

Hong Kong Financial Regulatory Newsletter

This publication provides highlights of the significant developments in regulations of the Hong Kong financial markets and analysis of new laws/regulations affecting the financial services sector in Hong Kong.



Key regulatory developments:

The Securities and Futures Commission (SFC)

- 28 Nov 2014 - Joint HKMA-SFC consultation conclusions on reporting and record keeping rules for OTC derivatives
- 27 Nov 2014 - Circular to Licensed Corporations Mitigating Cybersecurity Risks
- 26 Nov 2014 - Circular to All Licensed Corporations on Internet Trading Information Security Management and System Adequacy

The Hong Kong Monetary Authority (HKMA)

Basel II/III - Further guidance on Banking Capital and Disclosure Rules

- 31 Dec 2014 - Implementation Guidance on Banking (Capital) Rules and Banking (Disclosure) Rules

Basel III – Implementation of Liquidity Rules and other Requirements

- 24 Oct 2014 - Banking (Liquidity) Rules
- 24 Dec 2014 - Banking (Liquidity Coverage Ratio - Calculation of Total Net Cash Outflows) Code
- 24 Dec 2014 - Return of Liquidity Position of an Authorized Institution (Form MA(BS)1E) and Certificate of Compliance with the Banking Ordinance (Forms MA(BS)1F(a) and MA(BS)1F(b))

Stable Funding Requirement:

- 28 Nov 2014 - Stable Funding Requirement

Selling practices of Insurance products:

- 17 Dec 2014 - Disclosure of Remuneration Receivable in respect of Sale of Investment-Linked Assurance Scheme (“ILAS”) Products

- 8 Dec 2014 - Selling of Non-Linked Long Term Insurance (“NLTI”) Products
- 8 Dec 2014 - Mystery Shopping Programme Findings

Ethnic Minorities prevented by banks from opening bank accounts

- 18 Dec 2014 - Banking Services for Ethnic Minorities

RMB Liquidity Facility

- 27 Nov 2014 - Refinement of Overnight Repo under the Renminbi Liquidity Facility
- 3 Nov 2014 - Introduction of Intraday Repo under the Renminbi Liquidity Facility

Detailed Summary:

SFC

- **Joint HKMA-SFC consultation conclusions on reporting and record keeping rules for OTC derivatives**

The HKMA and the SFC has published their conclusions on a joint public consultation on the mandatory reporting and related record keeping obligations under the new over-the-counter (OTC) derivatives regime. The conclusions paper includes revised proposals which were formulated after taking into account feedback from the respondents. The major revisions include:

- The mandatory reporting and related record keeping obligations will commence first for authorized institutions, approved money brokers, licensed corporations and central counterparties, whilst the implementation of the same obligations will be deferred for other persons that are based in or operating from Hong Kong. This approach is adopted in response to market feedback that the reporting obligation should be introduced in phases by type of reporting entity – the more significant players should be subject to mandatory reporting first while others should be given more time to prepare for the new regime and are therefore covered in a later phase of implementation.
- Deferring the proposal to require authorized institutions and licensed corporations to report transactions that they have entered into in their capacity as a person registered or licensed to carry on Type 9 Regulated Activity (asset management). This will allow the market more time to sort out some of the reporting difficulties that arise in view of practices in the fund industry.
- Further extending or relaxing some of the exemptions and concessions in response to market feedback.

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- **Circular to Licensed Corporations Mitigating Cybersecurity Risks**

The SFC has issued a circular to draw to the attention of licensed corporations the cybersecurity risks that are currently facing the financial industry and, in particular, the recent massive cyber-attack on a financial institution overseas that was reported where hackers stole contact information of a significant number of its clients. Under *Part IV (Information Management) of the Internal Control Guidelines for Persons Licensed or Registered with the SFC*, policies and procedures are required to be established to ensure the integrity, security, availability, reliability and thoroughness of all information, including documentation and electronically stored data, relevant to the firm’s business operation. To help ensure compliance with the above requirement, licensed corporations are required to:

