Financial Services
Risk and Regulation

Regulatory updates newsletter
June 2020
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Introduction

Last month Eddie Yue, the Chief Executive of the HKMA, confirm the robustness of Hong Kong’s financial system in an Insight article. He referred to facts, such as the normal functioning of the HKD market, with interest rates staying low and the HKD exchange rate remaining stable, to clarify recent commentary due to geopolitical developments and reiterate Hong Kong’s strong fundamentals.

We also echo the HKMA’s thoughts and believe that Hong Kong’s financial system remains strong. Proactive financial regulations continue to provide the necessary guidance to the market players.

For this edition of our monthly regulatory newsletter, we highlight the following updates:

- The SFC released a consultation conclusions paper on proposals to refine the scope of regulated activities so that the corporate treasury activities of non-financial groups and certain portfolio compression services would not be captured under the over-the-counter (OTC) derivatives licensing regime.
- The SFC has begun a two-month consultation on proposals to amend the Code on Real Estate Investment Trusts (REITs) to provide Hong Kong REITs with more flexibility in making investments.
- The HKMA issued a circular to share key observations and good practices in AML/CFT control measures that have been identified in the recent thematic reviews.
- Number of updates from Insurance Authority including extension of Phase 2 of the temporary facilitative measures to tackle the outbreak of COVID-19, compliance with CPD requirements under the new regulatory regime for insurance intermediaries – additional Facilitative Measures, updated assessment on the Proposed Policy Holders’ Protection Scheme in Hong Kong and practice notes supplementing Standards and Practices 5.4 and 7.1 of the Code of Conduct for Licensed Insurance Brokers.
- HKMA issued revised SPM CA-G-1: Overview of Capital Adequacy Regime for Locally Incorporated Authorised Insurers and revised SPM: RE-1 “Recovery Planning”.
- LIBOR Reform Updates include BCBS The Basel Framework: frequently asked questions (FAQs); ISDA: HMRC Consultation Document on the taxation impacts arising from the withdrawal of LIBOR; Working group on euro risk-free rates recommends voluntary compensation for legacy swaption contracts affected by the discounting transition to the €STR; and Bank of England: Supporting Risk-Free Rate transition through the provision of compounded SONIA.

We hope you find our summary of these regulatory updates useful and we look forward to your feedback.

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The SFC released a consultation conclusions paper on proposals to refine the scope of regulated activities so that the corporate treasury activities of non-financial groups and certain portfolio compression services would not be captured under the over-the-counter (OTC) derivatives licensing regime.

Key highlights include:

- Taking into account the increasing popularity of central clearing for OTC derivative transactions, the SFC considers it appropriate to expand the carve-out for corporate treasury activities of non-financial groups to cover Type 12 RA.
- Narrow the scope of Type 11 RA so that it does not capture portfolio compression services (whether bilateral or multilateral) provided by a central counterparty (CCP) or a provider of client clearing services.
- Expand the carve-out from Type 12 RA so that, subject to certain prerequisites such as being regulated in a comparable jurisdiction for providing client clearing services and marketing their services through an AI or an LC, Type 12 RA does not capture overseas clearing members of overseas CCPs.
- Narrow the scope of Type 11 RA to carve out these clearing members' dealing and advising activities which are incidental to client clearing services.

(b) under Type 3 RA, to cover fund managers who deal in foreign exchange derivatives solely for the purpose of managing assets. For future flexibility, enable the SFC to prescribe (by subsidiary legislation) further classes of persons whose activities may be carved out from the scope of Type 9 RA.

• Existing requirements under the Guidelines on Competence should also apply to Types 11 and 12 RAs. New examination papers would be developed and existing examination papers would be modified to cover the industry and regulatory knowledge individual licensees are expected to have in relation to the new and expanded RAs.

Key Takeaways

The OTC derivatives licensing regime will not be implemented until the amendments to other relevant subsidiary legislations are completed. However, the industry should be prepared as the SFC does not plan to expose the final draft of the amendments for further public consultation. It will be published in the Government Gazette before the legislative changes are introduced into the Legislative Council.

Recommended Reading

Consultation conclusions on the OTC derivatives regime for Hong Kong
SFC proposes changes to the Code on Real Estate Investment Trusts

On 9 June, the SFC began a two-month consultation on proposals to amend the Code on Real Estate Investment Trusts (REITs) to provide Hong Kong REITs with more flexibility in making investments.

Proposed amendments to the REIT Code are in the following key areas:

- Minority holdings – to allow a REIT to invest in minority-owned properties subject to various conditions
- Property development – to allow a REIT to invest in property development projects in excess of the existing sub-limit of 10% of GAV subject to unitholders’ approval and other conditions
- Borrowing limit – to increase the limit on aggregate borrowings from 45% to 50%
- Connected party transactions and notifiable transactions – to broadly align with the requirements under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (Listing Rules).

