Risk Management and Regulation Newsletter

Welcome to the Risk Management and Regulation Newsletter

Welcome to the third issue of this newsletter. As always, we have brought together a summary of interesting and relevant risk management or regulatory developments with an applicability to many of our clients.

It is hard to have any kind of discussion on professional or personal matters in Hong Kong at present without the conversation quickly turning to the impact and fall out of COVID-19. While I think this is likely to be the norm for the next few months at least, there are some signs that indicate people are looking beyond COVID-19.

In our view, as companies and institutions respond to the effects of the pandemic, they will go through four phases: **Reaction** – responding to immediate challenges; **Resilience** – managing through uncertainty; **Recovery** – resetting and identifying opportunities; and the **New Reality** – adapting to a new world. My feeling is that many institutions in Hong Kong are very much into the Recovery stage and some are actively thinking and planning for the New Reality stage.

In this issue we deal with a range of topics:

- **Sustainable investing:** This is an increasingly important area that will continue to grow as consumers and investors are interested in both social and financial outcomes. Our survey sets out the current status and some challenges to be overcome.
- **Operational resilience:** COVID-19 has brought this to the fore and we expect to see financial institutions, in particular, place more emphasis on resilience and how they ensure they continue operating in times of disruption and stress.
- **Regulatory Driven Transformation:** The trend for financial institutions to use technology to solve risk and regulation issues is accelerating and KPMG has its own suite of solutions to address some typical pain points.
- **Risk management under COVID-19:** Financial risks are changing greatly in response to COVID-19 and here we set out the main impacts we have observed and our view on how banks should respond.
- **AML/CTF and Sanctions:** Digital IDs and how they can be used for customer due diligence purposes is the subject of a recent paper from the Financial Action Task Force – we dive into some of the key issues here.

We hope you enjoy this issue and would love to hear feedback from you.

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Topics in this issue:

Sustainable Investing

In the last decade, governments worldwide have enacted hundreds of measures to promote the awareness of environmental, social and governance issues (ESG).

The drive to create a more sustainable future involves a variety of actors: governments, regulators, capital markets, businesses and consumers; and they are being aided and abetted by green technologies and business model innovations.

KPMG's new report, ***Sustainable investing: fast-forwarding its evolution***, involving KPMG International, CREATE-Research, AIMA and CAIA Association, examines the trend towards sustainability investing and its impact on the alternative investment industry. The research includes insights from 135 institutional investors, hedge fund managers, long only managers and pension consultants in 13 countries and regions worldwide.

The in-depth research explores three key issues:

1. **What is the current state of progress in implementing sustainable investing?**
2. **What are the barriers to progress?**
3. **How are evolving best practices tackling these barriers?**

The report notes that on ESG, hedge fund managers are moving ahead with integrating ESG principles into their practices. To further succeed, they must also embrace emerging best practices and take control of their own narratives whether those demands come from investors, consultants, policymakers, regulators or even employees.

Survey respondents cited challenges with contracted investment horizons and only partial evidence of success as factors slowing progress. In KPMG's view, these challenges are the teething problems of a better form of investing. Sustainability is set to morph into the new normal, as our societies seek to overcome the side effects of the turbocharged capitalism of the past 40 years.

It is clear that ESG is becoming an increasingly important theme across all areas of asset management, and the findings and observations set out in our report are equally applicable to other asset classes. We believe that only responsible ownership and savvy implementation will deliver sustainability. They will also differentiate the winners from the losers.

A more sustainable future

Hedge fund managers' survey – key data points:

- **85%** Institutional investors are the biggest driver of demand for ESG-oriented hedge funds
- **55%** ESG-oriented hedge funds continue to target alpha returns, while managing fat-tailed far-off risks
- **15%** Hedge fund managers have embedded ESG factors across their strategies
- **63%** Progress hampered by lack of robust templates, consistent definitions and reliable data

Institutional investors' survey – key data points:

- **44%** ESG-oriented hedge funds can deliver alpha and also manage fat-tailed far-off risks
- **34%** Believe ESG is material to the financial performance of investee companies
- **75%** Too early to decide whether sustainable investing delivers double bottom-line outcomes
- **49%** Lack of consistent quality data is a challenge in the adoption process

