutions to allocate management and risk management capacities to deal with the impact of Covid-19 on their operations and exposures. From a medium-term perspective, institutions may wish to use the additional year to prepare for the impact of the rules. The ongoing epidemic and the collective measures taken by the government, the HKMA, the HKMCI and other organisations will change the risk structure of institutions’ credit exposure for years to come.

The consumption of capital buffers, changed repayment terms, likely increasing default rates and potential deprecations of collateral values could, in a worst case scenario, affect institutions beyond the local implementation date of the finalised Basel III reforms.

Institutions may therefore wish to consider the long-term capital requirements effects of today’s business decisions while, following the HKMA’s calls for supporting the real economy in the current situation.
Governance, culture and ethics continue to be key priorities for regulators both from a supervision and an enforcement perspective. This has been reflected by the record fines that were imposed against financial institutions in 2019 by the UK FCA, the SFC in Hong Kong and the US Securities and Exchange Commission (“SEC”).

Fines levied against individuals have also increased significantly and early 2020 saw a record fine being imposed on an individual. The reasons quoted for this were a “toxic” sales culture and systemic misconduct which impacted millions of customers.

As noted below, a number of regulators across the world have indicated that this will continue to be a high priority for them going forward.

**Australia:** Transforming governance, culture, remuneration and accountability (“GCRA”) are part of the Australia Prudential Regulation Authority’s (“APRA”) policy and supervision priorities for 2020. This includes conducting a range of GCRA-related supervisory reviews and deep dives, and using entity self-assessments to drive greater accountability.

Institutions are also continuing to address the findings from the Royal Commission. This includes enhancing existing governance structures and risk management practices to prevent unlawful conduct, reducing the excessive focus on financial gain and ensuring culture and values are aligned to fair, and compliant outcomes.

**UK:** Through speeches and publications, the FCA has put firms on notice that the process of assessing, managing and improving culture is a key focus and has stressed that drivers should ensure a culture of ‘ethical compliance’. The process of embedding such a culture within firms is an FCA cross-sector supervisory and enforcement priority set in its 2019/2020 Business Plan.

Culture and governance are also leading themes in enforcement. The increase in the number of enforcement investigations opened by the FCA on governance and accountability grounds indicates that this trend will continue in the coming years.

**Japan:** Culture has been emerging as an area of focus for the Japan Financial Services Agency (“JFSA”). In October 2018, it published its ‘Approach to Compliance Risk Management’ paper setting out its expectations in relation to corporate culture, governance and internal controls.

The JFSA has also indicated that a change in mindset is required to move away from what is being seen as a checklist-based approach to compliance and supervisory practices. Their expectation is that firms will adopt more forward-looking approaches to conduct risk.

**Singapore:** The Monetary Authority of Singapore (“MAS”) released its second consultation on the Proposed Guidelines on Individual Accountability and Conduct in June 2019. These requirements were finalised in Q1 2020 and have a one year transitional period.

The MAS also published further guidance in 2019 on the identification of Senior Managers, Core Management Functions and Material Risk Personnel, who will be held to account for the actions of their staff and the conduct of their business. The MAS also published specific responsibilities for the Board, further highlighting the expectation of organisational accountability at the highest levels.
In Hong Kong, culture continues to be a priority for the HKMA. This has been demonstrated through the culture self-assessments, hosting cultural dialogues with senior management and increasing focus on culture and conduct during reviews. We have set out below some of the thematic observations that are beginning to emerge in this area.

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**Continued need to evaluate / assess culture**

While there is no one size fits all model, the HKMA has an expectation that institutions will adopt a pragmatic approach to assessing culture by combining qualitative and quantitative data from multiple sources. Certain institutions that relied on narrow information sources (for example, employee survey results alone) need to consider more holistic approaches to this assessment process.

**Inadequate oversight of overseas operations**

Global or regional headquarters need to demonstrate how they are taking into account local circumstances and supporting overseas operations in implementing culture frameworks and enhancement initiatives. This may require moving away from the traditional 'top down' approach towards a 'bottom up' approach in order to ensure group frameworks are sufficiently tailored when being rolled out locally.

**Continued focus on incentive systems**

Incentive systems and the role they play in promoting sound culture and preventing misconduct remains an area of focus. Institutions should continue to evaluate their appropriateness in driving behaviour and customer outcomes. This area continues to evolve as part of the remediation in respect of the findings from the Royal Commission in Australia.

**Inadequate consideration of overseas misconduct incidents**

Most institutions’ consideration of overseas misconduct cases has been limited to sharing their background with employees. However, there has been insufficient evaluation of the underlying root causes of those incidents and assessment of whether similar issues may exist in their organisation.

**Cultural dashboards do not incorporate forward-looking indicators**

Most institutions have only incorporated backward-looking indicators in their culture dashboards. In order to enable senior management to better monitor culture, dashboards should provide more forward looking indicators, greater granularity and better analysis to focus management’s attention.

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**Looking Ahead**

In 2020, we expect to see greater interaction in the following areas.

- **Cultural dialogues** – While the HKMA have already commenced their cultural dialogues, we anticipate that this will be expanded to cover a broader range of institutions, directors and members of senior management.

- **Sharing of regulatory expectations and observations** – We expect further guidance will be shared with the industry in terms of regulatory expectations and good market practices observed.

