



2018 Hong Kong Banking Outlook



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Exciting possibilities ahead as fintech goes mainstream



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Overview

Welcome to our outlook for 2018, where our Banking team forecasts the key developments and trends in Hong Kong for the next year.

With the market environment starting to stabilise in 2017, there are a number of positive developments and opportunities in the year ahead for banks in Hong Kong to increase their profitability. We are seeing increasing signs that US interest rates will continue to rise, which is likely to benefit Hong Kong as liquidity in the city's system is pulled out to invest elsewhere. This may lead to better yields and increases in revenue for Hong Kong banks in 2018.

We also expect to see credit losses remain within their existing levels, with China's financial deleveraging proceeding at its current controlled pace without any large shocks that could cause potential losses for banks in Hong Kong.

Furthermore, we believe that 2018 will be the year where fintech goes mainstream in Hong Kong. We appear to have reached a tipping point where the adoption of fintech and other technologies across all aspects of banking has become a priority issue on the boardroom and executive committee agenda. This trend is likely to drive the industry towards making a step change in the adoption of fintech in the next 12 months.

However, it is important that banks bear in mind that technology changes are always more successful when they are business-led, rather than technology-led. Encouragingly, we are seeing that the industry is now recognising this, with banks increasingly ensuring that they first identify the problems they are facing before seeking out the best available technology to effectively solve the issues.

Certainly, for banks in Hong Kong, there is no shortage of problems – regulatory and compliance costs, conduct and culture risk, anti-money laundering issues – and banks will increasingly apply technology to tackle these issues, manage costs more effectively and maximise revenue generating opportunities.

Hong Kong's position as a key international financial centre cannot be ignored, and the city will continue to play a pivotal role in propelling China's growing influence and power on the world stage. In 2018, we expect mainland China to continue to use external investment as a soft power vehicle, as well as look to build new trading blocs and forge new alliances. One significant way to facilitate this is through the Belt and Road initiative. We therefore expect to see a major step change in Belt and Road financing that is arranged or facilitated through Hong Kong in the year ahead.

We believe that with these positive developments, Hong Kong's role of bringing together investors and investees, and facilitating inbound and outbound investment will be stronger than ever in the short-term.

New challenges on the horizon



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Macro trends affecting banking

A decade after the global financial crisis (GFC), the financial services industry worldwide is now nearing the end of the cycle of regulators and governments recouping money from banks through fines and other forms of redress. In the US alone, banks have paid USD 150 billion in fines since the GFC. The associated investigations and remediation activities have held back the level of investment and management time that could have been spent on innovation.

Going into 2018, there are a number of significant external factors that banks need to monitor and prepare for. Banks cannot ignore the geopolitical tensions and the more nationalistic and protectionist tone being taken by some leaders. Ongoing developments around Brexit continue to impact many international financial institutions, with several banks considering moving key business and staff out of the UK due to a lack of clarity over the path Brexit will take. We are also seeing similar reported issues around Catalonia's possible secession from Spain.

Banks will also continue to closely monitor the actions of the US in respect of regulation. While there is continued discussion about rolling back aspects of US regulation, the less reported area of concern is that the US appears to be stepping back from implementing Basel 3, which has been hammered out between the leading economic powers. As a result, some leading European nations have said that they will also not implement aspects of the regulation, as they only agreed to do so on the basis that the US would as well. The Basel framework has been an important mechanism for international cooperation in the post-GFC world, and its demise would leave a worrying vacuum.

One consequence of the increased capital requirements for banks has been to dramatically reduce the attractiveness of Fixed Income, Currencies and Commodities (FICC). This business has long been one of the biggest revenue engines for wholesale investment banks. As this area of business continues to shrink and become less profitable, it has forced many major investment banks to seek alternative growth strategies, which can put more pressure on executives to find new revenue streams. Banks need to be mindful of the need to drive profitable growth while maintaining a focus on promoting a sound banking culture and mitigating operational and conduct risk.