- Review the policies and procedures to manage cybersecurity threats, including thorough risk assessment processes, IT protocols, application management practices and supervision, where applicable;
- Identify cybersecurity risks and critically assess potential implications and major areas of vulnerabilities in the IT systems as related to their business operations taking into account their risk tolerance, if any;
- Assess the enhancement needs of the IT security controls to mitigate cybersecurity risks and the potential damage arising from such events, including but not limited to assessing the need of performing vulnerability or penetration tests or having tools or systems to detect and prevent cyber-attacks;
- Consider, where applicable, the cybersecurity controls of third-party service providers; and
- Ensure continuity of critical activities and systems in terms of technology resilience, business continuity management, contingency plans and crisis management.

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- **Circular to All Licensed Corporations on Internet Trading Information Security Management and System Adequacy**

The SFC has finalised a series of reviews of internet trading systems of selected licensed corporations (LCs) with a view of assessing the effectiveness of their information security management and system security controls. The major findings identified by the SFC in relation to design and control deficiencies that might expose the LCs and their clients to security and integrity risks are highlighted below:

- **Management Supervision and Information Technology (“IT”) Governance**
 - No formal IT management policies and procedures for change management, business continuity and disaster recovery management, vendor governance, privileged account management or monitoring of suspicious websites and mobile applications, etc., or these policies and procedures were insufficiently detailed or the actual implementation was poor;
 - Absence of independent and/or qualified IT and security risk management functions to proactively manage and monitor IT and security risks surrounding the internet trading systems. As a result, some of the major known IT and security risks have not been sufficiently anticipated or have never been proactively considered or addressed by the LCs;
 - Lack of comprehensive and regular security penetration tests conducted by qualified party(ies) for detecting internet security vulnerabilities;
 - Lack of comprehensive and regular IT risk assessment or IT audit conducted by party(ies) independent of the system development and maintenance functions; and
 - Infrequent and inadequate IT security awareness training and security tips provided to staff and clients respectively.
- **Operational Controls**
 - Insufficient authentication and password controls implemented on the internet trading systems to prevent unauthorised access;
 - Ineffective controls to ensure delivery of passwords to clients in a secure manner;
 - Insufficient audit trail for demonstrating checks and balances surrounding the system development life cycle and inadequate test cases developed to ensure proper testing of the internet trading systems before deployment; and
 - Poor design of network infrastructure (e.g. “Demilitarised Zone1” not implemented to separate internal and external networks) incapable of safeguarding the confidentiality and integrity of information stored in the internet trading systems and/or passed between internal and external networks.
- **Monitoring and Contingency**
 - Inadequate controls for monitoring abnormal user activities (e.g. change of IP address within a short period of time);
 - Insufficient backup facility (e.g. disaster recovery site was not established) for providing internet trading services or making alternative arrangements for receiving clients’ orders in an emergency that would considerably disrupt internet trading services provided to clients;
 - Infrequent and inadequate testing on the contingency plan for ensuring its viability and adequacy; and
 - Lack of incident reports or insufficient incident details (e.g. root cause analysis, remedial actions) for certain material system delays or system failures.

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HKMA

- **Implementation guidance on Banking (Capital) Rules and Banking (Disclosure) Rules**

The HKMA has issued additional supervisory guidance in relation to implementation of certain requirements under the Banking Capital Rules (BCR) and Banking (Disclosure) Rules (BDR) following recent assessment by the Basel Committee of Hong Kong’s compliance with the Basel 2/2.5/3 standards under the Committee’s Regulatory Consistency Assessment Programme.

