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The Evolving State of Compliance in Hong Kong

JANUARY 2017

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Finding equilibrium between promoting fintech innovation and protecting against regulatory exposure

Fintech-driven innovations play a large role in expanding financial inclusion and fintech is creating new market opportunities across the financial services industry. Asia's leading financial centres are vying to become the preferred destination for investment and growth. In the case of Hong Kong and Singapore, the revision of regulatory frameworks and supporting infrastructure is seen to play the most important role in creating advantages.

The Monetary Authority of Singapore (MAS) said in mid-April this year it would only regulate financial technology firms when they are sufficiently large to pose risks to the wider financial system. This characterises the city-state's so called 'sandbox' approach to fintech development. A few days later, Hong Kong's financial secretary John Tsang said the Special Administrative Region would set up a dedicated fintech start-up team under InvestHK and regulators would establish specialist offices to liaise with financial technology providers.

In an earlier communication, secretary for Financial Services and the Treasury Chan Ka-keung had this to say about Hong Kong's approach to fintech regulation: "When striking the right balance between protecting consumers and promoting innovation, we have to acknowledge that some of the small fintech start-ups may not have the same resources to deal with regulatory and compliance matters compared with established financial institutions [...] regulation should avoid being the hurdle to bringing genuine innovation to the financial services industry that benefits firms and customers."

While this is a clear nod to the importance of innovation, market commentators believe Hong Kong may have been too slow in encouraging fintech development. Hong Kong's Clearing and Settlement Systems (Amendment) Bill 2015 is a clear example of its different - and arguably more prescriptive approach - than in Singapore. This bill not only removed remittance business, one of the key Asia fintechs, from under the Hong Kong's Customs and Excise Department, but also set quite strict requirements for SVF (stored value facilities). One of the most controversial stipulations is the requirement that SVF have no less than HKD25 million (USD3.22 million) in paid up capital – a large sum for a start-up.

The most successful approach remains debatable. Regulators have to strike a balance between encouraging innovation and ensuring fintech providers do not become *"too big to fail"* in short order, as in the case of innovations such as Taobao's Yu'E Bao money market fund.

Adapting to regulatory impacts that challenge both innovators and industry stalwarts

The increased regulatory environment creates obstacles for conducting business and fintech firms are navigating the task of finding equilibrium between the business models that create market differentiation and a demanding regulatory environment. Chris Foye from LexisNexis Risk Solutions observes, “There is increasing regulatory scrutiny on certain types of fintech businesses as they are seen as potential easier targets for illicit money flows. As a result, one area where fintech companies are trying to differentiate themselves is through the ease of on-boarding whilst fulfilling regulatory obligations. For them reducing customer abandonment, providing a seamless experience, combatting money laundering and fraud are all key priorities.”

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—Chris Foye, LexisNexis

Regulations also present permanent operational challenges that technology and systems are still trying to navigate and ameliorate. Bankers roughly estimate it costs EUR20,000 (USD22,800) and takes as long as 60 days to perform due diligence, process and clear all the approvals to on-board an institution or high net worth individual as a client of a bank. These costs include the wages of an expanding corps of managers in compliance, risk consultants and services like private investigators. This is echoed by the LexisNexis 2016 True Cost of Compliance APAC study which found technology spend in Asia, on average, makes up a mere 19% of AML budgets. This suggests that technology use within AML operations in Asia is still somewhat immature, and that personnel costs are by far the largest portion (81%) of AML compliance spending in the region.

“It is true that some of the existing regulation makes it challenging to innovate, but this isn’t just a challenge for small or start-up companies,” says a Hong Kong-based head of regulation at a major global bank, “These challenges are equally difficult for the established players. On some level, it is important that there is a level playing field, while ensuring a conducive environment for innovation. This is happening in Singapore with their regulatory sandbox initiative.”

He continues, “That being said – regulating companies, not the technology, seems to provide a reasonable middle ground. However, ensuring important consumer and investor protection is essential. For all companies regardless of size, areas such as Know Your Customer (KYC), anti-money laundering and fraud protection must be critical competencies.”

Even the larger players can struggle with this range of requirements, according to Helen Kwok, director of finance and risk services at Accenture. “Clients want to continue catching up with innovation and obtain new business and revenue, but these come with new, emerging risks they may not fully understand,” she says.

Chris Foye agrees with the impact of the regulatory environment, “Traditional players are facing a major challenge with KYC. With increasing regulatory requirements and complexity, combined with significant manpower required to meet these obligations, there is a need to look at ways to streamline the on-boarding process and drive efficiencies. There is also a growing recognition that performing KYC in isolation for individuals and organisations does not allow them to effectively identify suspicious networks, illicit money flows and results in inefficiencies and ultimately a poorer user experience.”

