The Banking Regulation Review

Seventh Edition

Editor
Jan Putnis

Law Business Research

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For further information please email
nick.barette@lbresearch.com

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Editor
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Gideon Roberton

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CONTENTS

EDITOR'S PREFACE

Nearly eight years after the collapse of Lehman Brothers it might have been expected that fundamental questions about the business models, governance and territorial scope of large banks would have been answered clearly, but that is not yet truly the case. Debates rage on in many countries about 'too big to fail', management accountability in banks, resolution planning and conduct issues in the banking sector. What is the 'safest' form of international banking and what might shareholders in banks reasonably expect as a long-term rate of return on their investment? When is all this uncertainty going to end? Perhaps it never will for so long as large banks remain as important to the global economy as they are and the political classes throughout the world remain divided on whether this is a good thing. It is also worth remembering that the reform agenda that was born in the financial crisis of 2007–2009 established a very long implementation period – to 2019 and beyond – for many of the regulatory changes agreed upon by the G20 and the Basel Committee. So we are still in the midst of what will no doubt be seen in decades to come as the 'post-crisis' period in banking regulation.

Looking forward then, what can we see beyond the implementation of the post-crisis reforms? That depends, of course, in part on whether there is another cross-border banking crisis. It is worth noting in this context that localised banking failures remain commonplace, and with more countries around the world introducing specialised bank resolution regimes there will be further opportunities to test the uses and pitfalls of bail-in and other resolution powers.

The continuing debate about the impact of technology on banks has increased significantly in volume in much of the world in the past year. Forecasts of the eventual eclipse of banks by technology firms seem wide of the mark in the short to medium term, although there is clearly an 'adapt or die' threat to many banks in the longer term. One adaptation of sorts that we may well see more of in the next few years is banks acquiring technology firms (or otherwise entering into strategic partnerships with them).

The most obvious benefits of new technology in the banking sector concern the customer interface and market infrastructure. However, some important but less immediately obvious ways in which technology will continue to revolutionise banking arise in the context of the safety and soundness of banks. For example, some banks are looking at how innovative

uses of technology can improve their risk management, and ultimately the credibility of their recovery and resolution plans through, for example, more precise classification and management of derivative positions and counterparty relationships.

Many of the largest cross-border regulatory investigations into past conduct in the banking sector have drawn to a close over the past year. While for some that signalled the close of a painful and costly chapter in the post-crisis development of the banking sector, it remains difficult to conclude that the threat of further such investigations has gone away.

As an English lawyer it would be odd if I did not mention the June 2016 referendum in the UK on membership of the European Union, parochial though that may seem to some readers outside Europe. The legal and regulatory regime that will apply to business that banks undertake in and from London is, however, of global interest, and the result of the referendum, and its aftermath, will therefore be of very considerable importance to all large banks and many smaller ones.

This seventh edition of *The Banking Regulation Review* contains chapters provided by authors in 39 countries and territories in March and April 2016, as well as chapters on International Initiatives and the European Union. My sincere thanks, as in previous years, go to the authors who have made time to contribute their chapters despite their heavy workload.

The team at Law Business Research have, once again, tolerated the hectic schedules and frequent absences on business of many of the authors, and I would like to thank them for doing so with such good humour and understanding. Thank you also to the partners and staff of Slaughter and May in London and Hong Kong for continuing to encourage projects such as this book, and in particular to Ben Kingsley, Peter Lake, Nick Bonsall, Edward Burrows, Tim Fosh, Kristina Locmele and Helen McGrath.

Jan Putnis
Slaughter and May
London
May 2016

Chapter 15

HONG KONG

Peter Lake[1]

I INTRODUCTION

Hong Kong has a three-tier system of banking institutions covering licensed banks, restricted licence banks and deposit-taking companies. There are separate licensing regimes, laws and regulations governing money lenders and money brokers. As of 29 January 2016 there were 157 licensed banks, 24 restricted licence banks, 18 deposit-taking companies and 60 local representative offices of overseas banks in Hong Kong. The five largest licensed banks in Hong Kong measured by total assets are HSBC, Bank of China (Hong Kong), Hang Seng Bank, Standard Chartered Bank (Hong Kong) and Bank of East Asia. The Hong Kong Monetary Authority (HKMA) is the government authority responsible for maintaining monetary and banking stability in Hong Kong.

II THE REGULATORY REGIME APPLICABLE TO BANKS

Companies wishing to carry on banking business or the business of taking deposits in Hong Kong are required under the Banking Ordinance to be authorised by the HKMA. These institutions are referred to in the Banking Ordinance as 'authorized institutions' (AIs).

i The HKMA

The HKMA's functions and policy objectives are:

a maintaining currency stability;
b promoting the stability and integrity of the financial system;
c helping to maintain Hong Kong's status as an international financial centre; and
d managing the Exchange Fund (Hong Kong's official reserves).

1 Peter Lake is a partner at Slaughter and May. The author would like to thank his colleagues Jocelyn Poon and Chelsea Peng for their assistance in preparing this chapter.

The HKMA fulfils some of the functions of a central bank, such as formulating and implementing monetary policy, supervising banks and managing the Exchange Fund. Other functions, notably the issuance of bank notes, are carried out by three banks within Hong Kong's commercial banking sector: Bank of China, HSBC and Standard Chartered.

ii Banking regulation

The Banking Ordinance provides the legal framework for banking regulation, which is supplemented by two publications by the HKMA: the Supervisory Policy Manual and the Guide to Authorization. The Supervisory Policy Manual contains the HKMA's latest supervisory policies and practices. The Guide to Authorization sets out the HKMA's interpretation of the authorisation criteria, the procedures for processing applications for authorisation and the grounds for revocation of licences.

iii Local representative offices

Instead of seeking authorisation to be AIs, overseas banks may, with the approval of the HKMA, establish local representative offices in Hong Kong. Local representative offices are not allowed to engage in any banking or deposit-taking business in Hong Kong. Their role is therefore largely confined to liaison work between the overseas bank and its customers in Hong Kong.

iv AI eligibility criteria

Certain basic criteria must be satisfied to be eligible to become an AI and obtain a banking licence. The HKMA has general discretion to grant or refuse an application for authorisation and, if one or more of the criteria is not fulfilled, the HKMA must refuse the relevant application for authorisation. An AI must be a body corporate. Where the applicant for AI branch authorisation is a bank incorporated outside Hong Kong, the HKMA will confirm with the relevant overseas banking supervisory authority that it has given consent for the applicant to establish a branch in Hong Kong. The authorisation criteria for AIs, which are set out in the Seventh Schedule to the Banking Ordinance, ensure that only fit-and-proper institutions are entrusted with public deposits.

v Securities activities

The banking industry is regulated jointly by the HKMA and the Securities and Futures Commission of Hong Kong (SFC) to the extent that AIs carry on business in one or more 'regulated activities' as defined in the Securities and Futures Ordinance (SFO). Regulated activities include dealing in securities, advising on securities, advising on corporate finance and asset management.