The HKMA developed new and updated some existing guidance in the form of question and answers (Q&As) to reflect the passage of time and the implementation of revised or new Basel capital standards. The major changes include the following:

- Revisions or updates to the Q&As on capital calculation approaches, in particular:
 - the IRB capital floor requirements, reflecting the amendments set out in the HKMA’s circular letter of 20 December 2013;

- the treatment of default within a connected group, to elaborate on the application of relevant provisions under the IRB approach;
- the IRB top-down approach to calculate the risk-weighted amount for default risk of purchased receivables, to provide further guidance on the use of this approach; and
- the factors for considering whether a foreign exchange position of an authorized institution would qualify as a “structural position” for the purposes of market risk calculation.
- Issuance of new Q&As guidance in relation to:
 - the calculation of the delta-adjusted notional amount of an eligible instrument for hedging CVA risk (i.e. in the form of an option on a credit default swap) as an enhancement to an existing circular dated 4 September 2013 “Basel III implementation – Frequently Asked Questions (FAQs)”, covering the counterparty credit risk framework;
 - the calculation of credit risk for non-securitization exposures under the Standardised Approach; and
 - the general disclosures for credit risk to facilitate the consistent understanding of certain provisions of the BCR and the BDR.

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- **Basel III – Implementation of Liquidity Rules and other Requirements**

- **Banking (Liquidity) Rules**

The HKMA has issued a new set of rules made for the purpose of implementing the Basel III Liquidity Coverage Ratio (LCR), which seeks to promote banks’ resilience to short-term liquidity risks by ensuring that they have sufficient high quality liquid assets to meet their obligations for at least 30 calendar days under an acute stress scenario. The LCR will come into operation on 1 January 2015 and will only apply to AIs designated by the HKMA as “category 1 institutions” under the Liquidity Rules, mainly covering internationally active AIs or those larger or more sophisticated AIs that are significant to the general stability of the local banking system. Other AIs not designated as category 1 institutions (“category 2 institutions”) will be subject to the Liquidity Maintenance Ratio (LMR), a modified version of the existing Liquidity Ratio.

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- **Banking (Liquidity Coverage Ratio - Calculation of Total Net Cash Outflows) Code**

Following issuance of the Banking (Liquidity) Rules (BLR), the HKMA has gazetted the Banking (Liquidity Coverage Ratio- Calculation of Total Net Cash Outflows) Code (LCR Code). The LCR Code has been issued to provide guidance in respect of the provisions of the BLR that relate to the calculation of total net cash outflows under the LCR. The LCR Code, together with the BLR, will take effect from 1 January 2015.

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- **Return of Liquidity Position of an Authorized Institution (Form MA(BS)1E) and Certificate of Compliance with the Banking Ordinance (Forms MA(BS)1F(a) and MA(BS)1F(b))**

The HKMA has finalised changes to the Return of Liquidity Position of an Authorized Institution (Form MA(BS)1E) (and accompanying Completion Instructions) for the reporting of the liquidity coverage ratio (LCR) and liquidity maintenance ratio (LMR). The HKMA has also modified the Certificate of Compliance with the Banking Ordinance (Form MA(BS)1F(a) and Form MA(BS)1F(b)) (and accompanying Completion Instructions) for reporting by AIs incorporated in Hong Kong and AIs incorporated outside Hong Kong to reflect the new liquidity standards (i.e. LCR and LMR) under the Banking (Liquidity) Rules. The AIs are required to submit the revised Returns starting from the position of 31 January 2015.

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- **Stable Funding Requirement**

The HKMA introduced Stable Funding Requirement (SFR) in October 2013 requiring AIs with significant loan growth to ensure adequate stable funding to support their lending business from 2014 onwards. To streamline SFR’s operation and alleviate AIs’ reporting burden, the HKMA has implemented several refinements to the SFR with effect from January 2015. These refinements include, among other things, the following:

- AIs with total loans of HK\$10 billion or more and annualised average loan growth in the latest 8 quarters exceeding 15% will be required to observe the SFR;
- Frequency of review and report submission will be changed to quarterly;
- The SFR ratio applicable to an AI, subject to a cap of 100%, for calculating the stable funding to be obtained will be based on AI's quarterly loan growth rate; and
- Subject to certain caps and conditions, additional flexibility will be allowed for exempting loans and accepting Head Office's irrevocable committed liquidity facility as stable funding.