Across the world, non-traditional players are challenging the traditional banks, and banks are experimenting to find the right balance between treating these insurgents as competitors or partners. In mainland China, powerhouses Tencent and Alibaba are transforming the way business is done and are threatening to replace the traditional means of B2B commerce and trade finance payments conducted by banks. China already leads the world in mobile payments with volumes increasing five times in 2017 from the prior year to RMB59 trillion (USD 8.8 trillion)¹. This has led to the central bank mandating that all mobile payments will need to go through a centralised clearing house by next June to give the authorities greater visibility and control. With this trend showing no signs of abating, banks in Hong Kong and mainland China need to seriously consider how to transform, innovate and compete with the fast-growing non-financial players.

¹ The Financial Times, <https://www.ft.com/content/3bcb5150-7cce-11e7-9108-edda0bcb928>

Regulations reducing, but technology brings new complexity



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Regulatory landscape

As banks in Hong Kong continue to adjust to new regulatory requirements, there is a greater level of certainty around the regulatory environment in the city, which should give banks the confidence to develop business and opportunities. Furthermore, the optimism over the use of fintech and regtech to reduce costs, increase efficiency and enhance customer experience is also expected to develop further into 2018.

Hong Kong's regulators are also focusing more on promoting technology and innovation, and facilitating growth. While these steps are encouraging, it will be important for both the regulators and banks in Hong Kong to ensure that they balance this with their core responsibility of protecting investors and depositors, and maintaining the stability of the financial system.

As 2017 draws to a close, there is a cautious 'feel-good' factor over the global economy. This is partly because of synchronous global growth, which is perceived to be non-cyclical. In addition, the impact and winding down of quantitative easing in the US is expected to be smooth, provided it is managed well.

In parallel, the number of new global regulations has tapered off this year – the Basel 4 standards are likely to be finalised in the next few months – and 2018 is expected to be a time of calibration and implementation rather than revisiting rules and regulations.

In the US, after much discussion, it is unlikely that a rewrite of the Dodd-Frank Act will take place. The government is looking to downscale regulatory requirements for small and medium-sized institutions by increasing the threshold for which they are exempt.

However, there are some challenges and concerns that banks in Hong Kong need to address in 2018. First, cybercrime is an increasingly pervasive issue – quantifying the size and nature of potential losses is also particularly difficult – and banks need to continue to focus on managing cyber and related operational risks in the year ahead.

Second, anti-money laundering (AML) and counter-terrorist financing are still key areas of focus for banks both regionally and in Hong Kong. The rapid introduction of new providers and technologies in recent years is also creating new AML "typologies" and ways to launder money and hide terrorist financing, and is a challenge that banks in Hong Kong need to continue to tackle in the year ahead.

Another trend over the past few years has been the growing number of consumers who are diversifying to new providers, delivery and transaction methods. Many of these new providers are associated with technology and online services, and do not have a long history of managing customers' money, which creates the potential for things to go awry.

Collaboration not disruption

Fintech

Hong Kong's burgeoning fintech industry is increasingly becoming an area that banks in the city cannot ignore. In 2018, we expect to see closer collaboration between financial institutions and fintech firms, as banks continue to seek to digitise and adopt advanced technologies to improve their product and service offerings and increase efficiency.

Hong Kong's government and its regulators continue to foster fintech innovation and growth as the industry enters a new era of Smart Banking. In September, the Hong Kong Monetary Authority (HKMA) announced improvements to its existing fintech sandbox, and plans to link its sandbox with those of the Securities and Futures Commission and the Insurance Authority to create a single point of entry for piloting trials of fintech products.

In addition, an emerging global trend that is also taking root in Hong Kong is the use of open banking, which is designed to foster greater empowerment of customers, transparency and levels of competition. The HKMA recently introduced a new initiative to allow Open Application Programming Interfaces (APIs) in banking. While the policy framework is still being finalised, this will have an impact on the financial services sector, and will further promote innovation and collaboration between banks and fintech firms. Once the framework is in place, banks will be able to build on their traditional banking services by including add-ons from fintech companies that enhance their functionality – creating consolidated bank statements from multiple banks, for example.

