HKMA reboots virtual banking

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Hogan Lovells

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On 6 February, 2018, the Hong Kong Monetary Authority (the "**HKMA**") published draft revisions to its "Guideline on Authorization of Virtual Banks" (the "**Draft Guideline**").

The framework will support the authorization in Hong Kong of 'virtual banks', defined as banks which deliver retail banking services primarily, if not entirely, through the internet or other electronic channels rather than through physical branches.

Consultation on the Draft Guideline is open to the public through 15 March, 2018.

The existing framework and the vision going forward

Once finalized, the Draft Guideline will replace the HKMA's existing Guideline on Authorization of Virtual Banks issued on 5 May, 2000. The original guidelines, which were largely unused, were introduced to support Hong Kong market entry by offshore licensed financial institutions through Hong Kong-based internet banking operations, which were growing in popularity at the time.

HKMA Chief Executive Officer Norman Chan signaled his intention to overhaul the virtual banking framework in his September, 2017 speech calling for a "New Era of Smart Banking" in Hong Kong. A new virtual banking framework was put forward together with a number of other proposals, including the recently launched "Open API" consultation.

The HKMA's intention for the virtual banking consultation is to repurpose the existing framework to further support the growth of fintech and digital banking in Hong Kong. Critically, the revised framework will support the introduction of retail banking services by non-bank organizations rather than simply provide a digital route into the Hong Kong market for banks licensed elsewhere. The Draft Guideline explicitly refers to the aspiration that the authorization of virtual banks will support financial inclusion in Hong Kong, including with respect to small and medium-sized enterprises, and this aspect of HKMA policy impacts the nature of permitted business, as explained in more detail below.

The Hong Kong financial services market is very different from how matters stood in May, 2000. 2016 saw the launch of Hong Kong's stored value facility licensing regime and recent years have seen a noticeable surge in fintech investment. There are now a number of substantial non-bank payments services providers active in Hong Kong. These organizations will see the reboot of the virtual banking framework as an opportunity to expand into deposit-taking and monetization of their platforms through a wider universe of financial services.

On the basis of press accounts of comments attributed to HKMA Deputy Chief Executive Arthur Yuen, the scope of banking services available to virtual banks will be very broad, ranging from payments and deposits, through to loans and wealth management.

Some critical points for the consultation include the following:

What will the criteria be for authorization as a virtual bank?

The Draft Guideline makes reference to the HKMA's "Guideline on Minimum Criteria for Authorization" (the "**Guideline on Authorization Criteria**"), and in doing so it is clear that the same criteria applicable to institutions currently licensed under the Banking Ordinance will generally apply to virtual banks as well.

Hong Kong's current regulatory structure supports a three tier system, under which the HKMA regulates licensed banks, restricted licence banks ("**RLBs**") and deposit-taking companies ("**DTCs**") within their respective permitted scope of banking and deposit-taking business. All three tiers are subject, in broad terms, to the same authorization criteria.

Chief amongst the criteria applicable to all categories of licensees is the "fit and proper" assessment that applies to the applicants' directors, controllers, chief executives and executive officers. The HKMA is required to approve an institution's chief executive and directors (and their alternates) and assess whether or not candidates have sufficient skills, knowledge, experience, and soundness of judgment to undertake and fulfill his or her particular duties and responsibilities. The precise "fit and proper" criteria vary depending on the role and specific responsibilities involved, but in general the HKMA will also assess probity (general reputation, any past disqualifications and instances of non-compliance with law and codes of conduct) and financial soundness and strength (with a view to ensuring that the individual's personal financial affairs do not have an adverse impact on the position of the institution).

The Guideline on Authorization Criteria sets an expectation that one third of an institution's directors will be independent non-executive directors ("**INEDs**"). RLBs and DTCs are expected to have at least three INEDs, but the HKMA recognizes that the specific number of INEDs will depend on the size of the institution, the total number of directors and the institution's ownership structure.

