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HKMA Publishes Final Revised Guideline on the Authorisation of Virtual Banks

On 30 May 2018, the Hong Kong Monetary Authority ("**HKMA**") published the final version of the updated Guideline on the Authorisation of Virtual Banks (the "**Revised Guideline**"). At present, the Revised Guideline is in the form of a redline showing changes made since the version consulted on in February this year (the "**Consultation**"). Alongside the Revised Guideline, the HKMA has published an Annex setting out the consultation conclusions which provides an overview of the responses the HKMA received and the HKMA's commentary on the conclusions reached.

Our detailed client alert on the February proposals is included in the Annex below. The Revised Guideline does not depart materially from the Consultation, however it does provide further clarity on several points.

The key amendments and HKMA comments to take note of are:

Financial inclusion and customer base – some respondents had queried whether virtual banks were prohibited from offering services to non-retail customers, given the definition of "virtual bank". The HKMA has reminded firms that a "key objective" of introducing virtual banks is to help promote financial inclusion, and they should therefore target "primarily" the retail segment. It has however clarified that virtual banks may also provide services to other customer segments. The HKMA remains of the view that virtual banks should not impose any minimum balance requirements or low-balance fees on customers

Intermediate Holding Companies ("**IHC**") – the Consultation proposed that where a virtual bank applicant is not owned by a bank or financial institution, it must be held through a Hong Kong incorporated IHC. Respondents had noted that the IHC was to be subject to various conditions and had asked for further clarity around what these would mean in practice. The HKMA provided further details in paragraph 9 of the Revised Guideline, which now states that the conditions to be imposed on the IHC will likely cover requirements on capital adequacy, liquidity, large exposures, intra-group exposures and charges over assets, group structure, activities undertaken, risk management, fitness and propriety of directors and senior management and the submission of financial and other information to the HKMA. The HKMA notes that these are similar to conditions which may be imposed on banks owned by non-financial firms as set out in the "Guideline on Minimum Criteria for Authorisation"

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Parent company support – the HKMA has amended paragraph 10 to emphasise the importance of parent company support for the virtual bank, through financial, technological and other means

Face-to-face identity verification – in the Consultation, paragraph 12 had originally stated that one of the reasons for necessitating a physical presence in Hong Kong was to "allow the bank to verify the identity of its customers where necessary". Some respondents had queried whether this reference suggested that verification of identity was required to be done face-to-face at physical premises, which they believed was inconsistent with the concept of "virtual" banking. The HKMA has taken on board this feedback and, clarifying that there is no requirement for identity to be verified on a face-to-face basis, has deleted this wording

Physical presence – in paragraph 13, the HKMA has removed the requirement that records of transactions, books and accounts be kept in Hong Kong, as long as they are "accessible" to the HKMA

Technology risk – system resilience and business continuity management have been included as technology-related risks. The HKMA has also amended paragraph 15 to permit the submission of the independent assessment report on adequacy of information system controls by phases

Business plans and exit plans – the requirement for a virtual bank to have an exit plan is retained and paragraph 20 of the Revised Guideline provides some examples of areas that should be included in an exit plan, e.g. when the plan will be triggered, channels to be used to repay depositors and the sources of funding for making such payments. Regarding business plans, no change is made to the Revised Guideline, however the HKMA clarifies, in response to comments received, that there will be no grace period for compliance with the requirement not to engage in predatory business tactics (e.g. to allow a bank to rapidly grow its customer base in the early days of operation)

Outsourcing – no change is made to the outsourcing paragraph of the Revised Guideline, however it is worth noting some of the HKMA comments on the topic.

- the HKMA does not object to the use of external cloud computing services
- the HKMA is "open-minded to different forms of outsourcing"
- compliance with the SPM Outsourcing module is not required on a word for word basis if the applicant can demonstrate the outsourcing meets the supervisory requirements

Capital requirements – no change is made to the capital requirements, and, in response to feedback on the Consultation, the HKMA has taken the opportunity to remind applicants that the minimum paid-up capital requirement of HK$300 million is stipulated by law and is applicable to all licensed banks, and that it is not open to the HKMA to reduce this

Applicant Firms

For firms wishing to make a virtual bank application, the HKMA reminds potential applicants that the Revised Guideline should be read alongside the Guideline on Minimum Criteria for Authorisation which sets out detailed guidance on bank applications also relevant to virtual bank applications. There is also a team within the HKMA set up to answer virtual bank applicants' questions and provide some assistance on the application process.

The HKMA notes that it has received queries and indications of interest from over 50 companies since last September. Given the very large number of enquiries, the HKMA notes that unless a substantially complete application is submitted by an applicant by **31 August 2018**, the applicant will be most unlikely to be included in the first batch of virtual bank applications to be processed.