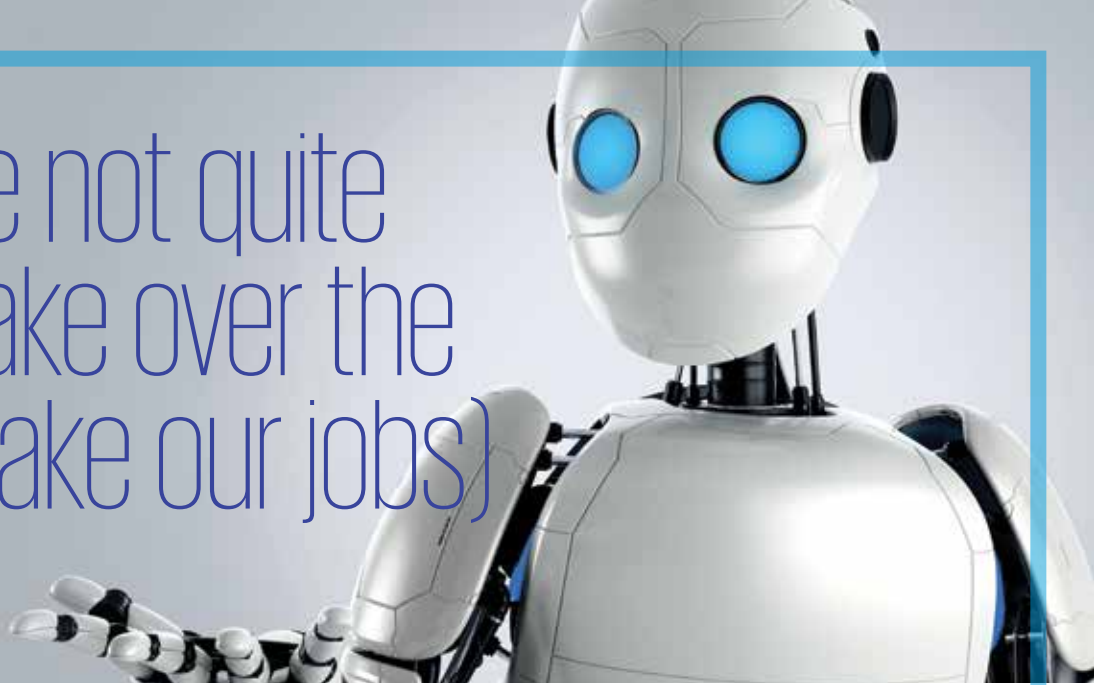
Also in the pipeline for banks and Stored Value Facilities operators is the Faster Payment System, which supports the use of mobile phones for payments in Hong Kong Dollars and Renminbi, with real-time settlement. An industry working group has also been set up to facilitate a common QR code standard between mainland China and Hong Kong, which should encourage greater use of mobile payments.

Finally, blockchain and Distributed Ledger Technology (DLT) has been a particular area of interest for banks in Hong Kong recently – especially around trade finance, digital identification and KYC – and we believe this will continue into 2018. The HKMA is expected to continue focusing on facilitating the development of blockchain and DLT platforms, although the regulator has also stressed that these technologies could raise legal and regulatory issues. While banks in Hong Kong will continue to explore blockchain and DLT technologies in the year ahead, they should also ensure that they carefully monitor regulatory developments and take steps to manage any potential associated risks.



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Robots are not quite ready to take over the world (or take our jobs)



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Robotics

Over the last 12 months, we have seen many banks in Hong Kong explore the use of robotics to automate processes, streamline their operations and increase efficiency, primarily throughout their back and middle office functions. While 2018 may not be the year where robots take over banking, we do expect rapid progress in this area during the next 12 months.

However, while these banks have actively experimented with proof of concepts and prototypes, some have done so without carefully thinking about how to most effectively apply advanced robotics technologies to their business. In many cases, robotics is just being used as a stop-gap measure to overcome flaws in the banks' system architecture.

Furthermore, many banks have not comprehensively considered and implemented strategies to deal with the potential data and security issues around robotics; digital data is a key component that allows robots to perform their functions effectively.

As a result, going into 2018, banks need to delve deeper into understanding the overall application of robotics throughout the organisation, and prioritise the specific processes they want to target. One example would be to examine business processes where structured (e.g. supplier databases) or unstructured data (e.g. emails, contracts) are used to make judgements and business decisions. If these user processes are labour intensive and time consuming, robotics would lend itself well to the task. Another potential area to target is stable, repeatable processes such as Balance Sheet Substantiation or Reconciliations. Increasingly, machine learning can be applied to bring more automated intelligence into these processes.