- **Supervisory focus reviews** – There will be an increasing number of information requests during on site and off site examinations in respect of culture, particularly in respect of culture assessments and targeted areas in response to instances of misconduct in the industry.
The changing asset and wealth management ("AWM") landscape

The AWM sector in Hong Kong is witnessing unprecedented transformations – from innovations in asset classes and distribution regimes to shifts in the regulatory landscape and the use of technology.

With the transformation well underway, asset managers will face disruption, uncertainty and challenges, but most importantly, opportunities will also present themselves. This is set against the backdrop of Asia projected to grow twice the global rate from 2020 to 2025 in regards to the accumulation of assets under management.

What’s new in the Hong Kong AWM sector?

Hong Kong has undergone rapid changes in the past few years resulting in more complex and interconnected financial markets.

Recent key regulatory milestones include launch of the OFC regime in Hong Kong and the Mutual Recognition of Funds ("MRF") agreement now extended to Switzerland, France, the UK, Luxembourg, and the Netherlands, apart from the first MRF signed with Mainland China. PwC continues to engage with the regulators to promote the development of a high quality market for the AWM sector.

In this publication, we discuss some of the key regulatory developments from the last six months that are bound to impact the course of the AWM sector in Hong Kong in the near future.

SFC requirements to licensed corporations on the use of external electronic data storage

The SFC has published a circular to licensed corporations ("LCs") on requirements for their use of external electronic data storage, including public and private cloud storage. The circular explains the undertaking and notice requirements in situations where an LC’s regulatory records are kept exclusively with External Data Storage Providers ("EDSPs").

Regulatory records are the records or documents that LCs are required to keep under the Securities and Futures Ordinance (Cap 571) ("SFO") or the Anti-Money Laundering and Counter-Terrorist Financing ("AML/CFT") Ordinance (Cap 615). LCs should designate Managers-In-Charge of Core Functions ("MICs") in Hong Kong to assist SFC’s access to such records when requested.
The SFC provides the following guidance on EDSPs:

- **Hong Kong EDSP requirement:** The LC must apply for approval with a Notice to the SFC on confirmation of consent to the EDSP on providing company data to the SFC as required.

- **Non-Hong Kong EDSP requirement:** The LC must apply for approval with an Undertaking by the EDSP on confirmation and undertaking of:
  - The receipt of LC’s consent to the EDSP on providing company data to the SFC as required by the regulator; and
  - Assistance to the SFC in providing company data.

- **MIC requirements and audit trail requirements:**
  - The LC should designate at least two individuals as MICs to have access of all regulatory records kept by the EDSP and ensure that the SFC has full access to these records upon demand; and
  - The LC shall ensure detailed audit trail information with complete record of any access to Regulatory Records.

- The guidance is not applicable to the following:
  - LCs which keep a full set of regulatory records at their premises in Hong Kong (for example, cloud storage for data backup); and
  - LCs which use computing services without keeping any regulatory records with an EDSP (for example, cloud computing for analytics and computations).

**Next Steps**

LCs with Regulatory Records kept exclusively with an EDSP shall apply for SFC approval along with the required Notice or Undertaking according to the location of EDSP.

LCs with approval prior to 31 October 2019 shall provide names of two MICs and no later than 30 June 2020, provide a copy of the Notice and confirmation on compliance with the SFC requirements.

Refer to our recent PwC publication on this regulatory update:

SFC licensing guidelines for family offices and private equity firms

In February 2019, the SFC revised the licensing booklet with the revamp focused on four major areas – business profile and clientele, financial strength and sustainability of substantial shareholders, management, and risk management and internal control measures.

In January 2020, the SFC issued additional guidance on the licensing obligations of family offices and private equity firms, clarifying any impeding questions. Therefore, we expect a lot more of these firms seeking licenses from the SFC in the near future.

SFC circular on the licensing obligations of family offices

On 7 January 2020, the SFC issued a circular that provides general guidance for family offices intending to carry out asset management or other services in Hong Kong.

A company or family office set up as a business to manage assets which include securities or futures contracts may be required to hold a license for type 9 regulated activity. The licensing implications of providing asset management services in Hong Kong do not hinge on whether clients are families. Therefore, the relationships amongst the beneficiaries of a family trust or between family members are not relevant in determining whether a license is required.

Next Steps

Family offices need to benchmark their activities with the SFC guidance to identify whether they may have licensing obligations.

Once identified, if relevant, the officers need to prepare and gather the relevant documents and submit them to the SFC along with the licensing application forms, questionnaires and supplements to attain the relevant SFC license(s).

Family offices also need to be cognisant of the on-going regulatory requirements set by the regulator, after obtaining the relevant license(s).