Peter Guy, Editor in Chief of Regulation Asia illustrates the disconnect between the customer perspective and the back office realities the regulatory climate has produced, “Today, banking customers in Hong Kong complain how difficult it is to open a bank account. So many self-evident and frustrating questions are being asked such as, “Why do you need a bank account?” Guy continues, “Today’s post financial crisis infrastructure and processes have attached substantial costs to everything from opening a bank deposit to trading securities: identity checking; transaction authentication; reliably and accurately transacting; and securely storing records. These activities seek to resolve problems of trust, fraud, and error. Substantial amounts of capital and collateral are also locked within the entire financial system to act as a buffer against the failure of trust and confidence that could lead to undesirable outcomes. Today, the costly structure of managing financial risk makes the economics of small sized transactions expensive, unaffordable and inaccessible – especially to low income members of the society.”

Guy observes, “Bankers worry that automation has not yet made a serious improvement in meeting all the regulatory requirements. System consultants are making a fortune designing and maintaining the compliance platforms. They say their bank clients are far away from unifying their operations to gain efficiencies.”

He observes, “For example, making blockchain work has proven to be more complicated and stuck in an early stage of development. Banks and their fintech consortiums are only beginning to develop a plan to start prototyping blockchain-based systems. They are struggling with how to manage innovation and inventive focus. Regulators are receptive and cooperative, but have not yet seen a fully working system ready for approval.”

Chris Foye concludes, “Technology providers are keen to work more closely with regulators and are actively seeking their input in the design phase, which should mitigate some of the concerns above, but given the ever changing nature and complexity of regulations, continuous innovation is required.”

Capturing growth opportunities and turning compliance into competitive advantage

Hong Kong is proving to be competitive. Singapore has Southeast Asia on its doorstep, and can link fintech to the growth of financial inclusion in the region. On the other hand, Hong Kong has China on its doorstep, a huge market, albeit one with its own burgeoning fintech sector.

According to Janos Barberis, founder of Fintech HK and the SuperCharger fintech accelerator, “The purposes of fintech in Hong Kong and Singapore are different. Singapore is more about B2B whereas Hong Kong is naturally B2C and a gateway to China - so can capture the scale coming from there. Hong Kong is also used as a gateway for entering India.”

Barberis agrees on the importance of striking a balance between speed of innovation and the ability to regulate it, as he adds: “Once you establish a regulatory architecture, it is difficult to rollback. Technology itself can help with that. By using machine learning, regulators will be able to understand something before it has happened, and have an answer ready. But, any sector with exponential growth has risk. The financial crisis was an example that showed how important it is to balance origination rate with quality of origination.”

William Piquard, a business developer at Hong Kong-based Gatecoin, suggests Hong Kong’s arguably stronger regulation can in fact be a competitive advantage for an organisation such as his. Indeed, the bitcoin exchange has gone to HKMA and asked to be regulated. “We are a digital currency exchange and aim to be the most compliant in the world. If we are to on-board financial institutions, they need to rely on a compliant partner. It is very important for us to conduct very strict KYC, and differentiate ourselves by cooperating with regulators.” Piquard continues, “The most efficient thing for us would be to have very strong guidelines so things are not left open to interpretation. We realise it is a sector in which you cannot make any mistakes.”

The head of regulation at a global bank agrees this is a vital factor - particularly as many fintech companies operate a straight to consumer model: “Regulators and supervisors have a responsibility to protect the small retail consumers and investors accessing fintech via payment gateways and in the credit provision space. Larger banks have invested tremendous resources to build highly developed and often regulated systems to offer secure services to their clients.”

At the same time, it is also vital that regulators themselves have the technical knowledge to support the competitiveness of Hong Kong’s fintech sector. At the 2015 Finnovasia event in Hong Kong, Adrian Fisher, Singapore-based TMT lawyer at Linklaters, said: “Regulators are not necessarily equipped to deal with things like new currencies, [or] lending where there is no banking intermediary”.

Financial institutions have a responsibility to make sure there is sufficient understanding, believes the bank head of regulation: “There is a new urgency here to articulate the importance of this space to regulators. Groups like the Asia Securities Industry & Financial Markets Association are bringing together the banks and other financial services companies to advocate on their collective concerns. And, regulators have been very open and receptive to collaborating. This is an area where firms and regulators are very optimistic about the potential benefits to consumers and the economy.”

Managing enforcement expectations with remediation overload

In addition to the growth of fintech, how Hong Kong is both adapting to and adopting global regulation is one of the key issues on institutions’ agenda this year. In early 2015, the Hong Kong Monetary Authority (HKMA) said in a letter to banks, it would follow the Basel timeline for implementation of a revised risk capital framework: “All relevant AIs are therefore strongly recommended to familiarise themselves with the new market risk capital standards in advance of any HKMA consultations, consider the implications of implementation for their institutions, and start preparing, to the extent practicable, for the local implementation of the revised framework.”