The foundation of the regulatory framework for the securities and futures industry is that carrying on a business in a regulated activity without a licence, and without reasonable excuse, is a criminal offence. AIs that carry on business in one or more regulated activities are defined as 'registered institutions' in the SFO. To become a registered institution, the institution in question must satisfy the SFC that it is a 'fit-and-proper' person.

The SFO sets out a limited number of regulated activities (such as leveraged foreign exchange trading and certain types of securities margin financing) that AIs may carry out without a licence.

vi Cross-border marketing

The Banking Ordinance prohibits marketing that invites members of Hong Kong's public to make deposits. The prohibition catches persons outside Hong Kong who market to persons in Hong Kong. The prohibition is subject to a number of exceptions, including invitations to make deposits with AIs and invitations to make deposits outside Hong Kong, which contain prescribed disclosures.

Hong Kong's securities legislation, under the SFO, similarly prohibits the active marketing of regulated activities to Hong Kong's public if the relevant service provider of the regulated activities has not been granted a licence by the SFC.

vii HKMA's approach to banks regulated by overseas regulators

The HKMA recognises that the primary authority for supervising overseas banks lies with the supervisory authority of the jurisdiction where the relevant bank is incorporated. Accordingly, not all of the provisions in the Banking Ordinance and the Supervisory Policy Manual are applicable to AIs incorporated outside Hong Kong. Corporate governance and capital adequacy are two areas where the Banking Ordinance and the Supervisory Policy Manual are not applicable to banks incorporated outside Hong Kong, although the Banking Ordinance does set out certain capital thresholds to be met by an institution in order to become and remain authorised.

However, the HKMA does retain supervising power over most matters of day-to-day conduct of banking affairs for overseas banks authorised in Hong Kong. Rules and guidelines under the Banking Ordinance covering areas such as the appointment of directors responsible for the Hong Kong operations of the overseas bank, the code of conduct of the Hong Kong operation, internal risk controls and risk management, liquidity management, trading activities and money laundering are applicable to overseas banks authorised in Hong Kong.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The primary responsibility for the prudent management of an AI rests with the board of directors and management itself. The HKMA issues guidance to AIs through its Supervisory Policy Manual. While the Supervisory Policy Manual does not itself have the force of law, any failure to adhere to any of the guidelines set out in it may call into question whether an AI continues to satisfy the minimum criteria for authorisation under the Banking Ordinance.

Continuous supervision

The HKMA adopts a 'continuous supervision' policy so as to detect and address problems at an early stage. Various techniques are used by the HKMA to gather information and to monitor the business of each AI, including:

a on-site and off-site examinations;
b prudential meetings with the senior management;
c meetings with the board of directors;
d cooperation with external auditors; and
e sharing information with other supervisors.

Furthermore, regular statutory returns are required to be submitted to the HKMA.

Risk-based approach

The HKMA adopts a risk-based approach to evaluate the safety and soundness of an AI, its risk-management systems and its internal controls. This enables the HKMA to pre-empt any serious threat to the stability of the banking system.

The eight major types of inherent risks identified by the HKMA are credit, interest rate, market liquidity, operational, legal, reputation and strategic risks. A risk-management rating is assigned and factored into the 'management' component and other relevant components of the CAMEL rating system, which is an internationally recognised framework for assessing capital adequacy, asset quality, management, earnings and liquidity. The output of the CAMEL system is a supervisory rating to reflect the HKMA's view of the overall safety and soundness of the relevant AI.

For a Hong Kong-incorporated AI, the HKMA normally conducts a regular supervisory review once a year. The supervisory review process is a comprehensive assessment of the level of capital that a Hong Kong-incorporated AI should set aside for the eight major types of inherent risks identified for the purpose of risk-based supervision.

The HKMA has issued rules under the Banking (Capital) Rules (Chapter 155L of the Laws of Hong Kong (Banking Ordinance)) that prescribe in detail how the capital adequacy of locally incorporated AIs should be calculated. These rules incorporate Basel III technical guidance. In addition, the HKMA's revised Supervisory Policy Manual module CA-G-5 (supervisory review process) sets out details of the changes to the supervisory review process that were necessitated by the implementation of the Basel III capital standards. On 1 January 2015, the Banking (Capital) Amendment Rules came into operation, which introduced several capital buffers that will be used to implement the second phase of the Basel III capital standards, including the capital conservation buffer, the countercyclical capital buffer and the higher loss absorbency (HLA) requirement. The capital conservation buffer is an additional layer of Common Equity Tier 1 (CET1) capital above the 'hard' minimum capital requirements that will be phased in equal annual increments to 2.5 per cent of banks' total risk-weighted assets by January 2019. The countercyclical capital buffer is a further requirement for CET1 capital ranging from zero to 2.5 per cent of risk-weighted assets for banks' private sector credit exposures in Hong Kong when the HKMA determines there is excess aggregate credit growth associated with a build-up of system-wide risk in Hong Kong. The HLA ratio will apply to domestic banks considered by the HKMA to be systemically important (there are currently no global systemically important banks headquartered and incorporated in Hong Kong). They will be obliged to comply with this requirement by maintaining an additional layer of CET1 capital ranging from 1 to 3.5 per cent of their total risk-weighted assets.

While there are separate regulators for the prudential supervision of securities, insurance, Mandatory Provident Fund schemes and money lending businesses in Hong Kong, the HKMA supervisory review process assesses all the major risks of a banking group, whether arising from banking or non-banking activities.