Refer to our recent PwC publication on this regulatory update:

<table>
<thead>
<tr>
<th>Single family offices</th>
<th>Multi-family offices</th>
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<tbody>
<tr>
<td>• A single family office operation can lead to different consequences under the licensing regime.</td>
<td>• If a multi-family office provides services to clients who are not related entities, it can not make use of the intra-group carve-out.</td>
</tr>
<tr>
<td>• If the family office is established as a separate legal entity which is wholly-owned by a trustee or a company that holds the assets of the family, it will not need a license as it will qualify for the intra-group carve-out as a fully discretionary investment manager of the securities or futures contracts portfolio.</td>
<td>• Where a multi-family office is granted full discretionary investment authority, its asset management activity would generally be similar to that of a licensed asset management company and therefore it would likely need to be licensed for Type 9 regulated activity.</td>
</tr>
<tr>
<td>• The family office is not required to be licensed for Type 9 regulated activity if it provides asset management services solely to related entities, which are defined as its wholly-owned subsidiaries, its holding company which holds all its issued shares or that holding company’s other wholly-owned subsidiaries.</td>
<td>• If it has not been delegated full discretionary investment authority and only provides securities investment advice and executes securities transactions, it may need to be licensed for other types of regulated activities, i.e. Type 1 regulated activity and Type 4 regulated activity.</td>
</tr>
<tr>
<td>• Where the investments include futures contracts, it may also need to be licensed for Type 2 and Type 5 regulated activity.</td>
<td></td>
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</tbody>
</table>
On 7 January 2020, the SFC issued a circular providing general guidance for private equity firms seeking to be licensed by the SFC to carry on a business of regulated activities in Hong Kong under Part V of the SFO. The SFC’s Licensing Handbook published in February 2019 states that a PE firm may be required to be licensed for one or more types of regulated activities depending on the types of business it conducts in Hong Kong.

The SFC has provided additional guidance as follows:

**Licensing requirements for general partners (“GPs”):** GPs are generally required to be licensed for Type 9 regulated activity (“RA9”) if they conduct fund management business in Hong Kong.

**Discretionary investment authority:** To differentiate RA9 from the regulated activities of advising on securities or futures contracts, the SFC takes the view that licensed asset managers must be granted full discretionary investment authority in respect of the funds they manage.

**Investment committee members:** Members of an investment committee who, either individually or jointly, play a dominant role in making investment decisions for the funds are required to be licensed as representatives and, where appropriate, be approved as Responsible Officers (“RO”).

**Investments in securities of private companies:** In determining whether an investment portfolio of a PE fund comprises securities or futures contracts for the purposes of RA9, the SFC will consider the composition of the entire investment portfolio.

**Offering co-investment opportunities:** If a PE firm offers investment opportunities to other persons whereby they may enter into securities transactions alongside the PE fund, the firm is generally required to be licensed for Type 1 regulated activity (“RA1”).

**Fund marketing activities:** As fund marketing activities generally constitute “dealing in securities”, a PE firm carrying on a business in such activities would generally be required to be licensed for RA1.

**Industry experience requirement for Responsible Officers:** In assessing whether an RO applicant of a PE firm has the required relevant industry experience to satisfy competence requirements, the SFC adopts a pragmatic approach and recognises a broad range of experience as long as the applicant can demonstrate that it is relevant to his or her proposed duties.

**Next Steps**

- PE firms need to benchmark their activities with the SFC guidance to identify their licensing obligations;
- Once identified, the firms and officers need to prepare and gather the relevant documents and submit them to the SFC along with the licensing application form, questionnaires and supplements to attain the relevant SFC license(s); and
- PE Firms also need to be cognisant of the on-going regulatory requirements set by the regulator, after obtaining the relevant license(s).

SFC proposes changes to the OFC regime

The first OFC was registered in Hong Kong in August 2019. PwC was a keen proponent of the establishment of OFCs, working with policymakers and the industry vigorously for more than a decade, to help shape and build an infrastructure for commonly used fund legal vehicles to be domiciled in Hong Kong.

On 20 December 2019, the SFC launched a consultation on enhancements to the OFC regime (the regime came into effect on 30 July 2018). The proposed enhancements are aimed at encouraging more private funds to set up in Hong Kong, which will in turn help further the city’s development as a full-service international asset management centre and preferred fund domicile place.

Custodian eligibility requirements for private OFCs and expansion of investment scope for private OFCs involve changes to the Code on Open-ended Fund Companies (“OFC Code”). Re-domiciliation of overseas corporate funds and significant controllers register requirements require legislative amendments. The SFC is seeking to introduce provisions in the SFO to allow it to make ancillary amendments to the OFC Rules.

The consultation on the enhancements to the OFC regime closed for comments on 20 February 2020, with the consultation proposing the following four enhancements:

<table>
<thead>
<tr>
<th>Code on Open-ended Fund Companies</th>
<th>Proposed Amendments</th>
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<tbody>
<tr>
<td>For a private or public OFC, custodian must be a Hong Kong or overseas institution or a trustee of a registered scheme under the Mandatory Provident Fund Schemes Ordinance.</td>
<td>Allow an intermediary, which is licensed or registered to carry on Type 1 regulated activity, to act as a custodian of private OFCs.</td>
</tr>
<tr>
<td>A private OFC must invest at least 90% of its gross asset value in securities and futures contracts and/or cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts.</td>
<td>An OFC may currently invest freely without any limit under the OFC Code in shares and debentures of overseas private companies. The amendment would allow an expansion of the investment scope of private OFCs to include loans, shares and debentures of Hong Kong private companies.</td>
</tr>
<tr>
<td>Corporate funds from overseas jurisdictions may re-domicile to Hong Kong by various means, for example an asset transfer or share swap.</td>
<td>Enhance the OFC regime by introducing a statutory mechanism to facilitate the re-domiciliation of overseas corporate funds to Hong Kong using the OFC structure (including, an existing fund’s corporate identity, continuity and track record would be preserved).</td>
</tr>
<tr>
<td>Currently, there are AML/CFT obligations imposed on the investment managers of OFCs and SFC-licensed or registered intermediaries involved in the sale of OFC shares.</td>
<td>To enhance the transparency of corporate beneficial ownership, requirements will be imposed on OFCs for the keeping of a register of beneficial shareholders under the OFC Rules, which will be similar to the significant controllers register requirements under the Companies Ordinance.</td>
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</table>

Next Steps

Asset managers should watch for the consultation conclusion from the SFC and prepare for the re-domiciliation requirements, once confirmed.