The investment restrictions applicable to REITs would be as follows:

- At least 75% of GAV must be invested in recurrent rental income generating real estate, including Qualified Minority-owned Properties which can satisfy the conditions imposed to ensure they are income-generating and the REIT has control and veto rights over some key matters involving the properties (Core Rental Income Generating Investments)
- Not more than 25% of GAV may be invested in:
  (i) property development projects (including uncompleted units);
  (ii) Non-qualified Minority-owned Properties
  (iii) Relevant Investments; and
  (iv) other ancillary investments (Non-core Investments).

Key Takeaways
By updating the regime, it is hoped that Hong Kong can be better positioned to capture more new REIT listings.

The consultation is open for comments on the proposed amendments to the REIT Code until 10 August 2020.

Recommended Reading
Consultation Paper on Proposed Amendments to the Code on Real Estate Investment Trusts
On 3 June, the HKMA issued a circular to share key observations and good practices in AML/CFT control measures that have been identified in the recent thematic reviews. This includes remote on-boarding initiatives, insights and observations from engagement with AIs and technology firms in the Fintech Supervisory Sandbox (FSS) and Chatroom, as well as supervision of virtual banks that have commenced or are in the process of commencing business.

To date, more than 10 AIs have launched remote on-boarding, while others are considering or testing similar initiatives.

Some of the key observations are:

- All AIs reviewed had performed ML/TF risk assessments, with review and approval by Financial Crime Compliance (or equivalent) teams, before launching new initiatives.
- The AIs reviewed adopted a risk-based approach to develop mitigating measures which were commensurate with the identified risks.
- AIs in the review recognised that remote on-boarding may involve ML/TF vulnerabilities which differ from some traditional processes (e.g. the scalability of fraudulent on-line applications). As a consequence, AIs in the review adopted a phased approach when launching remote on-boarding services, by initially targeting lower-risk customer segments and/or limiting the service scope (e.g. limited account functionality, lower transaction limits, restricting straight-through account opening).
- All AIs reviewed adopted ongoing quality assurance processes over the effectiveness of the end-to-end AML/CFT controls for remote on-boarding, including the technology deployed.
- The approach adopted by all AIs reflected the principle that CDD at on-boarding is only one part of effective AML/CFT. Since ML/TF risks will often only become apparent upon operation of the account, it is important to implement a monitoring system which is tailored to the risk profile of a customer relationship.
- Some good practices observed by the HKMA include regular sharing of information and intelligence. For example, some AIs established internal working groups with members from both Financial Crime Compliance (or equivalent) and anti-fraud teams to identify monitoring rules in the fraud monitoring system that had AML/CFT applications.

**Key Takeaways**

AIs considering to introduce remote on-boarding or enhance existing systems may make reference to the key observations and good practices set out in this report. AIs should also adopt a risk-based approach in applying control measures, which includes taking into consideration the size and complexity of target customer segments and service scope when deciding whether examples of good practices are relevant.

The HKMA also published the third issue of Regtech Watch, which outlines a series of use cases in AML/CFT. AIs can also refer the use cases where Regtech may help to make the implementation of AML/CFT measures more effective and efficient.

**Recommended Reading**

HKMA Circular

*Key observations and good practices in AML/CFT control measures for remote customer on-boarding initiatives*

HKMA Regtech Watch
Updates from Insurance Authority

Extension of Phase 2 of the Temporary Facilitative Measures to tackle the outbreak of COVID-19

Further to the IA circular on 27 March 2020 regarding Phase 2 of the temporary facilitative measures (“TFM”) to obviate the need to conduct face-to-face (“F2F”) meetings in order to minimise the risk of infection during the sale process of insurance policies, the IA sees the need to extend it in view of the current pandemic situation.

In this regard, Phase 2 of the TFM will be extended by three months to 30 September 2020 (based on policy application date) unless otherwise varied by the IA.

Compliance with CPD Requirements under the New Regulatory Regime for Insurance Intermediaries – Additional Facilitative Measures

The IA has decided to merge the Continuing Professional Development (“CPD”) assessment period for 23 September 2019 to 31 July 2020 with the CPD assessment period for 1 August 2020 to 31 July.

The IA issued a circular on 28 February 2020 regarding a temporary facilitative measure to extend the CPD fulfilment deadline this year by 3 months to 31 October 2020.

Updated Assessment on the Proposed Policy Holders’ Protection Scheme in Hong Kong

Further to the consultation with the Legislative Council Panel on Financial Affairs on the legislative proposals in 2018, the enabling legislation for establishing PPS is being prepared with a plan to introduce the relevant bill into the Legislative Council in the 2020/21 legislative session. Since the key parameters including the target fund sizes and levy rate under the proposal are based on actuarial study completed in 2012, a consultancy study has been commissioned to give an updated assessment before finalising the bill.

The IA is asking authorised insurers for their input by 14 July 2020, to facilitate this assessment.

Recommended Reading

Extension of Phase 2 of the Temporary Facilitative Measures to tackle the outbreak of COVID-19

Compliance with CPD Requirements under the New Regulatory Regime for Insurance Intermediaries – Additional Facilitative Measures

Updated Assessment on the Proposed Policy Holders’ Protection Scheme in Hong Kong

Practice Notes supplementing Standards and Practices 5.4 and 7.1 of the Code of Conduct for Licensed Insurance Brokers

The IA has issued two separate Practice Notes supplementing certain Standards and Practices of the Code of Conduct for Licensed Insurance Brokers.