Even eight years on from the financial crisis, however, many institutions have not yet started to implement these measures, or other global regulations, with many still stuck in efforts to remediate legacy issues. According to the global bank head of regulation: “Banks are constrained by the continuing need to implement global rule sets. A market like Hong Kong is particularly sensitive to cross-border inconsistencies as it hosts a range of international institutions with a variety of home regulators.” This is prompting firms of all sizes to question whether it makes sense to continue supporting the compliance costs of some types of business. If a business has a large number of legacy clients, cutting them off is impossible, which means the institution will have no choice but to continue with remediation, the implementation of internal controls, and hiring and training staff to deal with compliance requirements.

Chris Foye observes, “This has resulted in a greater number of institutions exploring ways to alleviate the pain of tier 1 alert remediation for AML by using 3rd party providers who can adhere to financial institutions data privacy and compliance requirements.”

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> —Aliette Leleux, Accenture

This is easier for the largest institutions, according to Aliette Leleux, Asia Pacific managing director and head of finance and risk at Accenture. “Regulators are pushing banks very hard to remediate and the banks have this as a priority. Most of the money that is being invested is in trying to fix the past and a small amount of budget is about building the future,” she says, “In terms of issues of internal models, and risk capital, it is easier for the largest institutions and there is a question of whether smaller banks can catch up.”

Balancing cross border opportunity and risk

Monetising Big Data may provide lucrative business opportunities. These opportunities should be thoroughly considered to ensure safeguards are in place to protect customers. As well as the challenge of remediation, Hong Kong institutions need to strike a balance by continuing to benefit from China’s economic growth and understanding the sources of that money. According to HKMA data, mainland-related lending by Hong Kong institutions hit HKD3.48 trillion (USD448.38 billion) at the end of the second quarter of 2015.

Across the border from Hong Kong, China remains in the midst of the ongoing anti-corruption campaign instigated by premier Li Keqiang. In a famous case, Qingdao-based metal importer Decheng Mining was alleged to have pledged the same collateral for multiple loans with fake documents to as many as 18 Hong Kong-based banks, including Standard Chartered, HSBC and Citibank.

“There is a lot of discussion about the operating model - whether it should be local, regional, global, and what can you do onshore or offshore. This is definitely an area of KYC/AML where there is a strong belief fintech will bring some benefit,” notes Accenture’s Leleux.

However, at the same time as bringing opportunities, the growing importance of data as a business resource can create its own problems. Hong Kong’s privacy commissioner has said: “Users of Big Data may claim that they are working with de-identified information, that is, data stripped of the name and other personal identifiers [...] They contend that with anonymisation, privacy is no longer an issue. However, such assertion may be a fallacy.”

This is because huge amounts of data can increase the risk of re-identification - in some cases with huge swathes of customer information being exposed. “This is an enormously challenging space,” says the global bank head of regulation. “The benefit to customers of having products and services tailored to their needs and preferences is critical to their satisfaction. Keeping the customers best interest in mind and being committed to their well-being is step one. Disclosure and transparency with the client and the regulators is also extremely important. I don’t think there is a large bank that would consider ‘run hard, apologise later’ an appropriate business strategy.”

For Janos Barberis, the key is to what extent banks will be allowed to monetise data, "It is very difficult for a bank to say it is making money from your data if it has been involved in a mis-selling scandal. Meanwhile, China has a rate of data generation that is not allowed in other jurisdictions - something which has helped it gain a competitive advantage."

At the same time, Xi's anti-corruption campaign has shown that the risk of making an error about a client in mainland China can have damaging consequences.

David Rosa, chief executive officer of Hong Kong-based mobile bank Neat, understands that mining data while maintaining privacy can be a delicate balance. He suggests institutions should err on the side of caution by sacrificing business opportunities to privacy concerns. "The same technology that is used in KYC can be applied on the commercial side, so in that sense compliance technology can be used to generate revenue. Its right that we should balance this with people's privacy, and we understand there will never be 100 percent conversion."

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> —Chris Foye, LexisNexis

Chris Foye concludes, "It is key Hong Kong continues to take advantage of its proximity to Mainland China and the economic benefits it brings whilst at the same time respecting regulatory obligations and privacy concerns. One area that financial institutions are exploring is the feasibility of having a local or offshore KYC utility. A local KYC utility with collaboration from the privacy commissioner and the regulator could be beneficial. It could be established from the outset to tackle all account types whether an individual or a corporate, would allow control to be retained within Hong Kong and would allow for standardisation to occur in a localised context in line with local regulations. This could be complemented with an offshore provider for certain account types where the business rationale make sense."

LexisNexis can help design an integrated KYC workflow that enables your business to avoid compliance process delays, reduce costs and concentrate on capturing more market share. Our solutions are designed to deliver a synthesized picture of your customer and the risk they may, or may not, pose to facilitate faster, more well-informed decisions across the entire customer lifecycle. We can help your business truly know your customer and understand the intricacies of their critical relationships and connections. Our solutions highlight and help identify potential AML risk before it impacts your business. By leveraging tools from LexisNexis you can implement a comprehensive compliance workflow without interrupting your core business.

Contact us to see how we can help you balance the goals of protecting your business and maintaining profitable operations.

For more information
www.lexisnexis.com/risk/apac
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