Refer to our recent PwC publication on this regulatory update:

Looking Ahead

While the above regulatory developments are expected to pave the way for the AWM sector in Hong Kong in the near future, they do also present some challenges.

The SFC requirements around the use of external electronic data storage will perhaps push licensed corporations to define a practical and sustainable cloud data strategy framework. The regulatory requirements will also push the overall sector to set cloud security standards and best practices on cloud data.

However, there remains a lot of confusion in relation to what data is captured under these requirements and whether non-Hong Kong EDSPs will be able or willing to provide the consents that the SFC has requested.

The information on licensing obligations of family offices by the SFC does provide helpful guidance to determine whether family offices can remain unregulated. However, for those that now face the prospect of needing to obtain a license there is a risk that an increasingly important source of business in Hong Kong, given the significant concentration of affluent individuals, may consider alternative locations to operate from. Similarly, while the guidance on the licensing obligations of PE firms may help Hong Kong become an attractive place to operate from for Asia based PE funds, this may also encourage PE firms to consider alternative venues. Although given Hong Kong continues to be the second largest Asian PE centre behind Mainland China, it is perhaps more likely that PE firms will embrace this regulation.

The proposed enhancements to the OFC regime by the SFC are aimed at encouraging more private funds to set up in Hong Kong. Time will tell whether these changes will be sufficient to encourage operators to move away from the traditional offshore fund centres.

Regulatory trends will continue to strive for more transparency and customer protection while enhancing Hong Kong’s stature as an asset and wealth management centre globally.
Guideline on Medical Insurance Business (GL31)

This new guideline applies to all authorised insurers and licensed insurance intermediaries selling medical insurance business, including individual and group business, individual indemnity hospital insurance plans under the Voluntary Health Insurance Scheme (“VHIS”) and any other types of medical insurance business.

The guideline sets out the standards and practices which insurers and insurance intermediaries should adopt to ensure fair treatment of policyholders when selling medical insurance business. The board of directors of an insurer is responsible for maintaining an oversight over the implementation of measures to ensure that the company complies with this guideline, and are ultimately responsible for fair treatment of policyholders. Controllers and senior management are responsible for observing and formulating the business practices for fair treatment of policyholders, respectively.

The key phases of process cycle covered in the guideline are:

- **Product design** – Ensure that (i) the design of a product meets the needs and interests of different policyholders; (ii) the price is reasonable; and (iii) appropriate distribution channels are being used.
- **Sales process** – Ensure sufficient monitoring on the selling process and take appropriate remediation if non-compliance occurs. The key requirements include:
  - Assess the needs of policyholders and make suitable recommendations;
  - Ensure product information is clear, adequate and not misleading;
  - Clearly explain key features, and terms and conditions of the policy;
  - Prohibit the offering of gifts to policyholders to distract them from making an informed decision;
  - Prohibit the offering of rebates of premiums or commissions to policyholders unless specified in the policy documents; and
  - Ensure competency of insurance intermediaries, and provide ongoing quality and ongoing training.
- **Claim handling** – Ensure claims are handled and settled fairly and promptly; and sufficient information is provided to policyholders.

Following the Insurance Authority’s takeover of the supervision of insurance intermediaries in September 2019, they have continued to place focus on the fair treatment of customers and development of regulations for insurance intermediaries. The IA has released several new regulations and guidelines since the second quarter of 2019, including a guideline on the carrying on of medical insurance business and an explanatory note on licensing requirements for the banking sector.

There was also further progress regarding the risk-based capital (“RBC”) regime. The IA conducted the second round of quantitative impact studies for the RBC regime, as well as released guidance on the prescribed scenarios to be adopted in the first reporting of own risk and solvency assessment results of insurers as required under the enterprise risk management guideline.
• **After-sale service** – Ensure compliance with the following key requirements:
  - Perform suitability testing on the products upon policyholders’ request;
  - Provide sufficient advance written notice to policyholders for changes in policy terms, including the reasons for such changes and properly follow up with policyholders’ queries;
  - Provide policyholders with an option to renew their policy without the new enhancements proposed at renewal of policies; and
  - Provide timely and suitable advice to policyholders on enquiries over claims and reimbursement limits as stated in policy documents.

• **Complaint handling** – Ensure policyholders are provided with information on complaint channels, including contact details and procedures for making complaints. Insurers and insurance intermediaries should have formal complaints handling policies and procedures to ensure complaints are handled fairly, effectively and promptly.

• **Handling of policyholders’ personal data** – Ensure the company exercises due care and diligence in collecting, handling, storing, using, transferring and disposing policyholders’ personal data.

• **VHIS-compliant policies** – Ensure (i) policyholders are provided with a clear explanation on the unique features of VHIS-compliant policies, differences between plans, eligibility for tax deductions and migration arrangements from a non-VHIS-compliant policy to a VHIS-compliant policy; and (ii) compliance with the requirements set out in the scheme documents issued by the Food and Health Bureau of the Government of HKSAR.