Similar to the existing arrangement, AIs that fall within the thresholds set out above will be given two months after each quarter end to achieve compliance if they are required to obtain additional stable funding. Thereafter, the applicability of SFR to AIs, including those AIs not yet falling within the thresholds, would be reviewed on a quarterly basis. While the SFR is and will continue to be only applicable to AIs meeting certain loan portfolio and credit growth thresholds, the HKMA may, on a case by case basis, require an AI engaging solely in private banking business to maintain a higher level of SFR ratio or require an AI outside of the scope of the SFR to observe the SFR if the HKMA is not satisfied with the quality of its liquidity risk management or is concerned with its arrangements.

Starting from end-December 2014 position, every AI meeting the revised thresholds should submit quarterly report in the format set out at by the HKMA within 14 calendar days after each quarter end. The first reporting deadline will be 14 January 2015.

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- **Disclosure of Remuneration Receivable in respect of Sale of Investment-Linked Assurance Scheme (“ILAS”) Products**

The HKMA has revised the remuneration disclosure statement contained in the Important Facts Statement (IFS) and requires AIs to adopt the revised remuneration disclosure statement in making pre-sale disclosure by no later than 1 January 2015.

The revised remuneration disclosure statement follows the standardized calculation methodology and disclosure format regarding intermediaries' remuneration for the sale of ILAS products issued by the Office of the Commissioner of Insurance. In addition, AIs should also adopt the following standards in making pre-sale remuneration disclosure, among other things, in order to provide customers with sufficient and relevant information about the remuneration and facilitate customers in making informed decisions:

- AIs should disclose and explain to the customer his/her right to ask for details of the remuneration in connection with the distribution of the ILAS product;
- If the customer wishes to know more about the remuneration, AIs should provide details including but not limited to the types, actual levels, actual amounts, actual basis of calculation, timing of receiving, etc. of the remuneration; and
- If the customer chooses a premium payment term for which the standard remuneration disclosure statement prepared by the insurance company does not disclose the specific remuneration (due to the adoption of a banding approach), AIs should disclose and explain to the customer his/her right to ask for the specific remuneration disclosure statement based on his/her chosen premium payment term, and should facilitate provision of such specific disclosure statement to the customer upon the latter's request.

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- **Selling of Non-Linked Long Term Insurance (“NLTI”) Products**

Following, HKMA's 2014 supervisory on-site examinations and mystery shopping exercise as well as handling of customer complaints, the HKMA has noticed that the selling practices in respect of NLTI products varied among AIs and has identified various areas for improvement in the selling practices. To enhance the selling practices with a view to ensuring appropriate protection of the interests of customers, the HKMA has issued a circular in relation to selling practices of NLTI plans requesting AIs to review and ensure that adequate policies, procedures and controls are implemented and sufficient staff training is provided for adoption of the practices expected by the HKMA in the sale of NLTI products in relation to the following areas:

- Due diligence on NLTI plans;
- Advertisement;
- Ensuring customer suitability;

- Vulnerable customers;
- Product disclosure; and
- Management supervision

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- **Mystery Shopping Programme Findings**

The HKMA has completed its yearly thematic review of the Sales Practices of investment and insurance products and issued the key findings/observations that came out from the review in the "Mystery Shopping Programme ("MSP") Findings" circular. During the 2013/2014 review period, the HKMA requested mystery shoppers to visit a mix of 20 small, medium and large-size banks engaged in selling investment and insurance products to HK investors. The aim of the MSP was to test robustness of banks' sales processes and related controls conducted by the sales teams in respect of the sale of investment products¹ and insurance products by AIs and assess the extent to which the applicable regulatory requirements issued by the HKMA, the SFC and the Hong Kong Federation of Insurers have been implemented. The review areas included: KYC procedures, risk disclosure, suitability assessment and implementation of HKMA's enhanced measures. The HKMA review was limited to information provided during the audio-recorded meetings of mystery shoppers with the bank staff and did not include review of firms' Sales Practice policies and procedures.

Key findings and observations:

Investment products:

- Disclosure of product features and key risks was not fully or clearly provided to clients by the sales staff. Although the sales staff provided a general disclosure of the key features and risks of the recommended investment products, they did not adequately explain certain salient features and risks, such as the higher credit risk and the higher vulnerability to the economic cycle of investment funds primarily investing in high-yield bonds.
- The sales staff did not properly handle risk mismatch and suggested the shopper to amend the answers to the RPQ (risk profile questionnaire) to obtain the client's higher risk tolerance result.
- The PICOP (pre-investment cooling-off period) exemptions were not communicated to vulnerable clients.