Operational Resilience in Financial Services

Crisis management becomes business-as-usual

The world, and Hong Kong in particular, has seen its fair share of disruptive events in recent times. Over the past twelve months, the world has seen the spread of the novel coronavirus, social unrest in Hong Kong and uncontrollable wildfires in Australia, among many other significant global and regional events that have severely impacted the day-to-day lives of many people, and the "business-as-usual" operations of many organisations across sectors, including financial services. These disruptions have not been one-off short-term ones, instead, they are significant enough to force organisations to permanently adapt their ways of working to ensure that they are able to operate under the "new normal".

The magnitude of the disruption means that the financial services sector needs to look at its operational resiliency as more than just another compliance exercise – it needs to be part of each organisation's overall strategic plan. Companies need to move away from being reactive and start proactively planning for not "if" but "when" circumstances change, and strongly consider that these changes may likely be permanent.

Leading banks have adopted the following guiding principles:

- A top-down approach to operational resilience driven by senior management and the board of directors.
- Embed an operational resilience mindset within the bank's culture.
- Identify and map out the people, data, systems, processes and third parties that support key business services to ensure the end-customer always receives a complete service experience.
- Define threshold tolerances (based on key measurements used in the services) and use extreme scenarios to conduct end-to-end testing.
- Develop approaches beyond traditional BCP planning to look through a business lens on managing disruption.
- Define appropriate escalation paths and decision-making procedures combined with effective and timely communication plans.
- Assume that disruption will occur.

Click **here** for the full paper KPMG published in March 2020, which includes further details such as longer-term considerations and the business benefits of operational resilience.

The art of adapting to a changing environment

What should you focus on:

Third party risk management
- Supply chain management
- Third party risk strategy, operating model and tooling

Effective Governance
- Resilience strategy
- Governance
- Policies and procedures
- Resilience culture and awareness
- Regulatory requirements

Target Operating Model
- Organisational accountability, roles and responsibilities
- Legal entity and booking strategy
- Local strategy
- Customer experience
- Critical service definition
- Business case definition

End-to-end testing
- Tolerance setting
- Scenario analysis
- Risk based test plan
- Testing execution

Analytics
- Data requirements assessment
- Data management
- Management reporting and KPIs

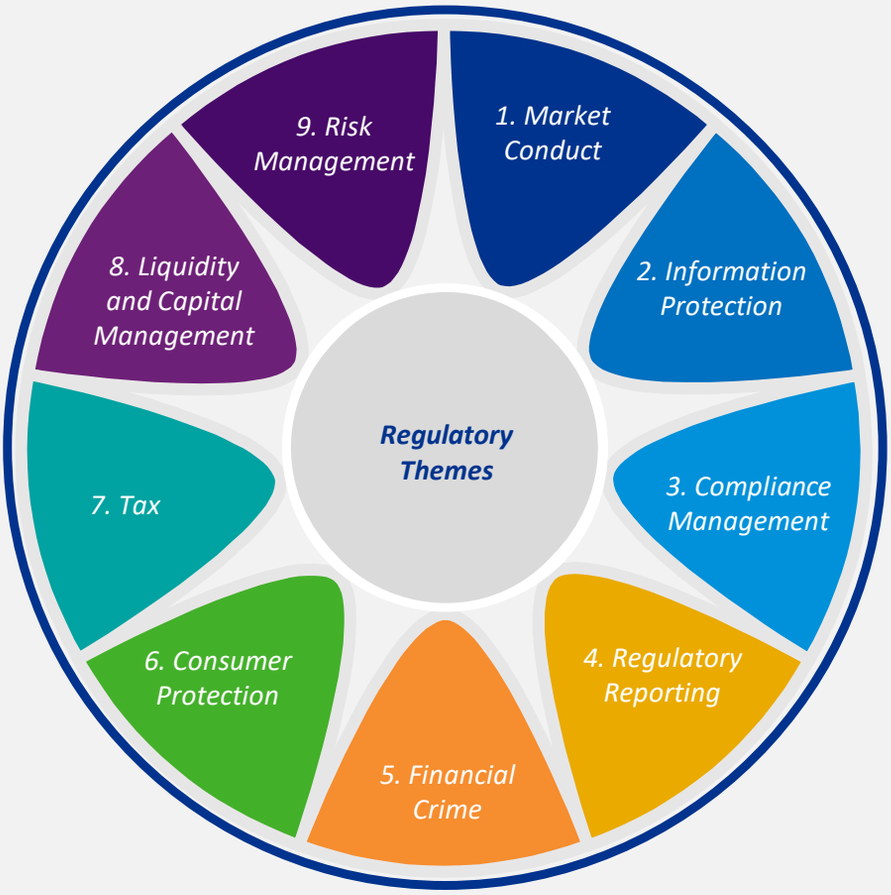
Recovery and response
- Crisis management
- Incident response
- BCP and disaster recovery
- Communication management
- Talent management