Hong Kong banks will therefore need to use the next 12 months to assess how the adoption of robotics and the subsequent process changes will affect their organisational and people strategies. One common misconception about advanced robotics technologies is that they will eliminate most of the jobs currently performed by the human workforce. On the contrary, robotics in banking helps take away some of the most undesirable jobs, which enables the bank to strategically deploy human resources to the areas where they add the most value, and allows the existing workforce to do their jobs more effectively.

As robotics continues to take root among financial institutions in Hong Kong, a key focus for banks in 2018 will be on developing their people and talent programmes to attract and retain the right skills. We are starting to see banks set up digital communities and help their teams understand the intricacies and benefits of working alongside a bot. This trend is undoubtedly going to continue, as banks adopt a more holistic approach to robotics, evaluate the potential impact of these technologies on controls and governance, and carefully consider which specific processes to target in order to minimise costs and maximise the value and effectiveness of their employees.

Technology is creating new ways of working, but humans remain important



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Technology

As we move into 2018, banks in Hong Kong are starting to take a more pragmatic approach to the application of technology, and how they manage and govern their data. 2016-17 was all about experimenting with new technologies on the fringes, learning about fintech and making investments into some of these fintech companies and emerging technologies. 2018 needs to see the realisation of value from some of these investments. Much of this investment was off to the side – for example, in Labs, accelerators or separate investment funds. 2018 is the time to apply the technology to everyday business problems – compliance and risk transformation or new models for client onboarding – and put it into practice.

With the adoption of this new technology, banks will need to revisit the skills and capability that exist. Banks are starting to realise the importance of having people who possess a deeper understanding of these technologies in more senior roles. This is important in order to better manage the associated risks and opportunities. For example, with increasing automation across core processes, banks cannot afford to have data leakages or embarrassing outages or downtime.

With this focus on skills and capability, 2018 will also need to see the start of organisational change as roles as we know them today will be different in the future. We will begin to see new ways of working – in the form of robotic process automation (RPA) and the application of artificial intelligence (AI) – but we believe that staff in more traditional roles will need to support these initiatives. Staff will need to teach the robots and cognitive technologies how to carry out tasks, as well as maintain an ongoing learning process for the machines. This will undoubtedly lead to exciting opportunities and better service for the customer. The use of RPA and AI will make life easier for the human workforce too – initially in the middle and back office functions – and enable the workforce to focus on higher value tasks.

2018 will see the public announcement of more prototypes in the market for the first time. Banks in Hong Kong are coming together in various consortiums to test the market and apply ground-breaking technology like Blockchain and cloud to market challenges such as trade, KYC and other traditional banking products and operations. This will have a disruptive impact on the traditional services provided by banks in Hong Kong, and they will need to quickly understand how it will impact their existing operations, people and risk profile.

Finally, and notwithstanding the investment in new and ground-breaking technologies, banks should not forget or underestimate the importance of data to all these processes. None of these new tools and ways of working will function without the right data to support them. While significant investment has already been made, more work remains for banks to be truly on top of their data.

Battling financial crime through technology



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Anti-Money Laundering

As we move into 2018, the Hong Kong Monetary Authority (HKMA) continues to make significant efforts to increase the effectiveness of the city's financial system by encouraging greater use of technology and promoting closer collaboration between the industry, regulators and the government. We believe that with regulatory scrutiny of anti-money laundering (AML) and counter-terrorist financing increasing – as well as the costs of compliance – the HKMA will continue to focus on banks posing the greatest money laundering and terrorist financing risks in 2018, as well as issue more guidance to help banks assess and understand risk.

Banks in Hong Kong have increasingly explored the use of technology and data analytics around AML – to enhance transaction monitoring, onboarding and CDD processes, for example – and we think this will continue in 2018. The HKMA has also voiced its strong support for banks that seek to leverage technology – the regulator has recently installed a designated officer as an AML contact point, and continues to work closely with its technology-risk team to provide banks with practical and timely advice.

We expect to see changes to certain aspects of the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (AMLO), as well as the Guideline on Anti-Money Laundering and Counter-Terrorist Financing (for Authorised Institutions). The changes – which could take effect in mid-2018 – are expected to make onboarding more efficient, improve the overall customer experience and align Hong Kong's rules with international standards.