Insurance products:

- Disclosure of the insurance product nature, premium charges and credit risk of the insurance company were not clearly explained or incorrectly provided to the clients.
- The sales staff failed to conduct adequate Financial Need Analysis or RPQ with the shoppers before recommending insurance products.
- The insurance products were introduced to shoppers who were not interested in obtaining insurance products.
- In some of the instances, insurance products did not match the client's circumstances in terms of needs and affordability.
- The sales staff tried to impose pressure or induce the clients to make immediate decisions to take up recommended insurance products on the grounds that the client could later consider cancelling the policy.

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- **Banking Services for Ethnic Minorities**

The HKMA has warned Authorized Institutions (AIs) refusing to provide or delay to process applications for banking services to certain ethnic groups because of their ethnic status that they acting against Principle 5 of the Treat Customers Fairly Charter (TCF Charter) and run the risk of breaching the relevant laws, in particular, the Race Discrimination Ordinance. As a result of this practice, the HKMA has asked AIs to undertake following steps in order to comply with the TCF Charter:

- Review internal policies and procedures and internal controls to ensure that they are in full compliance with the TCF Charter, the Code of Banking Practice and the relevant discrimination laws both in policy and in practice;
- Provide suitable training and guidance to front-line staff to enhance their understanding of the requirement under the TCF Charter;
- Set out clear guidelines to require front-line staff not to adopt any discriminatory act against ethnic groups in the provision of banking services;

- Adopt a flexible and pragmatic approach (where appropriate) in the process of securing documentary proof from applicants to support their applications for banking services; and
- Put in place a robust complaint handling system to process complaints in this regard promptly and sensibly and offer appropriate redress where justified.

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- **Refinement of Overnight Repo under the Renminbi Liquidity Facility**

The HKMA has introduced two refinements to the provision of the overnight funds under the RMB Liquidity Facility with effect from 8 December 2014. The two refinements are as follows:

- The operating hours of the facility will be extended to 6pm from previously 3pm. Specifically, Authorized Institutions participating in renminbi business in Hong Kong (Participating AIs) may contact the HKMA Dealing Room before 6pm each business day to request for an overnight sale and repurchase (repo) transaction under the facility.
- System enhancement has been made to provide for automated delivery-versus-payment (DvP) settlement of overnight repo transactions through the CMU system. In particular, Participating AIs, after having a deal confirmed with the HKMA Dealing Room in accordance with item 1 above, should input the overnight repo transaction via the CMU Member Terminal. The transactions will then be automatically processed, including the selection and transfer of securities and the corresponding settlement of funds. Participating AIs should also input a reverse repo transaction via the CMU Member Terminal the next day to repay the funds.

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- **Introduction of Intraday Repo under the Renminbi Liquidity Facility**

From 10 November 2014, the HKMA will provide renminbi (RMB) intraday liquidity to AIs participating in RMB business (Participating AIs) in Hong Kong. Under the existing RMB Liquidity Facility, the HKMA provides overnight funds on T+0 basis as well as one-day and one-week funds settled on T+1 basis. In light of the increased volume of payments alongside the growth of the offshore RMB market, the HKMA will provide intraday RMB funds of up to RMB10 billion to assist Participating AIs in managing their RMB liquidity and promote efficient payment flows in Hong Kong. This would also provide banks with greater flexibility in managing their payment flows upon the launch of the Shanghai-Hong Kong Stock Connect in the future. Starting from 10 November 2014, participating AIs may initiate a sale and repurchase (repo) transaction with the HKMA to obtain intraday RMB funds. The HKMA will charge a fee, based on the actual time of usage, with reference to the prevailing overnight interest rate. The existing list of securities eligible for the existing RMB liquidity facility will be expanded to include RMB bonds issued by China's policy banks in Hong Kong. This expanded list will be applicable for both the new intraday repo and the existing repo tenors.

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