Annex 1

GUIDELINE ON AUTHORIZATION OF VIRTUAL BANKS
CONSULTATION CONCLUSIONS

INTRODUCTION

The Hong Kong Monetary Authority (HKMA) conducted a public consultation on a draft revised Guideline on Authorization of Virtual Banks (the Guideline) between 6 February and 15 March 2018. During the public consultation, the HKMA received submissions from 25 respondents, including the Hong Kong Association of Banks, the DTC Association, the Consumer Council, chambers of commerce, an industry association from the fintech community, technology companies and professional firms.

All respondents supported the introduction of virtual banking in Hong Kong. Most of them also agreed that virtual banks should be subject to the same supervisory requirements applicable to conventional banks. There were, however, views on a few issues including the responsibility of virtual banks to help promote financial inclusion, the requirement on them to produce an exit plan, and subjecting virtual banks to the minimum paid-up capital requirement of HK$300 million currently specified in the Banking Ordinance. In addition, a number of respondents requested clarifications as regards how the HKMA will interpret and implement some of the requirements in the Guideline.

This note summarises major comments received during the consultation and the HKMA's responses to them. The HKMA would like to take this opportunity to thank all respondents for their views and comments.

MAJOR COMMENTS AND HKMA's RESPONSES

General (paragraphs 3-7)

All respondents supported the introduction of virtual banking in Hong Kong. While many respondents agreed that virtual banks, like conventional retail banks, should play an active role in promoting financial inclusion, a few respondents, particularly technology companies which indicated interest in operating a virtual bank, either questioned the reasonableness of this expectation or sought clarification as regards how virtual banks might fulfil this responsibility. These respondents did not support requiring virtual banks not to impose any minimum balance requirements or low-balance fees on customers, citing that this would create a burden on virtual banks and affect their commercial models or service offerings. Separately, some respondents misunderstood that the Guideline would not allow virtual banks to provide services to corporate customers.

<u>The HKMA's responses</u>: *Although the HKMA expects virtual banks to target primarily the retail segment, it has no intention to preclude virtual banks from providing banking services to other customer segments. The definition of virtual banks in paragraph 1 of the Guideline has been refined to avoid any possible confusion. The HKMA would also like to point out that a key objective of introducing virtual banks in Hong Kong is to help promote financial inclusion by leveraging on these banks' IT platforms that would lower the incremental cost of taking in additional customers. The HKMA therefore remains of the view that virtual banks should not impose any minimum balance requirements or low-balance fees on customers.*

Ownership (paragraphs 8-10)

No respondents indicated objection to allowing both financial and non-financial firms to own and operate a virtual bank, which is consistent with the HKMA's existing authorization policies. Several respondents expressed support for requiring virtual banks to operate in the form of a locally-incorporated subsidiary, although one respondent requested the HKMA to retain the flexibility of permitting virtual banks to operate in the form of a branch. Many respondents agreed that virtual banks majority-owned by non-financial firms should be held through a locally-incorporated intermediate holding company (IHC). Several respondents, however, requested clarity on the supervisory conditions to be imposed on IHCs. Some also asked for more flexible treatment in the case where a virtual bank applicant is owned less than 50% by a financial firm. A few respondents sought clarifications regarding the parental support expected of shareholder controllers of virtual banks and expressed the view that the Guideline should not preclude smaller companies from operating a virtual bank.

<u>The HKMA's responses</u>: *As virtual banks will primarily engage in retail business, the HKMA maintains the view that they should operate in the form of a locally-incorporated entity. This is in line with the HKMA's established supervisory policy. Considering the comments and requests for clarification received, the HKMA has included in paragraph 9 of the Guideline more details about the supervisory conditions that may be imposed on IHCs. These are basically the same conditions*

that may be imposed on IHCs of conventional banks owned by non-financial firms (see paragraph 36 of the Guideline on Minimum Criteria for Authorization). Paragraph 10 of the Guideline has also been amended to avoid any confusion that only applicants with strong parents are allowed to operate a virtual bank and to provide greater clarity as regards the parental support expected of shareholder controllers of virtual banks.

Ongoing supervision (paragraph 11)

The vast majority of respondents expressed support for maintaining a level-playing field for virtual banks and conventional banks, so as to create a fair, competitive and stable banking sector. A few respondents, however, requested the HKMA to consider adopting a more flexible supervisory framework for virtual banks to ensure their viability. One respondent, on the other hand, argued that more stringent supervisory requirements should be imposed on virtual banks given these banks' higher risk exposures.

Several respondents requested greater clarity on how the HKMA's supervisory requirements would be adapted on areas such as remote onboarding and credit risk management to fit virtual banks' business models. One respondent suggested the HKMA to make it clear in the Guideline that it would follow a technology-neutral approach to supervising virtual banks.