One of the major amendments is to the requirement on non-face-to-face account opening to allow greater flexibility and scope to leverage technology. The proposed changes also include raising the threshold of beneficial ownership from 10 percent to 25 percent, broadening the range of suitable intermediaries to make customer due diligence (CDD) more efficient, and amending the requirements on wire transfers to align with the revised Financial Action Task Force (FATF) standards.

Hong Kong's regulators and banks are gearing up for FATF's mutual evaluation of the city in June/July 2018. As part of this preparation, Hong Kong is undertaking its first money laundering/terrorist financing National Risk Assessment (NRA), which is expected to be published before the end of 2017. While banks in Hong Kong have improved their understanding and assessment of money laundering risks, we believe that there is still room for improvement. Banks should continue to adopt a risk-based approach in the coming year, and use the NRA to improve their own institutional risk assessments to allow them to focus on key risks and design their own controls and mitigating measures.

Hong Kong to go green



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Deals

We expect Hong Kong to continue to be a major fundraising hub – for IPOs, bond issuances as well as in the private equity and debt sectors – in 2018. Meanwhile, the landscape continues to evolve, with more PRC and regional banks and investment houses establishing themselves in Hong Kong. We expect this to continue in 2018, and banks in Hong Kong will need to consider how and where they wish to be positioned in this changing market, and seek to evolve that segment of their business to focus on the opportunities.

Located in the key financial and capital market in Asia, Hong Kong banks are well placed to capitalise on the deal-making and financing opportunities the region offers, especially as the city continues to play a prominent role in China's 13th Five-Year Plan and Belt and Road initiatives, as well as the emerging Greater Bay Area. These initiatives offer opportunities in a variety of sectors – ranging from infrastructure and real estate to healthcare and education – and we believe that banks in Hong Kong will use the year ahead to work out how they can participate in order to best serve their existing and potential clients.

With the Belt and Road initiative a major driver for the region – the initial phase of which will continue to focus on infrastructure lending – this is likely to lead to more financing demand, including for green bonds and green financing. Carrie Lam, Hong Kong's Chief Executive, indicated a greater focus on green bonds in her policy address earlier this year. Many corporates in Hong Kong are already considering or planning to issue green bonds, and banks in the city should prepare for growth in this area and consider how best to capitalise on this opportunity.

There has also been discussion around the possibility of Hong Kong establishing a green investment bank. The UK and several other developed countries have set up similar banks in recent years to facilitate and encourage green finance, and Hong Kong may take steps to follow suit in 2018. It is our view that we are heading towards a world where financing – particularly of large infrastructure projects – and awareness of environmental issues and the need for sustainable development are fast converging, and banks in Hong Kong need to prepare for this.

There will continue to be plenty of capital flowing into and through Hong Kong. However, many have found it challenging to connect their capital with the right opportunity. Banks that take a step back, broadly examine the current and potential opportunities, evolve their business as necessary, and pursue targeted areas of focus for deals and financing will be well placed as we go into 2018.

Conduct is the new focus



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Conduct

Conduct continues to remain high on the regulatory agenda globally and in Hong Kong, and banks need to use the year ahead to continue to strengthen their measures to mitigate conduct risk – the risk that misconduct by a financial services firm may cause its clients to suffer financial detriment or may harm market integrity.

The Hong Kong Monetary Authority's (HKMA) circular on Bank Culture Reform earlier this year emphasised that conduct is a key priority. The HKMA highlighted three pillars that promote a robust bank culture: governance, incentive systems, and assessment and feedback mechanisms. In 2018, we expect to see continued specific regulatory collaboration – primarily between the Hong Kong, UK and Australian regulators – on this topic, as well as more guidance and structure around their expectations.

In the coming months, and leading up to March 2018, the HKMA will want to see that banks have taken significant steps towards creating a comprehensive and appropriate conduct framework for their organisations. To this end, banks in the city need to focus on how to develop a conduct culture that strikes the right balance between profitability and maintaining sustainable business practices that generate value to end clients. This starts with senior management setting the tone from the top for conduct throughout the organisation – involving all three lines of the business – and ensuring that this is translated into business practices that are easily understood.