Echoing the content of the Revised Guideline, the HKMA press release notes it will give priority to "*applicants which can demonstrate that (i) they have sufficient financial, technology and other relevant resources to operate a virtual bank; (ii) they have a credible and viable business plan that would provide new customer experience and promote financial inclusion and fintech development; (iii) they have developed or can develop an appropriate IT platform to support their business plan; and (iv) they are ready to commence operation soon after a licence is granted*."

Please refer to the Annex below for our more detailed note from February on the changes to the virtual bank authorization guideline.

Annex

February 2018

HKMA consults on amendments to the "Guideline on Authorization of Virtual Banks" - what do you need to know about setting up a virtual bank?

On 6 February 2018, the Hong Kong Monetary Authority ("**HKMA**") launched a one-month Public Consultation on "Guideline on Authorization of Virtual Banks" (the "**Consultation**") on proposals to amend the Guideline on Authorization of Virtual Banks, originally issued by the HKMA in 2000 (the "**2000 Guideline**").

The Consultation proposes amended text to replace the 2000 Guideline. The deadline for submitting comments to the HKMA is 15 March 2018.

Key Takeaways - The proposals to update the 2000 Guideline are part of the HKMA's September 2017 package of initiatives to bring Hong Kong into a new era of smart banking. The proposals strike a balance between the caution that should be applied when on the one hand encouraging innovation and dealing with new technologies, the interest which can accompany rapid developments, and recognising the flexibility required to meet the changing landscape in this area, while on the other reminding applicants of the key minimum criteria that must be met to become authorised, given the importance of safeguarding customers' interests and the integrity and stability of the Hong Kong banking market.

The key new takeaways in the proposals are:

- HKMA regards virtual banking as a form of retail banking.
- Virtual banks will need to be locally-incorporated banks.
- Virtual banks must have a credible business plan and be more than a "concept".
- Both financial and non-financial firms will be permitted to own and operate a virtual bank – but non-financial firm's ownership will be subject to some conditions.
- Virtual banks must have an exit plan.
- Virtual banks will be subject to the same set of supervisory principles and key requirements as traditional banks, although the HKMA can adapt some of the requirements to suit the business models of virtual banks.
- Virtual banks will not be required to establish physical branches, but will need a local office.
- Virtual banks are expected to promote financial inclusion.

Background

The HKMA recognises that Hong Kong is moving towards a new era of smart banking, and in September 2017 it released a public statement announcing a package of initiatives to bring HK into this new era. The initiatives include the development of open banking through the development of the Open Application Programming Interface, an enhanced supervisory sandbox and the promotion of virtual banking. The HKMA specifically indicated in the statement that: *"The HKMA welcomes the introduction of virtual banks in Hong Kong and will consult the industry to review and amend the Guideline to Authorization of Virtual Banks issued in 2000".*

The Guidelines to Authorization of Virtual Banks were originally issued in 2000, at a time when many banks were raising the possibility of setting up virtual banks. Since then, there have been further developments in the technology sector which have been harnessed for the provision of financial services.

As with many other governments and financial regulators, both the Hong Kong Government and the HKMA recognise the potential of the Fintech revolution to improve access to financial services. In the Legislative Council, a written reply by the Secretary for Financial Services and the Treasury, Mr James Lau, responding to questions on the HKMA's authorisation policy for virtual banks, commented that reviewing the Guidelines from 2000[1], "*… will offer more choices to the public and facilitate Hong Kong to embrace the technological innovations in the financial sector*". In the same written reply however, Mr Lau was very clear that "*There is only one type of banking licence under the Banking Ordinance. In other words, the authorisation criteria for virtual banks and conventional banks are the same."*

These two ideas come through clearly in the Consultation.

Authorising a virtual bank and the HKMA's proposed amendments

What is a "virtual bank"?

The Consultation defines a virtual bank as a bank which "delivers <u>retail</u> banking services primarily, if not entirely through the internet or other electronic delivery channels <u>instead of physical branches</u>" - the underlined sections were added in the Consultation.

The Consultation proposes a new principle underlining the new "customer experience" which virtual banks can provide, and places emphasis on the fact that virtual banks "normally target the retail segment", and can therefore promote financial inclusion.

An additional proposed principle sets out that the HKMA expects virtual banks to play an "active role in promoting financial inclusion", and therefore virtual banks should not impose any minimum account balance requirement or low-balance fees.

[1] 13 December 2017 http://www.info.gov.hk/gia/general/201712/13/P2017121300376.htm

HKMA sandbox

In September 2016, the HKMA launched a Fintech Supervisory Sandbox to allow banks to test innovative Fintech products and initiatives within a live, controlled environment, before they are fully compliant.