<u>*The HKMA's responses*</u>*: The HKMA considers it important for virtual banks to be subject to the same set of supervisory requirements applicable to conventional banks. As the Guideline is intended to focus on high-level principles, the HKMA does not consider it suitable to elaborate in the Guideline how specific supervisory requirements will be adapted to suit the business models of virtual banks. That said, taking into account the comments received during the consultation, the HKMA has amended paragraph 11 to clarify that a risk-based and technology-neutral approach will be followed when the HKMA applies its supervisory requirements on virtual banking.*

Physical presence (paragraphs 12-13)

No respondents objected to the requirement that virtual banks should maintain a physical presence in Hong Kong (which would be their principal place of business in Hong Kong) and the expectation that they should not maintain any physical local branches. There was, however, a confusion among some respondents that virtual banks would be required to verify the identity of customers on a face-to-face basis at their principal place of business, which these respondents considered to be inconsistent with the concept of virtual banking. Two respondents questioned whether the books and records of virtual banks needed to be located in Hong Kong.

<u>The HKMA's responses</u>: The HKMA has amended paragraph 12 of the Guideline to clarify the objective of requiring virtual banks to have a physical presence in Hong Kong. References to identity verification have been removed to avoid the confusion that there is a requirement on virtual banks to verify the identity of customers on a face-to-face basis. Paragraph 13 has also been modified to make it clear that the books and records of virtual banks may be located outside Hong Kong so long as the HKMA has adequate access to them to perform its functions.

Technology risk and risk management (paragraphs 14-17)

Two respondents highlighted the importance of system resilience and business continuity management for virtual banks, given their heavy reliance on digital channels for service delivery. There was a recommendation to allow virtual bank applicants to submit the independent assessment report on adequacy of information system controls by phases, with the final report covering an overall evaluation of virtual banks' information systems to be submitted before the commencement of operation.

<u>The HKMA's responses</u>: The HKMA has taken on board the above suggestions and has refined paragraphs 14 to 16 of the Guideline to highlight the importance of system resilience and business continuity management to virtual banks and to allow the submission of the independent assessment report on adequacy of information system controls by phases.

Business plan (paragraphs 18-19)

Only a few respondents commented on the requirement on virtual bank applicants to present a credible and viable business plan. Nevertheless, one respondent questioned whether the HKMA would be able to determine if a virtual bank's business plan is credible and viable. As regards the requirement not to engage in predatory business tactics, one respondent suggested the HKMA to focus on sustainability and viability as a going concern rather than profitability, and another respondent suggested introducing “a grace period” for compliance so that virtual banks may build their client base rapidly during this period.

<u>*The HKMA’s responses*</u>*: Although the business models of virtual banks and conventional banks are different, both of them are engaged in the business of banking. Being a bank regulator, the HKMA has reviewed many business plans of banks. It believes it will be in the position to assess the credibility and viability of a virtual bank’s business plan.*

As stated in the Guideline, predatory tactics could be detrimental to the stability of the banking sector and could undermine the confidence of the general public in the bank engaged in such tactics. The HKMA therefore does not consider it appropriate to introduce a grace period for compliance with the requirement not to engage in predatory business tactics.

Exit plan (paragraph 20)

Some respondents expressed support for the requirement that virtual bank applicants should provide an exit plan, although there was also a comment that virtual banks should not be subject to this requirement which does not apply to conventional banks. Many respondents requested for more guidance on what should be covered in an exit plan.

<u>*The HKMA’s responses*</u>*: Given that virtual banking is a new business model in Hong Kong, the HKMA considers it prudent to require virtual bank applicants to produce an exit plan. This will be consistent with the practices of leading overseas authorities which have introduced similar requirements for virtual bank applicants. The HKMA has provided in paragraph 20 of the Guideline more guidance on the matters to be covered in an exit plan.*

Consumer protection (paragraphs 21-22)

One respondent indicated strong support for including references to the Treat Customers Fairly Charter, the Code of Banking Practice and other consumer protection principles in the Guideline. It added that stronger supervisory expectations could be attached to the proper use and protection of customer data by virtual banks. Another respondent underscored the importance of requiring virtual banks to provide user-friendly and easy-to-understand terms and conditions for banking services.

<u>The HKMA's responses</u>: *The HKMA agrees that virtual banks should have proper systems in place to protect the data of their customers, and that their terms and conditions for banking services should be user-friendly and easy-to-understand. Given the Code of Banking Practice already contains provisions covering these matters, the HKMA considers the wording in paragraphs 21 and 22 to remain appropriate.*

Outsourcing (paragraph 23)

Several respondents noted that virtual banks would make extensive use of cloud technology and outsource data storage and transaction processing to third-party service providers. They considered that the HKMA should be prepared for this development. One of these respondents suggested the HKMA to consider pre-approving a list of service providers so that virtual banks may select from the list without the need to seek prior approval from the HKMA. Another respondent pointed out that there is an intermediate stage between fully insourced and material outsourcing, and in such an environment, full compliance with the HKMA's Supervisory Policy Manual (SPM) module on Outsourcing was unnecessary.