Consolidated supervision

The capital adequacy, concentration of exposures and liquidity of a Hong Kong-incorporated AI are supervised on a consolidated basis to enable the HKMA to assess any weaknesses within a banking or financial group that may have an impact on the AI itself, and to take any necessary defensive or remedial actions. When supervising banking groups, the HKMA takes a flexible approach to determining the scope of consolidated supervision. As a general

rule, the banking group's local and overseas offices and financial subsidiaries are covered. Non-bank companies are included in the consolidation if they undertake 'financial' business such as hire purchase, credit cards or leasing. Where non-bank companies (e.g., securities firms or insurance companies) are adequately supervised by other supervisors, the HKMA will rely heavily on their cooperation to ensure effective overall supervision of the banking group. The HKMA will also consider contagion risk in relation to an AI's holding and sister companies.

ii Management of banks

One of the authorisation criteria under the Banking Ordinance is that the HKMA must be satisfied that the chief executive and directors of the applicant company are fit-and-proper persons to hold their respective positions. The HKMA will have regard to the person's experience, knowledge and skills, as well as his or her reputation and character, competence, soundness of judgement and diligence, whether he or she has a record of non-compliance with non-statutory codes or disciplinary records, his or her involvement as a director in any companies wound up by the court, and his or her business record and financial soundness and strength.

The legal and regulatory duties of the management of AIs are detailed in the HKMA's Supervisory Policy Manual modules on Corporate Governance (CG-1 to 6). In particular, the revised Supervisory Policy Manual module CG-1 (Corporate Governance of Locally Incorporated Authorized Institutions) sets out principles adopted by the HKMA in line with the Basel Committee on Banking Supervision's Principles for Enhancing Corporate Governance.

The board is ultimately responsible for the conduct of an AI's affairs, but the HKMA recognises that it may be beneficial for supervision of major functional areas to be delegated to certain specialised committees such as an executive committee, credit committee, asset and liability committee, remuneration committee and audit committee. It is also recognised that key functions and policies of an AI that is a subsidiary of another banking institution may be determined and centralised at the holding company level.

Outsourcing

The Supervisory Policy Manual module SA-2 (Outsourcing) sets out the HKMA's supervisory approach to outsourcing and the major points that the HKMA recommends AIs to address when outsourcing their activities. The HKMA's main concerns are with accountability, risk assessment, the ability of service providers, confidentiality of customer data, the degree of control the AI maintains over outsourced activities, contingency planning, and access to outsourced data by the HKMA's examiners and the AI's internal and external auditors.

iii Regulatory capital and liquidity

Capital adequacy ratio

The HKMA must be satisfied that an AI has financial resources that are adequate for the inherent risks in its business to reduce the risk of insolvency. All AIs are required under the Banking Ordinance to maintain minimum levels of share capital. As regards Hong Kong-incorporated AIs, the HKMA's framework for capital adequacy is based on Basel III (which was implemented in Hong Kong on 1 January 2013).

A Hong Kong-incorporated AI is required under the Banking (Capital) Rules to maintain a CET1 capital ratio of at least 4.5 per cent, a Tier 1 capital ratio of at least 6 per

cent and a total capital ratio of 8 per cent. Branches of foreign banks are not subject to this requirement but, based on the HKMA's past practice of generally requiring any foreign bank that wishes to establish a branch in Hong Kong to maintain a capital adequacy ratio of at least 8 per cent, it is likely that the HKMA will continue to require foreign banks to meet the three minimum risk-weighted capital ratios.

Under the supervisory review process discussed above, the HKMA may require the AI to have a capital buffer to cater for risks and uncertainties that are not already captured by the three minimum risk-weighted capital ratios. The HKMA has the power under the Banking Ordinance to vary any capital requirement rule applicable to an AI.

Capital buffers

As mentioned above, the HKMA has implemented the following capital buffers: the capital conservation buffer, the countercyclical capital buffer and (for domestic systematically important banks (D-SIBs)) the higher loss absorbency requirement.

The capital conservation buffer is being phased in equal annual increments. The capital conservation buffer is 0.625 per cent in 2016, and will increase to 1.25 per cent in 2017, to 1.875 per cent in 2018 and then to its upper level, 2.5 per cent, in 2019.

The level of the countercyclical capital buffer is determined by the HKMA's analysis on whether there is excess aggregate credit growth associated with a build-up of system-wide risk in Hong Kong. On 14 January 2016 the HKMA announced that the countercyclical capital buffer will increase from the current 0.625 per cent to 1.25 per cent with effect from 1 January 2017. This is in accordance with the maximum countercyclical counter buffer permitted for 2017 under the Basel III phase-in arrangement. The HKMA regards a continued build-up of the buffer as appropriate given the risks associated with recent credit and property market conditions.

The HLA requirement applies only to D-SIBs. On 31 December 2015 the HKMA announced that Hong Kong's list of D-SIBs remains unchanged from March 2015. The five D-SIBs are: The Hongkong and Shanghai Banking Corporation Limited, Bank of China (Hong Kong) Limited, Hang Seng Bank Limited, Standard Chartered Bank (Hong Kong) Limited and The Bank of East Asia, Limited. Each D-SIB will, in accordance with the Basel Committee arrangements, include a higher loss absorbency (HLA) requirement into the calculation of its regulatory capital buffers. Of the five banks, HKMA has designated to The Hongkong and Shanghai Banking Corporation Limited the highest HLA (0.625 per cent for 2016, 1.25 per cent for 2017) and to The Bank of East Asia, Limited the lowest HLA (0.25 per cent for 2016, 0.5 per cent for 2017).

A Hong Kong-incorporated AI is expected to discuss with the HKMA if it anticipates that any of its capital buffers will fall close to the buffer zone.

Solo and consolidated capital adequacy ratio

In broad terms, the Banking (Capital) Rules impose capital requirements on Hong Kong-incorporated AIs at two levels: on a solo basis and a consolidated basis.

All Hong Kong-incorporated AIs are required to maintain a capital adequacy ratio on a solo basis, which provides a measure of each institution's (including its local and overseas branches) capital strength. A Hong Kong-incorporated AI may apply to the HKMA to include in its capital base, for the purposes of calculation of its solo capital adequacy requirement, the capital invested in any subsidiary that meets the criteria set out in the Banking (Capital) Rules such that the capital adequacy ratio of that institution will be calculated on a 'solo-consolidated basis'.

Where a Hong Kong-incorporated AI undertakes other banking and financial business through subsidiary companies, the HKMA normally also requires the AI to maintain its capital adequacy ratio on a consolidated basis. This is to ensure that the Hong Kong institution's capital position is maintained at an adequate level taking into account its exposures to risks stemming from such subsidiaries. It is usually the practice of the HKMA to set the same minimum capital adequacy ratio requirement at both the solo and consolidated levels, unless the results of the supervisory review process justify otherwise.