The guideline is effective from 23 September 2020.

**Explanatory note on licensing requirements for the banking sector under the regulatory regime for insurance intermediaries**

With effect from 23 September 2019, the IA is the sole regulator to license and supervise all insurance intermediaries in Hong Kong. Under the new regime, any person carrying on a regulated activity will need to be licensed. Regulated activities can include the following acts:

- negotiating or arranging a contract of insurance;
- inviting or inducing, or attempting to invite or induce, a person to enter into a contract of insurance;
- inviting or inducing, or attempting to invite or induce, a person to make a material decision; or
- giving regulated advice.

In late October 2019, the IA issued an explanatory note on licensing requirements for the banking sector. The note provide guidance including examples of activities carried out by banking staff which could be considered to be a ‘regulated activity’; and as a result, institutions and relevant staff are required to be licensed unless an exemption is granted.

<table>
<thead>
<tr>
<th>Actions which might be considered Regulated Activities</th>
<th>Actions which might NOT be considered Regulated Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Encouraging, persuading or convincing a person to enter into an insurance contract or to make a material decision.</td>
<td>Communicating to provide generic information and not referring to a specific insurance product.</td>
</tr>
<tr>
<td>Providing recommendations or making statements with a view to the client placing reliance on that statement.</td>
<td>Referring a client to an insurance intermediary and making it clear that the staff member is not acting in the capacity of a licensed insurance intermediary, nor representing a licensed insurance intermediary.</td>
</tr>
</tbody>
</table>

Whether or not the action is considered to be regulated activity will depend on the specific facts of the situation.
Prescribed scenarios for General Insurance Business in relation to the Guideline on Enterprise Risk Management ("GL21")

On 13 January 2020, the IA issued the prescribed scenarios for general insurance business ("Prescribed Scenarios") in relation to the GL21. Under GL21, authorized insurers are required to submit their first Own Risk and Solvency Assessment ("ORSA") Report for the financial year ending on or after 31 December 2020. Authorized insurers should perform the ORSA at least on an annual basis to assess their risk profile and evaluate the effectiveness and adequacy of their risk management, including the quality and adequacy of available capital. The results of the ORSA, including the details of management actions and justifications, will be documented in the ORSA Report for submission to the IA.

The three Prescribed Scenarios to be adopted in the ORSA Report include:

1) **Market risk scenario** – based on insurer’s two largest undiversified market risk charges in the prescribed capital requirement of the regulatory capital requirements as at the valuation date;

2) **Self-defined insurance loss scenario** – based on insurer’s self-defined adverse scenario representing a 1-in-200 (i.e. 99.5% VaR) or more remote event; and

3) **Largest loss scenario with largest market risk scenario** – the combination of the insurer’s largest loss scenario (from scenario 2 and the largest market risk charge under the insurer’s regulatory capital requirements).

The IA can request insurers to test additional scenarios if the insurers are exposed to specific types of risk.

**Looking Ahead**

The IA has released various new regulations and guidelines in relation to insurance intermediaries and other matters. At the same time, the move towards the new RBC regime continues. In the current environment, the industry is facing significant challenges including the low interest rate environment, the drop in sales due to the coronavirus situation, the observed increasing volatility in the stock market, amongst others. We expect that the IA will continue to respond to the industries’ changing dynamics by providing new guidelines and other regulatory information.
Technology continues to drive regulation

Technology continues to play a critical role in the development of Hong Kong as a leading financial services centre, and as such regulators continue to be proactive in addressing the potential risks and challenges that institutions should be aware of when employing tech in their operations.

HKMA and PwC have jointly published a whitepaper on artificial intelligence: “Reshaping Banking with Artificial Intelligence”

Artificial intelligence is a critical disruptor for the corporate world which could contribute up to US$15.7 trillion to the global economy by 2030, according to PwC’s Artificial Intelligence Impact Index. To foster discussion about artificial intelligence and facilitate its development in Hong Kong, in December 2019 the HKMA commissioned PwC to publish a research paper titled “Reshaping Banking with Artificial Intelligence”.

Mr Edmond Lau, Senior Executive Director of the HKMA, said, “Artificial intelligence will bring profound changes to the way in which the banking industry operates. The appropriate adoption of the technology may have the potential to reshape banking in the future. Understanding the technology and its implications from the outset is crucial to fully unleash the power of artificial intelligence. We hope this artificial intelligence report as well as the subsequent reports will offer the industry some useful references for further adoption of the technology”.

Financial services is one of the pillars of Hong Kong’s economy, accounting for 7% of jobs and generating 18.9% of the city’s Gross Domestic Product (“GDP”). 70 of the world’s 100 largest financial institutions operate in the city, securing its role as an international financial centre. Banking alone makes up 40% of all financial services employment and 63% of the value that financial services add to Hong Kong’s GDP.

Maintaining the competitive position of the banking sector is of fundamental importance to Hong Kong.

Hong Kong has emerged as a top Asian Fintech hub – largely due to the support of policymakers. Hong Kong has traditionally been a global centre of commerce and a financial gateway to China as well as Asia. Policymakers seek to strengthen this prominence with a forward-thinking policy that supports innovations in the financial services sector.