Banks will also need to ensure that these practices are regularly monitored, and that positive conduct and behaviour is supported through performance management and incentive and reward programmes. Over the next 12 months, we expect to see more Hong Kong banks introduce risk culture frameworks incorporated into their broader conduct framework, and the leading institutions will continue to roll out risk and conduct analytics that provide management with dynamic multifactor MI that track and trend behavioural metrics. On the back of enhanced analytics, consequence management and a measured and fair response to both good and bad conduct examples will be top of mind across both financial institutions and regulators alike.

Finally, we have seen some global banks set up a centralised conduct risk office, often working in close collaboration with their own business risk lines and existing compliance functions – we see this framework along with the rollout of conduct risk analytics as the two areas that leading institutions can separate themselves from their market peers.

Spotlight on bank culture



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Culture

As 2018 approaches, Hong Kong's regulators are expected to continue examining how banks in the city manage their culture. The Hong Kong Monetary Authority (HKMA) issued a circular on Bank Culture Reform earlier this year, highlighting governance, incentive systems, and assessment and feedback mechanisms as the three pillars that promote a sound bank culture.

The HKMA has set a deadline of March 2018 for financial institutions to put an appropriate framework in place. While we do not expect to see strong enforcement around this in the immediate months following the deadline, the HKMA will certainly want to see that banks are making an effort to address the three pillars and promote a robust and holistic bank culture.

While the concept, and implications, of culture are not new for financial institutions in Hong Kong, the HKMA has really shone the spotlight on the issue this year, and is spurring many banks into action. Banks need to use the next few months to ensure that they have a clear ownership of culture across all levels of the organisation, and that they are reinforcing this by offering incentives and conducting regular assessments to ensure that the behaviours that are being adopted on a day-to-day basis are indeed the behaviours that the bank requires to deliver on its strategy.

To effectively assess whether the right culture has taken root, it is crucial for banks to adopt a combination of a top-down and bottom-up approach. The top-down approach involves examining where the organisation espouses to be; as demonstrated through a range of artifacts such as the organisation's values, policies and procedures, and working with the C-Suite and senior executives to get their views on what the bank culture is in practice and potential areas for improvement.

The bottom-up approach involves interacting with employees in the front line of the business and ensuring that they understand their role in maintaining an appropriate bank culture in their day-to-day work. Furthermore, banks can survey the organisation to identify if there are gaps between what the organisation upholds as good culture, and what really happens on the ground. Banks can then build a metric scorecard that can be monitored on an ongoing basis. We expect this to be a key piece for banks to articulate how their organisations are performing to the HKMA next year.

Separately, culture is also a component to consider for banks that are moving towards a more digital business model. The advent of robotic process automation, artificial intelligence and augmented reality is rapidly changing the way banks work and the skillsets they require. In 2018, banks need to consider how digitising and adopting advanced technologies might affect the organisational composition, skills, and leadership to manage a hybrid human-digital workforce, and how their bank culture will evolve in parallel.

Hong Kong gains traction as regional booking hub



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Banks' booking models

Over the past few years, global financial institutions have been moving towards establishing the capability to book markets business locally in Hong Kong. While this has not yet reached critical mass, we expect to see more banks explore the option of moving business to an Asian booking vehicle in 2018.

Many banks are also considering moving certain businesses out of their single global booking vehicles and into EU-based entities. This, in turn, could have an effect on the analysis some banks have conducted around the costs and benefits of using a single global booking vehicle, versus moving booking of Asian business to an Asia-based booking vehicle.

Another area for Hong Kong banks to closely monitor in the coming months is around the upcoming introduction of the Markets in Financial Instruments Directive II (MiFID II) in the EU in January 2018. In the lead up to this, we are seeing financial institutions work hard to implement the necessary processes, controls and systems to ensure compliance with the new framework. Meanwhile, there continues to be a lot of industry discussion around the issue of extraterritoriality, and the extent to which businesses in Asia have to build specific processes to ensure compliance with certain parts of MiFID II.

As institutions get a clearer picture of the costs involved, and clients get a better understanding of the impact MiFID II will have on their interactions with banks, we expect to see more organisations move business out of EU investment firms and into Asian booking vehicles. The implementation of the Fundamental Review of the trading book (FRTB) and the capital treatment required under local banking or securities regulations are also key factors that banks need to consider when evaluating whether to book business in a Hong Kong or other Asian vehicle.