Composition of capital base

Under the Banking Ordinance, the capital base of an AI is the sum of its Tier 1 capital and Tier 2 capital. Tier 1 capital is the sum of an AI's CET1 capital and its Additional Tier 1 capital. The key elements of the CET1 capital of an AI are the AI's CET1 capital instruments; the AI's retained earnings and other disclosed reserves; and the amount of minority interests arising from the CET1 capital instruments issued by the consolidated bank subsidiaries of the AI and held by third parties. The Banking (Capital) Rules also set out in detail how an AI's Additional Tier 1 capital and Tier 2 capital are to be calculated. In respect of each category of capital, the Banking (Capital) Rules also specify which items are to be excluded from the calculation, as well as which deductions are to be made.

Risk-weighted amount

The Banking (Capital) Rules set out various alternative approaches that a Hong Kong-incorporated AI can use to calculate its risk-weighted amounts for credit risk, market risk and operational risk. Each Hong Kong-incorporated AI is expected to choose options based on the results of its own detailed feasibility study. However, there is a default approach for each relevant risk that every Hong Kong AI must adopt unless the prior approval of the HKMA has been obtained for using another approach.

Most banks in Hong Kong use the standardised approach for both credit risk and market risk. For operating risk, the banks are approximately split between the standardised approach and the basic indicator approach.

Banks in Hong Kong generally have strong capital bases. The consolidated capital adequacy ratio of Hong Kong-incorporated AIs was well above the 8 per cent requirement under the Banking (Capital) Rules (18.1 per cent in September 2015).

Liquidity risk

The risk-based supervisory approach includes the continuous supervision of each AI's liquidity risk. Central to this is an assessment of the AI's ability to maintain adequate liquidity in the event of a liquidity crisis. The HKMA considers the amount of high-quality liquid assets that the AI can readily dispose of or pledge for funding; the results of stress tests on its cash-flow and liquidity positions; and the stability of the AI's funding sources and its contingency measures for dealing with crisis situations.

Amendments to the Banking Ordinance have been enacted to remove the liquidity ratio from the main body of the legislation and to allow the HKMA to make subsidiary legislation prescribing liquidity requirements to implement Basel III reforms. On 1 January 2015, the Banking (Liquidity) Rules implementing the Basel III liquidity coverage ratio (LCR) came into operation, which sought to promote banks' resilience to short-term liquidity risks by ensuring they have sufficient high quality liquid assets to meet their obligations for at

least 30 days under an acute stress scenario. This is in accordance with the timetable of the Basel Committee on Banking Supervision. In addition, it is the intention of the HKMA to introduce a new 'net stable funding ratio' by 1 January 2018.

The LCR applies only to AIs designated by the HKMA as 'category 1 institutions' under the liquidity rules. Category 1 institutions are those internationally active AIs or larger or more sophisticated AIs that are significant to the general stability of the local Hong Kong banking system. Other AIs not designated as category 1 institutions ('category 2 institutions') will be subject to the liquidity maintenance ratio, which is a modified version of the pre-existing liquidity ratio.

Liquidity adequacy

The Banking Ordinance stipulates that the HKMA should be satisfied that an AI continues to maintain adequate liquidity. In assessing this, the HKMA has particular regard to both quantitative factors (including liquidity ratio, maturity mismatch profile, loan to deposit ratio and intra-group claims) and qualitative factors (particularly the adequacy of systems and controls for managing liquidity risk).

All AIs are required to maintain a liquidity ratio of not less than 25 per cent in each calendar month, subject to the HKMA's power to vary the minimum liquidity ratio for particular AIs. The liquidity ratio for a given calendar month is the ratio of the sum of an AI's liquefiable assets, net of deductions required by the HKMA, to the sum of its qualifying liabilities for each working day of that month.

Whether incorporated in or outside Hong Kong, the liquidity ratio will apply only to an AI's principal place of business in Hong Kong and its local branches (i.e., excluding any subsidiaries or overseas branches of the AI). For a Hong Kong-incorporated AI, the HKMA may require the liquidity ratio to be calculated on a consolidated basis instead of an unconsolidated basis, or on both a consolidated and an unconsolidated basis.

Liquidity of Hong Kong banks

Hong Kong banks' balance sheets have remained liquid in the aftermath of the global financial crisis and, moreover, have improved over the past 12 months. The quarterly average liquidity ratio of retail banks in Hong Kong stood at 40.8 per cent (June 2014), 41.2 per cent (September 2014) and 41.1 per cent (December 2014). Following from the implementation of the new Basel III framework on 1 January 2015, the minimum requirement for liquidity coverage ratio for a category 1 institution is 60 per cent and the minimum requirement for a liquidity maintenance ratio for a category 2 institution is 25 per cent. The quarterly ratios for both categories of institution are well above the minimum requirements.

iv Recovery and resolution

The HKMA is a member of the Financial Stability Board (FSB) and has committed in principle to improving the effectiveness of its own resolution regime in light of the FSB policy paper, Key Attributes of Effective Resolution Regimes, published in October 2011. A joint consultation paper was published by the Financial Services and the Treasury Bureau of the Hong Kong government, the HKMA, the SFC and the Insurance Authority in January 2014 to seek public views on proposals for establishing an effective resolution regime in Hong Kong in line with the FSB's recommendations. The first stage of the consultation process closed on 6 April 2014. The second stage of the consultation exercise closed on 20 April 2015. The consultation response to the second stage of the consultation was released on 9 October 2015. Following the consultation process, the Financial Institutions (Resolution) Bill was published

in the Gazette on 20 November 2015 and was introduced into the Legislative Council for its first reading on 2 December 2015. The Bill seeks to establish a cross-sector resolution regime for global systemically important financial institutions (FIs) with a view to avoid or mitigate the risks otherwise posed by their non-viability to the stability of Hong Kong's financial system. The Bill is currently being reviewed by a Bill Committee. The HKMA is contributing to the process of drawing up international resolution and recovery plans as a member of the crisis management groups of eight global systemically important banks.

Although the resolution planning legislation has not yet been enacted, the HKMA today may still exercise a number of powers under the Banking Ordinance if, *inter alia*, an AI informs the HKMA that it is likely to become unable to meet its obligations, or that it is insolvent or about to suspend payment. The HKMA may also take such action unilaterally. In these circumstances, the HKMA, after consultation with the Financial Secretary of Hong Kong, may give directions to the AI in relation to its affairs, business and property.