<u>The HKMA's responses</u>: *As noted in the Guideline, the HKMA does not object in principle to outsourcing of computer or business operations by a virtual bank to a third-party service provider provided the relevant supervisory requirements are complied with. Outsourcing in this context includes the use of external cloud computing service. As a matter of fact, some banks are already using or exploring the use of cloud computing to enhance their operations.*

The HKMA envisages that a service provider may provide a wide range of outsourcing services to banks. Accepting a bank to use a particular service of a vendor does not necessarily mean that all the service offerings of that vendor fulfil the HKMA's supervisory requirements. In addition, a service that is suitable for one bank may not be suitable for another because the two banks may have different IT system environments and internal control systems. The HKMA therefore considers it necessary to carefully assess the feasibility of the suggestion to create a pre-approved list of service providers for outsourcing.

The HKMA is open-minded to different forms of outsourcing. If a bank can *demonstrate that it can fulfil the HKMA's supervisory expectations through alternative arrangements, the HKMA will not insist on complying with the requirements in the SPM module on Outsourcing word by word.*

Capital requirement (paragraph 24)

Several respondents recommended the HKMA to consider lowering the minimum paid-up capital requirement of HK$300 million for virtual bank applicants. Specifically, one respondent considered that the HKMA should allow flexibility for start-up virtual banks not to meet the minimum capital requirement if their businesses were subject to business restrictions. Another respondent suggested allowing a lower initial minimum paid-up capital requirement, similar to the level for deposit-taking companies (i.e. HK$25 million), but with flexible minimum deposit amounts and no minimum term of maturity. On the other hand, one respondent opined that the capital adequacy ratios to be observed by virtual banks should not be lower than those for conventional banks given the former's higher exposures to technology risk and concentration in certain asset classes.

The HKMA's responses: It should be noted that the capital requirements stipulated in the Banking Ordinance and the Banking (Capital) Rules (including the minimum paid-up capital requirement of HK$300 million) are applicable to all licensed banks. It is neither possible nor appropriate to lower the minimum capital requirement for virtual bank licensees. It is also worthwhile to note that the HKMA is not permitted to grant a banking licence to an applicant if it does not fulfil all the authorization criteria, even though the applicant agrees to be subject to restrictions on its business activities.

Others

The following comments, which were not directly related to the Guideline, were also received during the consultation:

(i) A few respondents recommended the HKMA to leverage on its Fintech Supervisory Sandbox and introduce a phased approach to licensing virtual banks, under which virtual banks will be subject to some business restrictions but they will not be required to fully satisfy the regulatory requirements during the initial phase;

(ii) Several respondents encouraged the HKMA to work closely with the Privacy Commissioner for Personal Data (PCPD) to provide greater clarity on how the existing personal data protection requirements will apply in the context of online banking;

(iii) Several respondents noted that digital onboarding and eKYC procedures were critical to the viability of virtual banks. They requested the HKMA to review its existing AML and KYC requirements and provide further guidance to the industry where appropriate. A respondent further recommended the HKMA to review all its existing prudential requirements to ensure their ongoing relevance to virtual banking;

(iv) A respondent urged the HKMA to provide more detailed guidance on the application process; to work with other stakeholders in educating the public on virtual banking and other technology-driven financial services so as to bridge the digital divide; and to develop a consolidated roadmap of various financial infrastructure initiatives relevant to Smart Banking and Bay Area development; and

(v) There was a suggestion for the HKMA to examine the underlying cost structure and the price setting of conventional banks and virtual banks in order to set fair and transparent regulatory requirements to promote healthy competition in the marketplace.

<u>The HKMA's responses</u>: The HKMA appreciates these comments and finds them helpful. It will take into account the comments in the course of processing the applications of virtual banks and in its subsequent supervision of them. As stated in paragraph 4 of the Guideline, the Guideline should be read together with the HKMA's Guideline on Minimum Criteria for Authorization, which contains very detailed guidance on how to apply for authorization under the Banking Ordinance. The HKMA has also set up a dedicated team to answer enquiries of virtual bank applicants and provide assistance during the application process.

Separately, the HKMA has launched a Banking Made Easy initiative and established an internal taskforce to review existing supervisory requirements so as to streamline any possible frictions to the use of digital banking services. One of the three work streams under the Banking Made Easy initiative seeks to identify and streamline supervisory requirements relating to remote or digital onboarding of customers. The

HKMA will consider providing suitable guidance to banks on this area going forward. Also as part of the Banking Made Easy initiative, the HKMA has reached out to the Office of the PCPD and relayed the industry's desire for greater clarity on how the existing personal data protection requirements will apply in the online banking environment. More dialogues between the Office of the PCPD and the banking sector will be organised. As noted above, the Banking Ordinance does not provide a flexibility allowing the HKMA to authorize a virtual bank without it meeting all the authorization criteria.

Hong Kong Monetary Authority
30 May 2018