A key finding of the report is that a whopping 90% of retail institutions in the Hong Kong market have already adopted artificial intelligence or have included it on their roadmap. The paper also analyses the key drivers of artificial intelligence adoption in the banking industry, as well as the barriers. We look at a wide range of use cases and provide a comprehensive implementation framework that can serve as a point of reference for institutions on their artificial intelligence journey.

In addition on 1 November 2019, the HKMA issued a circular titled “High-level Principles on Artificial Intelligence” which provides guidance to the banking sector on the use of artificial intelligence applications. The twelve principles listed in the document cover governance, application design and development, and on-going monitoring and maintenance on artificial intelligence. Institutions should apply these principles in proportion to the nature of their artificial intelligence applications and the level of risk involved. By leveraging best practice, we trust that Hong Kong can develop into a leading artificial intelligence innovation hub.

More information can be found at:
Highlights of new HKMA Supervisory Policy Manual (‘‘SPM’’) TM-E-1

The HKMA refreshed and issued the SPM TM-E-1 “Risk Management of E-banking” on 24 October 2019. Institutions are required to assess the compliance of actual control practices related to their e-banking systems against the latest guidance and sound practices set out in the aforementioned guidelines. The key changes to the regulatory requirements include:

• Revised controls in specific areas such as fraud risk and cyber risk, customer security, e-banking channels and business continuity;

• Expanded scope of controls to cover emerging technologies such as device binding, remote account on-boarding and soft token usage; and

• Increased flexibility over the implementation of e-banking controls allowed by the HKMA, such as customer authentication, customer notification channels, fraud monitoring mechanisms and account aggregation services.


Consultation on HKMA Cybersecurity Fortification Initiative (“CFI”)

Recently, the HKMA has conducted a holistic and independent review of the CFI after receiving feedback from the industry since its launch in 2016, and in the light of recent international developments in cybersecurity.

Taking into account practices adopted by major overseas jurisdictions, market conditions in Hong Kong, and feedback obtained from the pre-consultation preparation work, the following six overarching key themes have been identified as priorities for enhancing the CFI:

1. **Effectiveness** – recommendations that aim to allow institutions to better evaluate the quality and value of their implemented cyber controls, such as enhancing Control Principles to make them more principle-based and implementable over a wider range of technologies and use cases, as well as introducing the Blue Team requirements for the Intelligence-led Cyber Attack Simulation Testing (“iCAST”) exercise to measure the effectiveness of an institution’s detection, response, and recovery functions.

2. **Alignment** – recommendations that aim to align the CFI with various overseas practices and regulations, such as updating the Control Principles to cater for new technology trends, an updated certification list for the Professional Development Programme (“PDP”), and revised iCAST requirements.

3. **Guidance** – recommendations that aim to provide clear advice to institutions on key topics in the Cyber Resilience Assessment Framework (“C-RAF”) assessments, such as a refined inherent risk profile calculation approach, a set of expected objectives and sample success criteria for the Control Principles under Maturity Assessment, and iCAST baseline expectations.

4. **Flexibility** – recommendations that aim to reduce institutions’ compliance costs without impacting the banking sector’s cyber resilience, such as the option to be exempted from specific assessments by leveraging the assessment results of their group or headquarters, and allowing AIs to opt in to a classification of “high” inherent risk.

5. **Simplicity** – recommendations that aim to streamline the C-RAF assessments and improve its user-friendliness, such as provision of a Generic Threat Landscape Report that institutions can refer to when drafting their tailored Threat Intelligence Report and develop testing scenarios.

6. **Collaboration** – recommendations that aim to foster improved collaboration between peers, across the ecosystem, and with the HKMA, such as proposed functional and technical enhancements of the Cyber Intelligence Sharing Platform (“CISP”) to improve the exchange of cyber threat intelligence across the industry.

The project is currently at industry consultation phase (at the time of writing this publication), with the CFI v2.0 targeted to be finalised by Q2 2020.
Looking Ahead

As the technologies available to institutions continue to evolve, they may have substantial impacts on how these institutes operate. While using these technologies may offer advantages to the business, they may also present new, information technology-related risks, for which the business needs to be proactive in addressing.

The fast-paced, ever-changing technology landscape has resulted in an increased focus on technology risk management and cyber-security risk management. Regulators continue to expect senior management to have a sufficient understanding of the technology-related risks to their institutions, in order to enable them to anticipate challenges and manage emerging risk areas.
Technology driven AML risk management

The invasion of technology has driven meaningful change to the financial sector, most notably in the rapid development of technologically-based innovations in the provision of financial products and services, collectively known as FinTech.

In more recent years, technology has also begun to significantly influence how institutions manage their obligations in meeting statutory and regulatory requirements for anti-money laundering and countering financing of terrorism (“AML/CFT”). While technology will bring much benefits, such as better customer experience, and more efficient operating process etc., criminals will exploit new technology to commit crime.

How do FIs and regulators tackle the challenges?

Big data analytics, artificial intelligence, cloud computing, etc. have begun to be used as solutions in the financial sector to resolve regulatory requirements. These innovative tools, commonly known as RegTech, are being implemented as solutions for compliance with AML requirements.

Financial regulators from different jurisdictions are realising the value in using technology to efficiently meet AML/CFT compliance objectives, including the AML regulatory bodies in the UK, Australia and Hong Kong who are actively advocating closer collaboration between developers and institutions subject to AML/CFT regulations.