A new guideline, RE-1, on recovery planning has been added to the Supervisory Policy Manual, which aims to inform AIs of the key elements of effective recovery planning, and to set out the HKMA's approach and expectations in respect of its review of recovery plans.

A new guideline on resolution planning will be prepared in due course, when the relevant legislation has been passed.

IV CONDUCT OF BUSINESS

i Conduct-of-business rules

The HKMA requires AIs to establish a Code of Conduct setting out the standards of behaviour expected of their management and employees. The Code should discourage conflicts of interest, the granting and receiving of credit by members of staff to themselves or their relatives, bribery, personal investments when in possession of price-sensitive information and outside employment. It should also encourage staff to handle personal data carefully and contribute to the good reputation of the AI by reporting any illegal activities. The HKMA requires the effectiveness of the Code and related systems to be audited regularly.

In December 2010, the HKMA revised module IC-1 of the Supervisory Policy Manual, General Risk Management Controls, to reflect changes in international standards and practices in response to lessons learned from the recent financial crisis.

ii The Code of Banking Practice

A revised Code of Banking Practice (Code), issued jointly by the Hong Kong Association of Banks and the Deposit-taking Companies Association and endorsed by the HKMA, was launched on 6 February 2015. The revised Code gives wider protection to customers and promotes good banking practices by aligning with international standards on financial consumer protection. Some amendments include extending the scope of the Code to subordinated and affiliated companies controlled by AIs, and integrating the G20 High-level Principles on Financial Consumer Protection as general principles for AIs to follow when providing services and products to their customers. The Code is issued on a voluntary basis, although the HKMA expects all AIs to comply with it and the HKMA monitors compliance. It covers areas such as terms and conditions, fees and charges, use of customer information, residential mortgage financing, card services and electronic banking services.

iii Banking confidentiality

Under common law, a term imposing a duty of confidentiality may be implied in contracts between a bank and its customer. The duty of confidentiality applies to information arising directly from the customer's account, other information obtained through the relationship between the bank and the customer, or in coming to decisions about the bank's treatment of its customers. For the purpose of this duty, where a banking group is structured through subsidiary companies, each subsidiary is considered as a separate entity. Therefore, restrictions on disclosure apply equally to transfers of information within a banking group as to transfers to a third party. In contrast, branches of a single corporate entity are considered to form part of the same entity. Therefore, information may be transferred freely between them subject to any applicable data protection laws.

There are four heads of acceptable disclosure of a customer's confidential information by a bank:

a compulsion of law;
b duty to the public;
c interests of the bank; and
d express or implied consent of the customer.

Head (c) is only applicable where disclosure is needed to protect the bank and not simply where it would be commercially advantageous.

Personal data is regulated in Hong Kong by the Personal Data (Privacy) Ordinance (PDPO). The purpose of the PDPO is to protect the privacy interests of living individuals in relation to personal data. It applies to any person (a data user) who controls the collection, holding, processing or use of personal data in Hong Kong. A 'person' for the purposes of identifying a data user includes 'any public body, any body of persons, corporate or unincorporated'. Branches as well as subsidiary companies may constitute separate data users, and transfers between them should be in accordance with the PDPO. A third party to whom data is outsourced (e.g., for the completion of IT tasks) will not be a data user for the purposes of the PDPO in relation to data it 'holds, processes or uses solely on behalf of another person' if it does not hold, process or use that data for any of its own purposes. This exemption is not available where the third party is involved in the collection of data.

According to the Code, AIs should treat their customers' (and former customers') banking affairs as private and confidential, and should at all times comply with the PDPO and any relevant codes of practice issued or approved by the Privacy Commissioner in the collection, use and holding of customer information.

In October 2014, the Office of the Privacy Commissioner for Personal Data, Hong Kong, published a Guidance Note on the Proper Handling on Customers' Personal data for the Banking Industry, which explains for the benefit of banks the PDPO requirements in relation to the collection, holding, processing and use of customer data. The Guidance Note contains a number of useful case studies that are based on matters that have been considered by the Privacy Commissioner.

iv Potential sources of liability

The Supervisory Policy Manual reminds directors of AIs to be aware of their legal obligations under all applicable laws and regulations, including but not limited to the Banking Ordinance, the Companies Ordinance, the SFO, the PDPO, the Drug Trafficking (Recovery

or Proceeds) Ordinance, the Organised and Serious Crimes Ordinance, the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance and the Prevention of Bribery Ordinance.

The SFO contains provisions on market misconduct (insider dealing, market manipulation, disclosure of false or misleading information, etc.). The SFO also contains several key provisions applicable to AIs that are registered with the SFC to carry on a business in one or more regulated activities. In general, AIs are subject to the provisions of the SFO in the same way as licensed corporations (i.e., institutions that are licensed by the SFC) in respect of their regulated activities. The major areas of difference, arising from the need to avoid regulatory overlap with the Banking Ordinance, are capital requirements and the handling of client money.

Directors may be held personally liable for non-compliance with many of the requirements under the Banking Ordinance and the SFO. In certain circumstances, such as under some offences in the Theft Ordinance, directors may be held criminally liable for offences committed by companies of which they are a director.

V FUNDING

Customer deposits are the most important source of funding for retail banks in Hong Kong. They have recently accounted for over 70 per cent of total liabilities. The high level of customer deposits has kept customer deposit rates at a low level: the monthly average savings deposit rates per annum of less than HK$100,000 quoted by leading licensed banks has remained at 0.01 per cent since October 2008 . The high level of customer deposits also contributes to the low rate of interest offered on Hong Kong dollar loans by licensed banks in the Hong Kong interbank market (HIBOR): the quarterly average of one-month HIBOR stood at 0.29 per cent (January 2016).

i Stable funding requirement (SFR)

The HKMA introduced an SFR in October 2013, which required AIs with significant loan growth to ensure they had adequate stable funding to support their lending business. The HKMA conducted a review of the SFR in 2014 and introduced several refinements that took effect from January 2015. These refinements were primarily aimed at streamlining the SFR and reducing the AIs' reporting burden. It is intended that the SFR will continue in place until the international standard Net Stable Funding Ratio is introduced under Basel III in 2018.

ii Provision of liquidity assistance by the HKMA

Intraday liquidity

The HKMA provides liquidity assistance to licensed banks on their request, if necessary, through conducting foreign exchange swaps between the US dollar and the Hong Kong dollar, and lending money against collateral of a credit quality acceptable to the HKMA. Intraday repos that fail to be reversed before the close of the business day will be carried into overnight borrowing through the discount window arrangement described below. These two arrangements were introduced in 2008 as part of five precautionary and temporary measures to enhance the framework of liquidity provision to the banking system in Hong Kong in light of the global financial conditions at that time. The other three measures were withdrawn in March 2009, but these two arrangements remain in place.