Regulatory Driven Transformation

KPMG believes that technology is key to keeping pace with ever-increasing regulatory changes. As regulators across the world – including the ASPAC region – demand more stability and transparency, they also demand more information and greater accountability from financial institutions and their leaders.

While different jurisdictions and markets across the globe present a range of regulatory requirements, we have seen certain key themes emerge which are increasingly the focus of almost all regulators. Given that each jurisdiction will have unique compliance expectations, the need to efficiently and effectively manage these rules across all operating locations has brought urgency for financial institutions to employ Regulatory Technology (RegTech) solutions.

A Universe of Regulatory Themes



We are pleased to present our views on these key regulatory themes and the KPMG technologies that can help financial institutions address the challenges they face in meeting these regulatory requirements. We combine our technology specialists with our deep risk and regulatory subject matter experts, while leveraging our wealth of experience, to provide you with a strategic, adaptable way of meeting current and future regulatory challenges.

Click **here** for the full paper KPMG published in April 2020, which includes an assessment of the current challenges, benefits presented through the use of RegTech, and the various available RegTech solutions across regulatory themes.

How technology can help meet regulatory requirements

RegTech Solutions:

- Sanctions Alert Classifier
- Pre-investigation Profiling
- Automated Transaction Monitoring System Tuning
- Customer Activity Dashboard
- Trade Compliance Analytics
- TPRM Assessment and Compliance Hub (KaVACH)
- Credit Model Validation Tools
- AI in Control
- Cognitive Contract Analysis
- AI Powered Automation – Voice to Text and NLP Analytics
- Integrated Analytics for GRC
- Performance and risk monitoring solution (K-PRISM)
- Automated Exchange of Information (AEOI) Reporting Tool
- Digital Treasury Country Guides

Financial Risk Management for Banks

The COVID-19 pandemic has enveloped the world within weeks, and continues to put severe strain on people and businesses in Hong Kong. The banking industry is particularly impacted by volatile market conditions, deteriorating credit quality and business continuity challenges among other things. The unexpected crisis also raises questions around banks' existing risk management frameworks in terms of their effectiveness and agility.

These are unprecedented times for CROs, risk functions and key decision makers need to navigate their organisation through unchartered waters in these turbulent times. The four core financial risk types have been materially impacted under the crisis and have direct implications for banks' capital management.

There are some key action points to be considered by banks – both in the short term to support crisis management, but also in the medium- to long-term to support the way forward once the worst shock has passed.

The immediate issues that banks face on financial risks:

Credit Risk

- Deteriorating credit quality across certain sectors needs to be reflected with timely updates to credit ratings and analysis on impacts to RWA, refreshing of credit limits, and bolstering workout units.
- Government support programs and relief measures need to be reflected in credit provisions as this will have an impact on IFRS 9 ECL – relief measures and staging of loans, economic forecasts, disclosure.

Market Risk

- Due to the stressed market conditions, banks will need to re-allocate risk-based limits (especially on trading book sensitivity limit breaches), revise stress testing scenarios and back-testing methodologies.
- Fair value adjustments to account for liquidity discounts, close-out costs (bid-offer spread widening) and movements in credit valuation adjustment, funding spreads and greater volatility.