Finally, another focal point for Hong Kong banks is the impact of the G20 derivative reforms in the region. While there has been a lot of progress in 2017, we expect to see more clarity in 2018 on the outstanding parts of those regulations that are pending implementation in Asia – for example, a new Type 11 regulated activity around OTC derivatives, as well as matters concerning trading obligations and substituted compliance. All of this is expected to help financial institutions in Hong Kong get a clearer view of the potential impact of changing their existing legal entity booking arrangements.

NPL outlook for Hong Kong is promising with expectation of positive developments in China



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Non-Performing Loans

While the reported number of non-performing loans (NPLs) in China is steadying, government authorities, regulators and banks are making a more concerted effort to address this concern. At a national economic level, the Central Government and the People's Bank of China have clearly emphasised that relieving overcapacity problems and restructuring the inefficiencies in the economy are key priorities. Debt for equity swaps and NPL securitisation are expected to be more commonly used by debtors and PRC banks, respectively, as a means to achieve this.

In 2018, we expect the Central Government to make a stronger push to ensure that inefficient 'zombie' companies – organisations that continue to operate even though they are insolvent or near bankruptcy – are either restructured or wound up in an orderly manner under China's Enterprise Bankruptcy Law. These efforts to manage the economic environment in China should relieve investors' concerns that China is heading towards a hard landing.

On the other hand, our clients in Hong Kong tell us that they have not had much concern over the rate of delinquent debt to date. Indeed, in Hong Kong, a lot of the facilities that are provided are secured, and banks that are holding real estate property as a security may be more confident in the debt servicing ability of their customers.

Many financial institutions in Hong Kong continue to maintain very tight credit monitoring systems, allowing them to react quickly as soon as they pick up early warning signs about potential non-performing customers. We believe this trend will continue, and that the credit position of the banks in Hong Kong is unlikely to deteriorate in 2018.

However, while Hong Kong banks have been managing well in recent years, they must not become complacent. Financial institutions should use the year ahead to ensure that they improve and maintain their risk management frameworks, all the way from pre-lending assessment through to post-lending monitoring and collection.

Furthermore, banks should seek to elevate risk management to a more strategic role to enable them to strike the right balance between lending to viable borrowers in order to grow their business, and adopting practical risk management strategies to minimise losses.

The next issue for enforcement?



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Non-Financial Regulatory Reporting

Over the last few years, Hong Kong's regulators have intensified their focus on regulatory reporting for banks. This comes as an effort to obtain greater visibility on the business side of the banks, as opposed to their financial strength, and the corresponding impact on the local market.

In particular, one area where we expect to see more enforcement through thematic reviews in 2018 is around Non-Financial Regulatory Reporting (NFRF), which covers reports typically produced by functions outside the finance area of an organisation, and generally includes transactional, position, compliance and front office reporting. For example, the Securities and Futures Commission have been active in investigating misreporting on large open position reports (LOPR) – a daily position report.

The level of governance and awareness around NFRF continues to vary vastly across organisations due to the decentralised nature of report production across departments and locations. Banks in Hong Kong therefore need to focus on enhancing overall NFRF governance across all departments, and clearly defining and documenting responsibilities and procedures to maintain an efficient, controlled reporting process.

Data is a key concern in NFRF, and banks should seek to push capture of all relevant reporting fields required upstream, and to implement data checks and validations prior to report production. Some organisations have established data lakes with reporting engines attached, which simplifies data input but can make establishing data lineage challenging.

Establishing QA as a second line for defence for NFRF is increasingly seen as a priority, but presents challenges around ring-fencing the right level of skill and experience to make the function operate effectively. In addition, banks are seeking to leverage data and analytics tools to identify and predict where there may be high risks of misreporting.

Centralised and dynamic change management processes to maintain compliance of constantly evolving banks' businesses with local regulatory environments across multiple jurisdictions are key to establishing a sustainable NFRF production process. This will enable them to establish, on a real-time basis, how changes to one regulation or transaction flow might affect regulatory reports and processes in other locations.

Lastly, we expect that banks will increasingly seek to rationalise layers of control and reduce NFRF costs in 2018. Some potential solutions for banks to consider are automation and robotics, offshoring, creating centres of excellence, and exploring the use of managed services.

