Hong Kong Concludes Payments Regulation Consultation
November 2014

On 31st October, the Hong Kong government published its conclusions to the consultation process launched in May, 2013 by the Financial Services and Treasury Bureau (the "**FSTB**") and the Hong Kong Monetary Authority (the "**HKMA**") for a proposed new regulatory regime for stored value facilities ("**SVF**") and retail payment systems ("**RPS**").

Headline Points

The government has made few changes from the outlines for the new regime set out in its May, 2013 consultation paper, but there are some notable exceptions:

- The government has to some degree taken on board concerns that the new regime would give banks unfair competitive advantage in the emerging payments field. As per the original proposal, banks will continue to enjoy the benefit of being deemed to be licensed to operate SVFs, but will be obliged to keep their SVF float separate from deposits and other funds and meet the same float safeguarding principles applicable to non-bank SVFs.
- The potential scope of SVF regulation has been reduced to exclude "non-money" facilities, such as loyalty schemes, airmiles and coupons intended for use on e-commerce platforms selling third party digital content and software.
- Non-device SVFs will not be subject to a HKD3,000 blanket maximum stored value, as originally proposed, but will instead by subject to maximum value requirements specifically set out in the applicable licence.

The efforts made by the government to level the playing field between bank and non-bank SVFs go some way towards addressing critics' concerns. However, the smallest non-bank SVFs may continue to find there to be market entry challenges, such as the requirement that they hold a licence through a Hong Kong company having no less than HKD25 million in capital. Requirements such as this compare unfavourably to Singapore, for example, where SVFs having less than SGD30 million in float continue to be unregulated.

The government's concluding remarks offer little in the way of specific criteria for the designation of RPSs under the new regime. Some respondents had proposed that the government specify objective minimum criteria, such as a total daily transaction value of HKD 5 million or an average of 10,000 system users per day. The government noted these requests but did not comment on their appropriateness. The government did go into specifics in identifying certain types of system infrastructure that it proposes would not be caught by the RPS regime, such as point of sales systems, telecommunications systems and network infrastructures. The detailed designation criteria therefore remain to be seen.

The government has announced that it intends to press on with the current timetable, which proposes that a draft bill be introduced to the Legislative Council in the 2014-15 legislative session.

A number of respondents pressed for a transitional period of 12 to 18 months following the introduction of the new regime. The government noted that a phased introduction of the regime would be pursued, but did not give any specific indication as to timing.

The Proposal for SVFs

At present, only device based multi-purpose SVFs are regulated in Hong Kong. The sole active licensee, Octopus Cards Limited, is licensed under the Banking Ordinance (the "**BO**") as a deposit-taking company. Non-device based SVFs are currently unregulated as such, and a key policy objective for the reform is to bring these facilities into the regulatory fold.

Under the new regime, all multi-purpose SVFs (whether device-based or not) would be regulated under the Clearing and Settlements Systems Ordinance (the "**CSSO**"). Key features of the new licensing regime are that licensees:

- be a Hong Kong incorporated company with principal business restricted to the SVF;
- have a minimum of HKD25 million in paid up capital;
- meet certain "fit and proper" requirements; and
- provide a trust account or bank guarantee to cover float requirements.

A Level Playing Field for SVFs?

A point of contention for some with the new SVF regime is the government's initial proposal that banks licensed under the BO be automatically deemed licensed as SVF providers and enjoy a waiver of the float security requirements. The government's rationale for the distinction was that licensed banks are already subject to substantial prudential requirements (including liquidity and capital adequacy requirements) and float volumes are likely to be small in comparison to their overall deposit-base.

Non-bank respondents to the consultation process, however, believe this aspect of the new regime would give the banks competitive advantage.

In its conclusions, the government has maintained its proposal that licensed banks to deemed to be licensed to operate SVFs, but has responded to non-bank criticisms by proposing to bring both bank and non-bank SVFs under a common set of float safeguarding principles –

- a requirement to have in place float protection measures that adequately protect the float; and
- a requirement to keep the float separate from the licensee's other funds.

The government paper goes on to say that the HKMA would have the discretion to assess float safeguarding measures against these principles on a case-by-case basis, taking into account factors such as the licensee's governance structure, financial strength, scale of business, risk management procedures and internal control environment.

Money, not "Money's Worth"

A number of respondents expressed concerns about the potentially wide scope of the definition of SVF put forward in the consultation paper. The particular point of focus was the extended definition of redeemable value covering "money's worth" in addition to money.

Respondents expressed concern that reference to "money's worth" may sweep in a wide range of customer loyalty schemes, such as airmiles and cash rewards schemes.

The government has reacted to these criticisms by proposing to not regulate certain categories of coupons and reward schemes, including prepaid cards or coupons issued by "single online store platforms" offering third party digital media content, games and apps. Coupons issued by these online platforms, the government notes, are typically issued for downloads of content to one device or a small number of devices and behave more like single-purpose SVFs than the multi-purpose SVFs that are the subject of the proposed regulations.

Maximum Stored Value

A number of respondents expressed concerns about the government's proposal to limit SVFs to HKD3,000 in maximum stored value per user. This amount tracks the current threshold for record-keeping and customer due diligence requirements under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance. On the basis that non-device SVFs are likely to be linked to credit cards and bank accounts (which are separately regulated for anti-money laundering and terrorist financing purposes), the government has now proposed that non-device SVFs will not be subject to any blanket maximum stored value, but will instead receive individual treatment under licensing terms.

Minimum Capital

The government's proposal that licensees be subject to a HKD25 million capital requirement also drew criticism, with a number of commentators apparently believing that this would serve as a barrier to market entry for some.

The government, however, declined to change its position, noting that the minimum capital requirement is intended to avoid possible contagion by offshore business and serve as a financial buffer on top of the float protection measures.

<u>The Proposal for RPSs</u>

RPSs are currently subject to self-regulation in Hong Kong. Eight payment card scheme operators with credit or debit card businesses in Hong Kong have committed to an HKMA-endorsed voluntary "Code of Practice for Payment Card Scheme Operators," but there is no formal regulation, except to the extent the system is separately regulated under the Money Service Operator licensing regime applicable to remittance services.

Under the proposals, designated RPSs would be regulated under rules and procedures adapted from existing CSSO requirements, (i.e., the principles that currently cover interbank clearing house transfer systems and some other key market settlements systems in Hong Kong). The HKMA would be entitled to designate an RPS if disruptions to the RPS are likely to result in one or more of the following:

- monetary or financial stability or the functioning of Hong Kong as an international financial centre being adversely affected;
- public confidence in payment systems or the financial system being adversely affected; or
- day-to-day commercial activities being adversely and materially affected.

What will it take to be "designated"?

The government did not set out specific criteria for designating an RPS under the new regime, although the government did note that a number of respondents had proposed that specific, objective materiality thresholds for designation, such as a minimum daily transaction value of HKD 5 million or a minimum of 10,000 system users per day. The comments suggest that these recommendations will be taken into account, but without any commitment as to specifics.

The government was clearer in addressing questions as to whether or not certain types of systems would or would not be designated.

Point of sales systems, telecommunications systems and network infrastructures are unlikely to be caught by the new regime, as are ATM systems and other systems and infrastructure that form part of licensed bank operations (and so are already effectively regulated).

While the government noted that the credit card industry respondents were divided on the point of bringing existing card schemes under a mandatory regulatory regime, it took the view that the application of the proposed regime to card schemes would be proportionate to the growing importance and complexity of RPS and in line with international regulatory trends. It therefore seems likely that larger card schemes will be caught by the new RPS regime.

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