Those considering virtual bank authorization will be very interested to understand how the authorization criteria will be adapted to the virtual context. Uniquely for the virtual banking context, the HKMA indicates that boards of directors for virtual banks will need to possess requisite knowledge and experience with due regard to the technology-driven business model being undertaken.

Capital requirements and ownership structure?

There will be much focus in the consultation on who may participate in virtual banking, and in practical terms much will turn on expected capital requirements and the nature of regulatory commitments that must be made by holding companies.

It is clear that given the retail banking focus envisaged by the HKMA, virtual banks are expected to be incorporated locally. However, it is no longer the case that virtual banks must be controlled by a regulated financial institution or a financial holding company, removing a critical impediment to development under the existing framework.

A key passage in the Draft Guideline states that the HKMA is open to applicants controlled by Hong Kong incorporated holding companies in non-financial sectors (including technology), provided that the holding company or intermediate holding company, as the case may be, accepts supervisory conditions relating to matters such as capital adequacy, risk management and financial reporting to the HKMA (Chapter 4 of the HKMA's Guide to Authorization provides more detail on the nature of conditions that are likely to be expected). If the HKMA's existing guidance is followed, it should be the case that a special purpose holding company that has no business other than holding shares in the licensee would be permissible, but the precise capital structure expected by the HKMA in each case will need to be considered in detail.

The Draft Guidance does not specify any minimum capital requirements (i.e., paid-up share capital and/or balance of share premium account) but we can expect that requirements will be reconciled with the existing three tiers of minimum capital requirements for licensed banks (HK$300 million), RLBs (HK$100 million) and DTCs (HK$25 million).

Constraints on the virtual business model?

Virtual banks will be required to maintain a physical presence and a principal place of business in Hong Kong. A branch network will not be required, but the HKMA expects that a virtual bank will need to have adequate points of contact available to both the HKMA and customers, and will need a physical presence in order to administer customer due diligence requirements, which remain largely paper-driven and based on a face-to-face meeting as part of the account opening process. The approach to customer due diligence is under review, and it may well be the case that the introduction of virtual banking models as accepted banking practice will put further pressure on efforts to modernize practices.

Virtual banks will be expected to adhere to the HKMA's "Treat Customers Fairly" Charter and the HKMA-endorsed Code of Banking Practice. In keeping the financial inclusion objective, there will be no minimum account balances at virtual banks and low balance fees will not be permitted.

Key risk management requirements?

The Draft Guideline indicate that the HKMA's general risk-based supervisory framework will apply to virtual banks, referencing the modules for credit, interest rate, market, liquidity, operational, reputational, legal and strategic risks. Participation in Hong Kong's depositor protection scheme will also be required.

Technology risk management ("**TRM**") is highlighted as a critical area of risk management, stating that applicants will be required to submit an independent assessment report on their computer hardware, systems, security, procedures and controls from a qualified and independent expert.

The specific requirement of an independent expert assessment of technology is consistent with the HKMA's existing TM-E-1 Supervisory Policy Manual for "Risk Management of e-banking", which calls for such an assessment when a licensed bank launches a new digital service delivery channel or makes a major enhancement to an existing e-banking service.

The Draft Guideline also specifically refers to the HKMA's SA-2 Supervisory Policy Manual for "Outsourcing", the HKMA noting here that it does not object in principle to outsourcing of virtual banking operations provided that plans are discussed with the HKMA in advance and the SA-2 requirements are met, which include controls in areas such as TRM and data protection. Flexibility to outsource will no doubt benefit applicants seeking to rely on group technology and infrastructure in connection or leverage the middle and back office operations of financial institutions as part of their operating strategies.

Conclusions

The HKMA's relaunch of its virtual banking regulatory framework is a promising sign for the continued development of Hong Kong's fintech and digital banking ecosystem. The success of the stored value facility regime (which now has thirteen licensees) is noteworthy as a first step towards broader based technology-driven financial services regulation. Virtual banking promises a much larger potential scale of financial services to non-bank businesses. A balanced and proportionate application of regulatory oversight in this area would mark a further step forward for Hong Kong in its step to be a regional fintech leader.

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