• The first Practice Note, which supplements Standard and Practice 5.4 in the Code of Conduct, sets out the minimum information which the IA expects a licensed insurance broker company to include in the terms and conditions of its client agreements for linked long term business (i.e. ILAS policies).

• The second Practice Notice, which supplements Standard and Practice 7.1 of the Code of Conduct, sets out the minimum information which the IA expects a licensed insurance broker company to disclose to a client with respect to remuneration received from an insurer for arranging an insurance policy with the insurer on behalf of the client.
HKMA revises SPM modules on overview of capital adequacy regime for locally incorporated AIs and “Recovery Planning”

HKMA issues revised SPM CA-G-1: Overview of Capital Adequacy Regime for Locally Incorporated Authorised Institutions

Following consultation with the two industry Associations, the HKMA issued by notice in the Gazette a revised version of the SPM module “Overview of Capital Adequacy Regime for Locally Incorporated Authorized Institutions” as a statutory guideline under section 7(3) of the Banking Ordinance.

The changes incorporated in the revised SPM module are mainly to:

• revise the guidance on the self-assessment of proposed capital instruments to be included within an AIs capital base so as to align with the equivalent guidance in the Code of Practice "Resolution Planning - LAC Requirements" (LAC-1);

• update the guidance in relation to capital buffer, revised securitisation framework, sovereign concentration risk, leverage ratio and interest rate risks in the banking book to reflect the current capital regime in Hong Kong (in terms of both legal framework and associated supervisory practices); and

• outline the HKMA's plan to implement the remaining BCBS capital standards, covering those in relation to the Basel III final reform package.

HKMA issues revised SPM: RE-1 “Recovery Planning”

Following consultation with the two industry Associations, the HKMA issued by notice in the Gazette a revised version of the SPM module RE-1 “Recovery Planning” as a statutory guideline under section 7(3) of the Banking Ordinance.

The revised SPM module has incorporated the additional guidance relating to recovery planning set out in the HKMA's circular of 6 July 2017 (with appropriate modifications), and reflected the latest developments in related local and international standards and practices.

Recommended Reading

Supervisory Policy Manual (“SPM”) CA-G-1: “Overview of Capital Adequacy Regime for Locally Incorporated Authorised Institutions” (Revised)

Supervisory Policy Manual (SPM): RE-1 “Recovery Planning” (Revised)
BCBS The Basel Framework: frequently asked questions (FAQs)
To help promote consistent interpretation of the Basel framework, the Basel Committee periodically publishes the answers to FAQs. This document sets out a number of FAQs that the Committee has agreed to add to the Basel Framework. They cover a range of issues relating to the reform of benchmark reference rates, including definition of capital, market risk, counterparty credit risk, liquidity and operational risk.

ISDA: HMRC Consultation Document on the taxation impacts arising from the withdrawal of LIBOR
UK Finance and ISDA welcome the publication of a consultation document on “the taxation impacts arising from the withdrawal of LIBOR”, together with HMRC’s draft guidance on the subject. The consultation document and guidance are helpful vehicles for raising the profile of benchmark reform, and importantly, for providing greater certainty to taxpayers on the tax implications of transition.

UK Finance and ISDA have drafted a joint response to certain questions in the consultation.

Working group on euro risk-free rates recommends voluntary compensation for legacy swaption contracts affected by the discounting transition to the €STR
The private sector working group on euro risk-free rates has endorsed a recommendation that counterparties voluntarily exchange compensation for legacy swaption contracts affected by the transition of central counterparty discounting from the euro overnight index average (EONIA) to the euro short-term rate (€STR), which has been postponed from 30 June 2020 to 27 July 2020. Market participants are advised to contact swaption counterparties to discuss and decide on voluntary compensation.

No single preferred option for implementing voluntary compensation, but several potential modalities identified.

Bank of England: Supporting Risk-Free Rate transition through the provision of compounded SONIA
Having reviewed feedback to the February discussion paper the Bank has set out its position:

- Given near universal support from respondents, the Bank has confirmed it will publish a daily SONIA Compounded Index. It anticipates that publication of the SONIA Compounded Index will commence in early August. The precise date will be confirmed in due course.
- Given a lack of consensus on both the usefulness of SONIA “period averages” and the conventions underpinning such rates, in line with the position set out in the February discussion paper, the Bank will not be producing them at this time.

Key Takeaways
As banks in Hong Kong firm up their transition plan, it is an imperative for them to refer to the FAQs by the BCBS as well as other commentary by international authorities.

Financial firms should pay particular attention to discounting transition implication for bilaterally traded swaptions. While the ARRC and WG on Euro RFRs recommends a voluntary compensation mechanism, it is not clear that market participants expecting valuation changes in their favour would have any incentive to join such an agreement.
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LIBOR Reform Updates

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