United Kingdom

In July 2019, the UK’s FCA held a week-long Global Anti-Money Laundering and Financial Crime TechSprint to attempt to find better ways of increasing the detection and prevention rates of financial crime.

Australia

Since March 2019 the Australian Transaction Reports and Analysis Centre (“AUSTRAC”) has held 47 one-on-one sessions with RegTechs across Sydney, Melbourne and Brisbane to understand their products under development, and how they will meet the needs of the regulated population in understanding their legislation and requirements. In addition, AUSTRAC partnered with the RegTech Association to host the inaugural “RegTech Collab TechSprint” on 2 June 2019, presenting real-life scenarios faced by reporting entities (“REs”) and regulators to 17 Australian and international RegTechs. This collaboration allowed them to design and develop more effective, fit-for-purpose products that address the challenges of both regulators and REs. AUSTRAC has recently hosted the third RegTech Colab TechSprint on 18 February 2020 in Sydney, the focus of which was the transaction monitoring program and transaction reporting.
Hong Kong

The HKMA hosted its first AML/CFT RegTech Forum on 22 and 25 November 2019 attended by 400 stakeholders including regulators, institutions, and other stakeholders within the HKMA AML/CFT systems as well as experts from the RegTech sector to emphasise three important points:

• **Smoothing out the process of RegTech adoption:** Bringing together the banking sector and technology experts to share experiences and increase their collective understanding of technologies and the challenges that need to be addressed.

• **The HKMA’s role in the adoption of RegTech:** The HKMA acts as an agent to drive change and will continue to play that role by bringing the sectors together, and by identifying opportunities in how technology can be applied to further enhance the effectiveness of the AML/CFT regime as well as to increase the positive impact of information and intelligence sharing.

• **Continuous effort to protect the integrity of the financial system:** Both the HKMA and the banking sector must be constantly on guard to protect the integrity of the highly efficient financial system.

HKMA’s Next Steps

Enabling the use of AML/CFT RegTech by institutions will be one of the HKMA’s key supervisory focuses in 2020. They will seek to maintain the positive momentum generated by the AML/CFT RegTech Forum by focusing on the following efforts:

**Forthcoming activities**

• **“Accelerators”** – Introducing an appropriate assessment framework that helps institutions to review their existing AML/CFT processes and identify opportunities for RegTech adoption; conducting a follow-up industry survey on RegTech adoption;

• **“Enablers”** – Hosting interactive “lab sessions” with institutions to experiment with machine learning methods for transaction screening/ transaction monitoring (“TS/TM”); and

• **“Collaborators”** - Working with Fraud & Money Laundering Intelligence Taskforce institutions to further build out a common set of fundamental requirements around data, analytics, information delivery, collaboration as well as skills and expertise; further enhancing the effectiveness of the AML/CFT ecosystem and the positive impacts of information and intelligence sharing.

**Knowledge-sharing**

• The HKMA will produce a series of case studies for sharing with the industry after collecting institutions’ responses to the HKMA online survey, and conduct further surveys to inform changes in adoption rates and trends. This work will be supplemented by peer-to-peer knowledge exchange amongst institutions, commencing with the first discussion in early 2020 about leveraging a wider data set (for example IP address) to enable analysts to better identify and understand the full extent of evolving ML/TF risks. More sharing sessions on emerging trends and industry practices are expected in 2020.

• The HKMA will continue to engage international standard setters and peer regulators, and conduct international comparative research into the role of RegTech in AML/CFT efforts and share these learnings with the banking industry and stakeholders.
Looking Ahead: Streamlining AML with New Technology

Many institutions are now investing significantly in RegTech, such as artificial intelligence and machine learning in monitoring their customer transactions and activities. These technologies allow institutions to implement “intelligent automation” (i.e. the automation of the company’s processes using business process management and specific task-level processes using robotic process management, supported by analytics and decisions made by artificial intelligence) to determine whether a transaction is suspicious or not.

Institutions across the globe are conducting proofs-of-concept (“POC”) to test the effectiveness of using these technologies. In Hong Kong, some institutions have already completed the POC stage and are now at the implementation stage of applying these technologies in their transaction monitoring process.

Given RegTech provides a streamlined process for some data-heavy areas such as customer due diligence and transaction monitoring (which are tedious and time consuming), virtual banks could definitely gain significant benefits from adopting these technologies.

In view of the regulators’ active promotion on the use of technology, compliance officers should adapt to rapidly innovating technologies, particularly for data-heavy areas such as customer due diligence and transaction monitoring. While there is great potential from the use of technology, institutions should remain cognisant of the need to ensure such use of technologies is well governed and managed.
Over the past year, we have seen rapid developments and hurried adoptions of many tax rules internationally on transparency and paying a fair share of tax. The codification of economic substance requirements bring fundamental changes to the regulation of investment funds in no- or low-tax jurisdictions and more compliance and ongoing obligations for taxpayers. Meanwhile, the OECD’s BEPS project ("BEPS 2.0") continues to evolve, casting a close eye over digital economy and transparency. How will Hong Kong maintain (or enhance) the competitiveness of its tax system and business environment against such an international tax rules overhaul?

What’s new in Hong Kong tax?

Against this backdrop, the Hong Kong tax environment has changed markedly in the last few years. We are seeing Hong Kong strike a delicate balance between the need to ensure the regime is defendable against international scrutiny and public pressure, while at the same time, retain its attractiveness and competitiveness as an international financial centre.