Overnight liquidity

Temporary overnight funding is available to licensed banks in Hong Kong through the discount window. The discount window facility was introduced in September 1998 and is a mechanism through which licensed banks can borrow Hong Kong dollar funds from the HKMA through repurchase agreements using eligible securities as collateral. On 15 December 2014, the HKMA introduced a Hong Kong dollar discount facility for Hong Kong Government Bonds to all licensed banks in Hong Kong.

Renminbi (RMB) Liquidity Facility

The RMB Liquidity Facility was introduced by the HKMA to address potential short-term liquidity demands in the offshore RMB market, which may be due to seasonal factors or capital market activities. The facility was first launched in June 2012. In the light of experience in operating the facility and developments in the offshore RMB market, the HKMA has made numerous enhancements to the facility in the past four years. Under the RMB Liquidity Facility, banks can obtain RMB from the HKMA on an overnight, one-day, one-week or intraday basis.

Lender of last resort

The HKMA has the ability to provide liquidity to AIs as the lender of last resort (LOLR) using the resources provided by the Exchange Fund, which the HKMA uses to regulate the exchange value of the Hong Kong dollar. It is believed that the HKMA has never had to exercise its function as LOLR.

The HKMA issued a policy statement in March 2009 explaining its role as the LOLR. The guiding principle governing the provision of LOLR support to an AI is whether the failure of that institution, either by itself or through spreading contagion to other entities, would damage the stability of the exchange rate, or monetary or financial systems. Given LOLR support will only be provided when failure of the AI might have systemic implications, LOLR support will not normally be given to branches of foreign banks operating in Hong Kong. The HKMA expects the head office of such a branch to be its source of LOLR support and, in the absence of such support, such a branch may have to close its operations in Hong Kong.

Deposit protection scheme (DPS)

The LOLR arrangement is complemented by the DPS, which was launched in 2006 under the Deposit Protection Scheme Ordinance (DPS Ordinance) under which eligible deposits are protected. Eligible deposits exclude:

a structured deposits;
b bearer instruments;
c term deposits with a maturity exceeding five years;
d deposits where the repayments are secured on the assets of the member of the DPS;
e offshore deposits;
f deposits held for the account of the Exchange Fund; and
g deposits held by an excluded person under the DPS Ordinance.

The HKMA acts as an executive arm of the Hong Kong Deposit Protection Board in administering the DPS.

Only licensed banks are required and are eligible to participate in the DPS. This is consistent with the aim of the DPS, which is to protect small depositors. A small number of licensed banks, which are branches of overseas-incorporated banks that are already covered by appropriate overseas deposit protection schemes, are exempted from the DPS.

The DPS is pre-funded by contributions by each member of the scheme. Further, the Deposit Protection Board has secured a credit facility from the Exchange Fund. The size of the credit facility is sufficient to cope with the simultaneous failures of two medium-sized banks.

Compensation will be paid to depositors when the court issues a winding-up order; or the HKMA, after consultation with the Financial Secretary, instructs the Deposit Protection Board to pay compensation. Under the DPS, each depositor (whether an individual or a corporate) who is not an excluded person under the DPS Ordinance is entitled to a maximum of HK$500,000 of compensation for each failed scheme member with which it places deposits. The amount of compensation entitlement will be calculated net of any liabilities owed by that depositor to the scheme member.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

Control of Hong Kong-incorporated AIs

The Banking Ordinance provides that no person shall become a controller of a Hong Kong-incorporated AI without the prior approval of the HKMA. A controller includes the following:

a an indirect controller: a person in accordance with whose directions or instructions the directors of the institution are accustomed to act;

b a majority shareholder controller: a person who controls over 50 per cent of the voting rights of the institution; and

c a minority shareholder controller: a person who controls between 10 and 50 per cent of the voting rights of the institution.

Note-issuing banks

Pursuant to Section 3(5) of the Legal Tender Notes Issue Ordinance, the Financial Secretary may amend any terms and conditions to which the authorisation to issue bank notes was granted. Shortly after Temasek Holdings, a Singapore state investment company, acquired a stake in Standard Chartered in 2006, the Financial Secretary of Hong Kong approved an additional policy requirement relating to the continuing authorisation of banks to be note-issuing banks. This provided that a note-issuing bank shall not have any close association with any foreign government or foreign government-controlled entity, which either alone or with associates is entitled to control 20 per cent or more of the voting power of the note-issuing bank or its holding company. In effect, the policy requirement is a barrier to controlling 20 per cent or more of the voting power of any of the three note-issuing banks in Hong Kong (although a determined bidder may not view the note-issuing status as a fundamental issue).

Overseas-incorporated AIs

While the acquisition of shareholdings and control in AIs incorporated outside Hong Kong do not need to be approved by the HKMA, the HKMA still needs to be satisfied

that a person who is to be a controller of the AI is a fit-and-proper person to hold such a position. In doing so, the HKMA will rely heavily on the views of the home supervisor of the overseas-incorporated AI.

ii Approval process for controllers of Hong Kong-incorporated AIs

Application

A person seeking to become a controller of a Hong Kong-incorporated AI must first serve on the HKMA a written notice of intention. The written notice must be submitted together with any supporting documents requested by the HKMA.

It is generally the policy of the HKMA that a person who intends to hold 50 per cent or more of the share capital of a Hong Kong-incorporated AI should be a well-established bank or other supervised financial institution in good standing in the financial community and with appropriate experience. It is, however, possible for non-financial institutions and other entities – such as PRC state-owned enterprises – to become controllers of Hong Kong-incorporated AIs.

Timing

The Banking Ordinance does not specify when the written notice needs to be submitted to the HKMA. However, the HKMA's preference is to be approached at the earliest appropriate opportunity, and recent experience has indicated that the HKMA expects to be approached for an approval in principle before the formal application process begins. This includes an expectation to pre-vet any proposed announcement of the sale of an AI (regardless of whether they are incorporated in Hong Kong or not).