Tax policy makes Hong Kong a more attractive place to do business



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Tax

The implementation of the OECD's Base Erosion and Profit Shifting (BEPS) initiative, as well as the upcoming first round of reporting under the Common Reporting Standard (CRS) are undoubtedly going to create operational challenges for banks in Hong Kong in 2018. However, there is also a lot of potential for growth, with the government signalling its intent to introduce incentives and enhance the city's tax system to benefit the financial services sector (and others) and make Hong Kong more competitive.

We expect to see more policy initiatives to encourage businesses to domicile in Hong Kong. The Hong Kong government is seeking ideas and submissions from banking groups and industry associations on ways to increase the city's competitiveness and benefit the financial services sector and others. We expect there to be discussions around enhancing Hong Kong as a booking location for business, which includes expanding the city's double tax treaty network, and looking carefully at funding cost deductions, particularly for non-banking entities in a financial services group.

In her policy address earlier this year, Carrie Lam, Hong Kong's Chief Executive, proposed measures to enhance R&D tax deductions from the government, which could hit as much as a 300% deduction for a capped amount of R&D expenditure, and 200% thereafter. This could benefit Hong Kong banks and help them achieve tax savings, especially as R&D accounts for a lot of IT spending. The R&D tax incentive could help to encourage more spending on technology, including fintech from Hong Kong banks.

With the Inland Revenue Department looking to implement the BEPS initiatives, a key focus will be on the new – and Hong Kong's first – formal transfer pricing rules. For larger banking groups, this will require them to do country by country reporting and develop a local and possibly master file, which summarises all transactions between related parties within the group. While the concept of transfer pricing is not new to many banks that have dealt with it in other jurisdictions, there is expected to be a lot of work around ensuring that financial institutions in Hong Kong have the right documentation in place to comply with the new rules.

Banks in Hong Kong may also encounter operational challenges early next year as they prepare for the first round of CRS reporting. One of the lessons learned from countries that have already reported for Financial Year 2016-2017 is not to look at your data at the last minute. Hong Kong banks need to ensure that they start carefully examining and cleansing their data – with the help of data analytics tools and technologies – prior to submitting to the authorities.

A year of growth



James Harte
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In the ten years since the global financial crisis, the overwhelming focus for banks has been on reducing costs and managing risks. However, the landscape is starting to change, and the investments that banks have made to improve their risk management and governance are starting to pay off. Amid rising interest rates and decreasing regulatory spending for banks, we believe that 2018 will be a year of growth for banks.

To achieve this growth, there are a number of developments and opportunities for banks in Hong Kong to consider. While Hong Kong's mature market poses a challenge – competition is fierce and the city boasts an extremely high banking penetration rate (~96 percent) – we see three major areas of growth for banks in Hong Kong.

First, despite the buzz – and sometimes confusion – around how best to apply fintech, we see an unprecedented opportunity for banks in Hong Kong to increase their revenue and reduce costs. Fintech will provide revenue generating opportunities by facilitating the introduction of new products and driving cross-selling of relevant and tailored products, as well as unlocking previously uneconomic customer segments – including both retail and SME clients – that can now be profitably served. Furthermore, fintech can help defend/drive revenue growth by catering to the needs of today's digitally-savvy millennials (who make up about 29 percent of Hong Kong's workforce), as well as 'new economy' – and increasingly tech-savvy 'old economy' – companies.

Second, mainland China continues to drive opportunities for banks in Hong Kong. The integration of Hong Kong into the mainland is leading to an increasing number of mainland Chinese individuals living and working in Hong Kong, and mainland corporates seeking to raise capital and use Hong Kong as the headquarters of their international divisions. This trend is going to continue, and banks need to ensure that they create propositions that are more tailored towards mainland Chinese corporates and retail customers. Furthermore, wealth and asset management continues to be a profitable business for banks in Hong Kong, and the city remains the first stop for mainland Chinese clients looking to manage their wealth globally. This is particularly notable as we are starting to see a once in a lifetime intergenerational wealth shift in China. Banks therefore need to think about how to capitalise on this opportunity and offer more sophisticated ways to manage wealth for a new generation of high-net-worth individuals.

Lastly, there are plenty of opportunities for banks in Hong Kong to take advantage of financing the Belt and Road initiative, while the city's role as a 'super-connector' to the Asia Pacific region and beyond will offer new avenues of growth.

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