In particular, the AWM industry in Hong Kong has benefitted from these changes and we are anticipating further enhancements to complete the ecosystem. Following the introduction of the unified profits tax exemption regime for all privately-offered funds, and the introduction of the Hong Kong open-ended fund company OFC vehicle, which provides more flexibility when it comes to domiciliation, private equity market players were keen to see some developments in their sector.

The proposed limited partnerships for funds regime is coming

As announced in the Financial Secretary’s 2020-21 Budget Speech, the government has been "making full efforts to introduce new fund structures, including the preparation of a new legislation on the establishment of a limited partnership regime".

On 20 March 2020, the Limited Partnership Fund Bill (the Bill) was gazetted, introducing a new registration regime for limited partnership funds ("LPFs") to be set up and operate in Hong Kong. With the unified tax exemption and OFC regime already in place, and the anticipation of the carried interest tax concession coming in 2020-21, the introduction of an LPF regime is another big step towards building a more extensive AWM ecosystem in Hong Kong.

When enacted, this legislation will be separate from the antiquated Limited Partnerships Ordinance (or LPO), which does not cater to the needs of an investment fund, but will continue to apply to existing non-fund limited partnerships. We are pleased to see that the Government has responded to the industry’s call for a modernised regime to cater for Hong Kong domiciled limited partnership funds and has presented the Bill to move this forward. The Bill has considered and incorporated several concerns raised by the industry, and strikes a good balance between the need for a robust framework, and a simple and easy to implement regime.

We expect that these changes would bring a wealth of opportunities to Hong Kong. Complementing the OFC regime, the LPF provides another common structure for alternative asset classes, and adds to the necessary infrastructure for attracting more investment funds and fund managers to Hong Kong. This would give market players more flexibility in structuring the fund vehicle and operations, and more importantly in aligning the domicile of the fund with commercial substance under the current international tax environment. Additionally, a Hong Kong domiciled fund with substance in Hong Kong would set a good foundation for the fund to enjoy tax treaty protection.

After the Bill is introduced into the Legislative Council, it is likely that a Bills Committee will be formed to scrutinise the Bill and seek comments from the stakeholders. Upon enactment of the Bill into law, the LPF regime will be effective from 31 August 2020.
Carried interest – more clarity and a tax concession

The 2020-21 Budget also announced clarity on another anticipated issue – carried interest. Specifically, the proposed introduction of a tax concession for carried interest, to further promote Hong Kong as a private equity hub. This has been a long time coming, being a contentious issue of debate for industry players for many years, and would further modernise Hong Kong’s tax regime.

This development, coupled with the broader regulatory framework to support the setup of Hong Kong limited partnerships, will enhance Hong Kong’s competitive edge.

We will provide you with more updates as these arise.

Some other notable developments and measures include:

Insurance incentives are being broadened

The insurance sector is an integral part of Hong Kong’s financial services industry. Currently, there is a concessionary profits tax rate of 8.25% (i.e. 50% of the standard rate) for captive insurance business and reinsurance business of professional reinsurers in Hong Kong.

The government proposes to extend this concessionary tax rate to:

- general reinsurance business of direct insurers;
- certain classes of general insurance business; and
- certain classes of insurance brokerage business.

These measures will enhance the competitiveness of Hong Kong’s tax regime for the insurance industry. We expect this will attract more insurers and insurance brokers to establish their business in Hong Kong and help create a more competitive business environment in the region. It can also facilitate the insurance sector to capitalise on the new business opportunities from Mainland China’s Belt and Road Initiative and the Greater Bay Area development.

Ship leasing businesses in Hong Kong to enjoy concessions too

The Hong Kong Government gazetted the Inland Revenue (Amendment) Ship Leasing Tax Concessions Bill 2020 on 17 January 2020, which introduces concessionary tax regimes for qualifying ship lessors (at a 0% profits tax rate) and qualifying ship leasing managers. As with other concessionary tax regimes, the ship leasing bill is no different, involving very complicated qualifying conditions and anti-abuse rules. Nonetheless, these regimes will foster the development of ship financing and leasing businesses in Hong Kong and should be particularly attractive to ship leasing companies looking to set up base in the region.

The Inland Revenue Department’s (“IRD”) view on digital economy, e-commerce, and digital assets

On 27 March 2020, the IRD issued its revised draft practice note on digital economy, e-commerce, and digital assets (“DIPN 39”). The revised DIPN 39 sets out the taxation principles that broadly apply to e-commerce transactions and digital assets.

It is worth noting that the revised DIPN 39 now states that a server in Hong Kong can create a permanent establishment in Hong Kong if the server is capable of concluding contracts even without the involvement of human activities in Hong Kong. This creates uncertainty to non-resident companies trading securities through a server in Hong Kong. The revised DIPN 39 also includes a new section on digital assets (for example cryptocurrencies, cryptoassets and digital tokens), setting out the general taxation treatments of different types of digital assets and transactions.

The IRD expects this revised DIPN 39 would require further updating given the international tax rules to address the tax challenges of the digitalisation of the economy would be introduced in 2020.

Looking Ahead

Tax developments are complex and bring with them a level of uncertainty to taxpayers. The IRD has also prepared the draft practice note on the profits tax exemption for funds (“DIPN 61”). Comments on the draft have been sought from industry practitioners and market players and we await the finalisation and issuance in the coming months.
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