The HKMA then has up to three months from the date of service of the notice to serve a notice of consent, and recent cases show that the HKMA may need the full three months, particularly if the proposed controller is not an established bank or financial institution. In other, more straightforward cases, this period is normally six weeks to two months. The HKMA will be taken to have consented to a person becoming a controller of the Hong Kong-incorporated AI if it does not serve on him or her a notice of objection within the three-month period.

Considerations

In granting the notice of consent, the HKMA:

a must be satisfied that the person is a fit and proper person to become a controller of the Hong Kong-incorporated AI;

b must be satisfied that the interests of depositors and potential depositors of that Hong Kong-incorporated AI would not be threatened by that person becoming a controller;

c takes into account the person's likely influence on that Hong Kong-incorporated AI if he or she were to become a controller; and

d will take into account the financial position, reputation or conduct of the applicant to determine whether the controller could potentially damage the Hong Kong-incorporated AI through contagion.

In granting the notice of consent, the HKMA may specify such conditions as it thinks proper to safeguard the interests of depositors and potential depositors.

Although not explicitly set out in the legislation, the HKMA will take similar considerations into account when considering controllers of non-Hong Kong incorporated AIs, which it will review in the context of whether the AI remains fit and proper.

Approval
If the HKMA has served a notice of consent to the applicant, that person must become a controller before the expiration of 12 months from the date on which he or she was served such a notice of consent.

Controller financial support
Where a minority or majority shareholding in a Hong Kong-incorporated AI is to be acquired, the HKMA will generally require the acquiring shareholder controller to provide a letter of comfort committing to provide capital support, liquidity support or both to the AI, if necessary. The form of the letter of comfort is set out in the HKMA's Guide to Authorization.

Transfers of banking business
While other common law jurisdictions have a court-sanctioned scheme process to effect the transfer of banking business without the consent of the depositors or other counterparties, Hong Kong does not have an equivalent process.

Notification to the HKMA
A Hong Kong-incorporated AI cannot make any arrangement, or enter into any agreement for the sale or disposal of all or any part of its banking business or its business of taking deposits, without the prior written approval of the HKMA.

Private member's bill
In a business or asset transfer in Hong Kong, private legislation is the only alternative to obtaining individual customer consent. A private member's bill is legislation of a special kind intended to affect or benefit some particular person, association or corporate body. It may be used to transfer all or part of a company's business to another company or to extinguish the rights of any creditor of the company, or both. The private member's bill procedure has been used for a number of bank mergers with a Hong Kong element (e.g., Citibank, Dao Heng Bank, Standard Chartered and Bank of Communication (Hong Kong) Limited), although this procedure is rare and is not currently favoured by the HKMA. The private member's bill procedure is, however, being used in respect of the Hong Kong domestication of the businesses of Bank of Communications Co, Ltd, Hong Kong Branch by transferring that business to a Hong Kong company, Bank of Communications (Hong Kong) Limited. The customer consent route was used in the Standard Chartered–American Express Bank integration in 2008, the Australia and New Zealand Bank–Royal Bank of Scotland integration in 2009 and the Union Bancaire Privée, UBP SA–Coutts integration in 2016.

VII THE YEAR IN REVIEW

A number of significant regulatory developments occurred in 2015 and early 2016.

i Remuneration

On 12 March 2015 the HKMA updated its Guideline on a Sound Remuneration System (CG-5) to require locally incorporated AIs to disclose the extent of their compliance, and explain non-compliance, with that guideline. The guideline incorporates relevant disclosure standards issued by the Basel Committee in July 2011.

ii China–Hong Kong Mutual Recognition of Funds

On 22 May 2015 the SFC and the China Securities Regulatory Commission announced a scheme to mutually recognise certain retail funds between the PRC and Hong Kong. This enables certain Hong Kong retail funds to be marketed in China, and vice versa. On 9 July 2015 the HKMA announced a new cross border link with the PRC (via the HKMA's Central Moneymarkets Unit Fund Order Routing and Settlement Service) to provide order routing and settlement support for this cross border initiative.

iii Stored value facilities and retail payment systems

A regulatory regime for stored value facilities (such as Octopus cards) and retail payment systems commenced on 13 November 2015. The HKMA will implement, supervise and enforce the regime, subject to a one-year grace period. Licensed banks are deemed licensed to issue and operate stored value facilities.

In addition, the HKMA may designate retail payment systems to ensure their safe and robust operation under prudential regulation. Only those retail payment systems that pose risk to the monetary or financial stability of Hong Kong (or where there are matters of significant public interest) will be so designated.

iv Resolution regime

The HKMA, together with the SFC and the Insurance Authority, have furthered their proposals to establish a cross-sector resolution regime for financial institutions including financial market infrastructure. A draft bill, the Financial Institutions (Resolution) Bill, was published on 20 November 2015 and introduced into the Legislative Council on 2 December 2015.

v Competition Ordinance

Hong Kong's Competition Ordinance came into operation on 14 December 2015, introducing competition law principles to the banking sector. Much work has been carried out by the industry association the Hong Kong Association of Banks to assist the industry in complying with the new regime.

vi Industry-wide competency framework

The HKMA announced on 18 December 2015 its intention to introduce an industry-wide voluntary competency framework, building on the existing enhanced competency framework for private wealth management practitioners that was launched in June 2014. The programme will start with anti-money laundering and counter-terrorist financing. The framework is expected to be rolled out by the end of 2016.

vii Market risk capital requirements

In line with the Basel Committee's final standards on Minimum Capital Requirement for Market Risk issued on 14 January 2016, the HKMA intends to implement the new market risk standards by 1 January 2019, with related bank regulatory reporting commencing 31 December 2019. This initiative involves a significant overhaul of the current market risk capital framework and will likely impact upon capital requirements, systems, data and resources of Hong Kong AIs.

viii OTC derivatives

The HKMA and the SFC issued in February 2016 consultation conclusions on OTC derivatives. The conclusions covered mandatory reporting and mandatory clearing.

Mandatory reporting of OTC derivatives came into effect on 10 July 2015 (although licensed banks were previously reporting OTC derivatives under simplified interim reporting requirements introduced in 2013). The scope of mandatory reporting currently covers certain interest rate swaps and non-deliverable forwards and is intended to be expanded – subject to the passing of necessary legislation – with effect from 1 July 2017 to also include FX derivatives, equity derivatives, credit derivatives and commodity derivatives.