Liquidity Risk

- Being unprepared for the unexpected liquidity constraints from heavy drawdowns and limited access to alternative funding sources.
- Challenges on practicability and flexibility of existing stress testing and liquidity risk framework.
- Lack of ad-hoc assessments and effective escalation protocol.

Operational Risk

- Uncertainties of COVID-19 impacts on operational processes putting strain on operational risks.
- Striking the right balance between cost cutting and smooth operations.
- Regulatory and business focus on operational resilience.

Click **here** for the full paper KPMG published in April 2020 for further details of COVID-19 impacts on the four key risks areas.

COVID-19 implications for credit, market, operational and liquidity risk

Key links:

Regulator's response to the COVID-19 crisis:
Click **here** for the flyer KPMG published in April 2020 with details on actions taken by regulators globally in response to COVID-19.

COVID-19 implications for model risk management:
Risk models developed in a pre-COVID-19 macro-economic landscape may not be as reliable given the current market dynamics which puts pressure on those responsible for managing and validating these models. Are risk model outputs still reliable during this crisis? What actions should be taken given their widespread usage in risk management, pricing, financial reporting, and business decisioning? Click **here** for the flyer where KPMG sets out some key COVID-19 impacts.

Guidance from the Financial Action Task Force (FATF) and Hong Kong Monetary Authority (HKMA) on COVID-19's impact on AML/CFT

On 1 April 2020, the FATF president issued a statement on how the risk-based approach of the FATF standards provides for emerging threats and vulnerabilities to be managed effectively and is in support of COVID-19 aid and containment efforts. In particular, the FATF president encouraged governments to work with financial institutions (FIs) and other businesses to use digital customer onboarding and financial technology in light of social distancing measures whilst remaining alert to emerging ML/TF risks.

The HKMA issued a letter on 7 April 2020 to Authorized Institutions (AIs) and Stored Value Facilities licensees (SVFs) that sets out the related support, guidance and assistance to support swift and effective implementation of AML/CFT measures in response to COVID-19. The HKMA stated that the provision of remote account opening and use of financial technology will provide significant opportunities to manage some of the challenges presented by the COVID-19 situation. AIs and SVFs are to remain vigilant to COVID-19 related financial crime risks, such as face mask scams that have impacted Hong Kong.

On 4 May 2020, the FATF issued a guidance paper that discusses the new financial crime threats and vulnerabilities stemming from COVID-19, the current impact on AML/CFT efforts by governments, as well as the private sector and FATF's suggested policy responses to support the swift and effective implementation of measures against COVID-19. In particular, the paper discusses the increased fraud, cybercrime and bribery as well as corruption risks due to recent changes in financial behaviors and patterns because of the increased financial volatility and uncertainty associated with COVID-19. The paper also provides examples of AML/CFT policy responses including (i) domestic coordination to assess the impact of COVID-19 on AML/CFT risks and systems; (ii) strengthened communication with the private sector; (iii) encouraging the full use of a risk-based approach to customer due diligence; and (iv) supporting electronic and digital payment options.

In summary, both FATF and HKMA alluded to heightened ML/TF and fraud risks associated with COVID-19 and FIs are encouraged to adopt financial technology, e.g. remote on-boarding measures, to manage the challenges presented by the current situation in relation to account opening procedures, customer due diligence (CDD) processes and provision of other essential services digitally as opposed to physically. Nevertheless, whilst the current situation presents a unique opportunity to incentivize FIs to expedite the implementation of digital banking measures, FIs should be reminded that it must not be done at the expense of the FI's electronic banking/technology risk management practices and legal and regulatory obligations in relation to CDD. In particular, FIs should also make reference to FATF's guidance paper on Digital Identity (see next page).