The sandbox is only available to AIs, not to start-ups and other unlicensed businesses.

In September 2017, the HKMA enhanced the sandbox to include the following features:
- Chatroom to provide speedy feedback to banks and tech firms at an early stage of their fintech projects
- Tech firms can access the Sandbox by seeking feedback from the Chatroom without going through a bank
- Single point of entry for HKMA, SFC & IA sandboxes for cross-sector fintech products.

As mentioned above, there is only one banking licence for virtual banks and conventional banks, therefore the principle from the 2000 Guideline that the HKMA will need to be satisfied that the minimum criteria for authorisation from the Seventh Schedule of the Banking Ordinance is met, and maintained throughout the life of the bank.

Scope and structure of a virtual bank

A virtual bank must be Hong Kong incorporated. This is a new proposal in the Consultation.

Ownership: The Consultation suggests that there are two options:

(a) At least 50% owned by a well-established bank or a financial institution in good standing and supervised by a recognised authority in Hong Kong or elsewhere.

(b) A new proposal, that non-bank/financial institutions can own a virtual bank, provided this is held through a holding company incorporated in Hong Kong with supervisory conditions imposed on this intermediate holding company in respect of its capital adequacy, risk management and submission of financial and other requirements to the HKMA.

It is worth noting that the same majority and minority controller requirements would apply as with conventional banks, including that they must be fit and proper.

Business plan: A virtual bank must have substance and cannot simply be a "concept". It should have a concrete and credible business plan setting out how it intends to conduct its business and how it proposes to comply with the authorisation criteria on an ongoing basis.

The Consultation retains the guidance stating that it would be a concern if virtual banks were using aggressive, loss-making tactics in order to obtain market share, adding in that there should at least be a credible plan for profitability in the medium term where such approach is taken.

Physical presence: the HKMA proposes to remove the requirement for virtual banks to establish physical branches, however they will need to have physical presence in Hong Kong, again because of the retail nature of the business, the HKMA considers it necessary to provide a point of contact for customers.

Exit plan: The Consultation proposes that virtual banks must have an exit plan to ensure it can unwind its business in an orderly manner.

Capital requirements and other ongoing financial requirements

The Consultation proposes that virtual banks maintain adequate capital "commensurate with the nature of their operations and the banking risks they are undertaking". In addition, as with conventional banks, virtual banks will be subject to requirements including;

The Requirement to be Incorporated in Hong Kong

Paragraph 8 of the Consultation:

"*Since virtual banks will engage primarily in retail businesses covering a large segment of retail customers, they are expected to operate in the form of a locally incorporated bank. This is in line with the established policy of requiring banks that operate significant retail businesses to be locally-incorporated entities.*"

- Minimum capital adequacy ratios;
- Adequate liquidity requirements to meet obligations as they will fall due; and
- Adequate control of large exposures.

Governance

Virtual banks will need to satisfy the same corporate governance requirements as other locally-incorporated banks, so for example, they must appoint a chief executive with integrity and competence, appoint fit and proper directors and senior management and have independent non-executive directors.

A new proposal in the Consultation sets out that the board of directors and senior management should have requisite IT knowledge and experience given the technology driven business models.

Risk and Outsourcing

Virtual banks have to assess and understand their particular risk exposure, and as a minimum standard identify the eight basic types of risk set out in the HKMA's risk- based supervisory framework.

The HKMA does however underline the importance of technology related risk, requiring security and technology controls which are "fit-for-purpose". Virtual banks must commission an independent report on its computer hardware, systems, security, procedures and controls and ensure there are regular reviews.

In reality, in view of the continuous threat of hacking and cyber-crime, cyber security is a top agenda item for all banks and an area of increased focus for regulators too.

These risk requirements have not changed from the 2000 Guideline.

The HKMA also states that it does not object in principle to outsourcing of computer or business operations of a virtual bank, however it encourages banks to discuss plans with the HKMA.

Timing

Any comments on the Consultation should be submitted by 15 March 2018, in writing. The HKMA is planning to issue a revised guideline in May 2018.

The HKMA continues to be open to applications from virtual bank applicants. Applicants should review the revised guidelines in the Consultation when preparing their application. The HKMA has said that it "*will give due regard to the extent to which the authorization of the applicant will promote fintech and innovation, new customer experience and financial inclusion in Hong Kong*".

Ongoing Supervision

Paragraph 11 of the Consultation:

"Virtual banks will be subject to the same set of supervisory requirements applicable to conventional banks. That said, some of these requirements will need to be adapted to suit the business models of virtual banks."

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