Mandatory clearing of OTC derivatives has been delayed and is now expected to commence on 1 September 2016, subject to the passing of legislation. The first phase of mandatory clearing will focus on certain standardised interest rate swaps denominated in USD, EUR, GBP, JPY or HKD and entered into between major dealers such as AIs, approved money brokers and licensed corporations (or entered into between a major dealer and a financial service provider specified on a list prepared by the SFC and approved by the HKMA).

VIII OUTLOOK AND CONCLUSIONS

We anticipate the following areas of focus or development for the next 12 months:

a further work from AIs to ready themselves for the Hong Kong changes to implement recommendations from the Basel Committee;

b continuing pressure from regulators in respect of KYC systems (and in this regard noting the proposed introduction by the HKMA of a competency framework for anti-money laundering and counter-terrorist financing to enhance competency in this area); and

c AIs to take preparatory steps for the introduction of a resolution regime.

We may also see further issuances of Additional Tier 1 capital instruments.

Appendix 1

ABOUT THE AUTHORS

NICK BONSALL

Slaughter and May

Nick Bonsall has been a partner in the financial regulation group at Slaughter and May in London since May 2016. He advises on the supervision and regulation of banks, investment firms, payment institutions, insurance companies and building societies. Recently, his work has involved advising on various financial regulatory aspects of the acquisition and disposal of banking businesses, including through the FSMA banking business transfer regime, and on various matters relating to bank recovery and resolution plans. He has also advised on financial services outsourcings, the UK electronic money and payment services regimes, and agreements for the distribution of retail investment products. He graduated from the University of Edinburgh with a degree in mathematics and statistics, and qualified as a solicitor in England and Wales in 2009.

EDWARD BURROWS

Slaughter and May

Edward Burrows is an associate in the financial regulation group at Slaughter and May in London. He qualified as a solicitor in England and Wales in 2013. His practice incorporates advisory, transactional and contentious work for a broad range of financial institutions. During his time at Slaughter and May, he has advised on various aspects of the supervision and regulation of banks, in particular regulatory capital, remuneration, governance arrangements, the senior managers regime and outsourcing. Before becoming a solicitor, he graduated with a law degree and obtained a postgraduate commercial LLM from the University of Cambridge.

TIMOTHY FOSH

Slaughter and May

Timothy Fosh is an associate in the financial regulation group at Slaughter and May in London. His practice incorporates transactional and non-transactional work for a variety of financial and non-financial institutions. His practice has recently involved providing advice on many elements of UK banking regulation (including the ring-fencing regime, capital

requirements and the UK implementation of the Bank Recovery and Resolution Directive), as well as advising on the regulation of the trading of derivatives and financial instruments more generally. He has also recently advised a number of banks and fund managers on structuring and material outsourcing issues, as well as advising on the acquisition of certain consumer credit and intermediary firms. He graduated with a degree in classics from Durham University in 2007, and qualified as a solicitor in England and Wales in 2012.

PETER LAKE

Slaughter and May

Peter Lake is a partner in Slaughter and May's Hong Kong office. He is involved in a wide range of corporate, banking and finance work, advising leading companies, financial institutions and fund management groups from Hong Kong, the United Kingdom and elsewhere. He has advised on acquisitions, investments and financings as well as providing regulatory advice to a number of funds and financial institutions. He is listed as a leading lawyer in the *Who's Who Legal Banking 2016* for Finance and for Regulatory in Hong Kong, and ranked for Banking & Finance (China), Hong Kong-based (International Firms) and Financial Services (China), Non-contentious Regulatory (International Firms) in *Chambers Asia 2015* and *Chambers Global 2015*. He is also listed as a leading lawyer for Banking and Finance in the *Asia Pacific IFLR 1000 2016* and for Banking and Finance (Hong Kong), Capital Markets (Debt) (Hong Kong) and Investment Funds (Hong Kong) in the *Asia Pacific Legal 500 2016*. He is a member of the APLMA Documentation Committee. Mr Lake read law at Emmanuel College, Cambridge, and is qualified in England and Wales and in Hong Kong.

KRISTINA LOCMELE

Slaughter and May

Kristina Locmele is a senior associate at Slaughter and May in London. She acts for a broad range of financial institutions, including banks, insurance companies, investment firms, asset managers, payment institutions, e-money issuers and consumer credit providers, and non-regulated firms on regulatory matters, including in the context of corporate and commercial transactions. Kristina has extensive experience advising on various payment services, e-money and consumer credit issues, most recently, in relation to structuring and perimeter issues arising out of the integration of the consumer credit regime into the main UK financial services regulatory framework and the proposed amendments to the payment services regime. Kristina also provides specialist advice on structural reform and recovery and resolution planning and consequential changes to group structures and business models.

HELEN McGRATH

Slaughter and May

Helen McGrath is an associate in the financial regulation group at Slaughter and May in London. Her practice incorporates advisory, transactional and contentious work for a broad range of financial institutions. During her time at Slaughter and May, Mrs McGrath has advised on the supervision and regulation of investment firms, banks, insurance companies and lenders. Her practice has recently involved advising on the UK implementation of the Bank Recovery and Resolution Directive, as well as providing advice to regulated payment service providers on their ongoing obligations and the impact of upcoming reforms. Mrs McGrath graduated with a master's degree in natural sciences (physics) from the University of Cambridge in 2009, and qualified as a solicitor in England and Wales in 2013.

JAN PUTNIS

Slaughter and May

Jan Putnis has been a partner at Slaughter and May in London since 2003. His practice focuses on financial regulation, with particular emphasis on international corporate and commercial transactions. Mr Putnis acts for a broad range of financial institutions, including banks, insurance groups and asset managers, on strategic regulatory matters and investigations, cross-border and domestic mergers and acquisitions, and outsourcings. His work involves extensive advice on regulatory capital and on capital structures of new businesses, as well as capital structures to facilitate acquisitions and group reorganisations. Mr Putnis qualified as a solicitor in 1996. In a previous life, he graduated with a degree in physics from Oxford University in 1992.

SLAUGHTER AND MAY

47th Floor, Jardine House
One Connaught Place
Central
Hong Kong
Tel: +852 2521 0551
Fax: +852 2845 2125
peter.lake@slaughterandmay.com

One Bunhill Row
London
EC1Y 8YY
United Kingdom
Tel: +44 20 7600 1200
Fax: +44 20 7090 5000

www.slaughterandmay.com