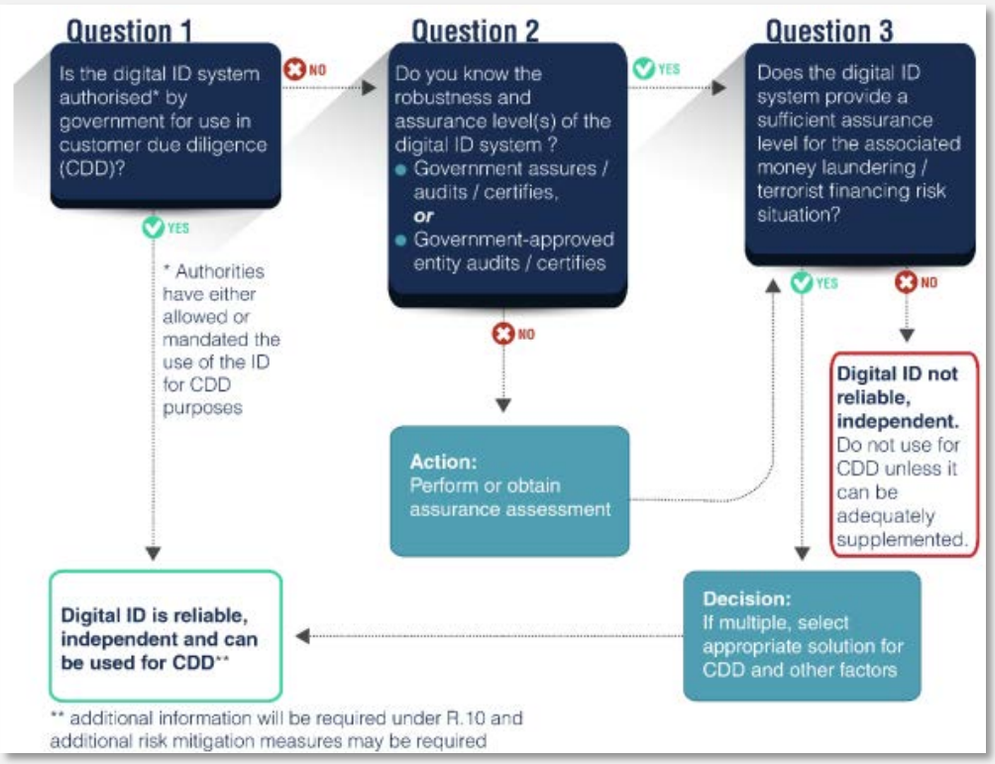
Anti-Money Laundering / Counter-Financing of Terrorism and Sanctions

Key points from FATF and HKMA guidance on COVID-19:

- Government and the private sector should work together to address the challenges brought by the COVID-19 pandemic
- The COVID-19 pandemic has created new sources of proceeds for illicit actors
- FIs are encouraged to adopt digital customer onboarding and financial technology whilst remaining alert to emerging ML/TF risks

FATF Guidance on Digital Identity

The FATF published a guidance paper on digital identity on 6 March 2020. The guidance aims to help government agencies/regulators, FIs, virtual asset service providers and other regulated entities determine whether a digital Identity (ID) solution is appropriate for customer due diligence. The guidance, which is technology-neutral, explores the benefits of digital ID systems and recommended that the potential challenges and risks of digital ID systems should be taken into consideration during implementation. It is also clarified that non-face-to-face customer-identification and transactions that rely on reliable, independent digital ID systems with appropriate risk mitigation measures in place, may present a standard or lower level of risk. FATF has provided the following decision process flow for regulated entities considering to adopt digital ID solutions:



Source: FATF Guidance paper on Digital Identity, Figure 1. decision process for regulated entities

It is expected that regulators and FIs in Hong Kong would make appropriate reference to the guidance and recommendations set out in the FATF guidance paper when assessing the digital ID and/or remote on-boarding solutions adopted by the regulated entities.

Over the past year, KPMG has assisted a number of FIs including traditional retail and commercial banks and virtual banks in connection with their implementation of remote on-boarding solutions. In line with the FATF Guidance, we assisted FIs, in particular, to assess the assurance levels of the remote onboarding solutions based on their technology, architecture and governance. The FIs could then make a risk-based determination of whether the digital ID system is sufficiently reliable or require further enhancements to appropriately mitigate impersonation fraud risks.

Anti-Money Laundering / Counter-Financing of Terrorism and Sanctions

Key points from FATF's guidance on digital ID:

- Digital ID could be widely adopted in the public and private sector
- Digital ID systems offer significant benefits for improving customer identification and authentication process
- Assessment on the reliability and independence of the digital ID system is key

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