



Preparation for regulators' (HKMA / SFC / IA) on-site inspections and reviews Mazars financial services offering

Background

Since the 2008 financial crisis, regulators have taken a more prudent approach on supervising financial institutions. As a result, on-site inspections, which is one of the key means adopted by regulators to supervise financial institutions, have become increasingly challenging for financial institutions.

Inevitably the most effective way for a financial institution to deal with a regulator inspection is simply to ensure it has complied with ALL the regulatory requirements, but this is way much easier said than done. It is therefore imperative that an institution finds a way to get through the inspection quickly and without any major finding that could cause serious consequences (e.g. fines or prosecution) and **PLANNING** is the key word to manage this.

This document provides some of the more frequently asked questions (“FAQs”) about how an institution should be preparing for an upcoming regulatory inspection and how we are able to help your institution to go through that process.

Preparation for regulators’ on-site inspections and reviews - FAQs

1. How does the regulator determine the need to conduct an inspection on an institution?

The regulator’s decision to conduct an inspection is driven by a number of different factors. One of the most notable is whether the institution is considered as “**high risk**” or “**high impact**”, as any control issues / failures of these institutions will have significant impact to customers, investors and/or the market at large.

In the above context,

- “**High risk**” institutions refer to those that warrant closer supervisory attention to their management style (e.g. more aggressive style) or the state of their systems and controls (e.g. known breaches of regulations or other internal control issues in the past); and
- “**High impact**” institutions refer to those whose volume of activities in the market, number of customers served, or amount of client or fund assets held are so significant that any instability in their operations may have a significant impact on the customers’/investors’/insurers’ confidence and market stability.

2. What are the different types of on-site inspections conducted by regulators?

Generally speaking and depending on the individual regulator, there are three key types of regulatory on-site inspections, namely:

- **Routine inspections:** These are general checks on an institution’s systems and controls, as well as its compliance with the relevant rules and regulations. Typically, before the inspection is due to commence, the inspection team will identify the key potential risk areas and formulate an inspection plan.
- **Special inspections:** These are performed on institutions suspected to pose imminent risks to the market or to their customers, for example where there is a reason to suspect a fraud. Inspection steps are tailor-made to cater for the specific circumstances of each case. Normally, a special inspection involves carrying out detailed substantive testing and forensic reviews by the regulator.

Special inspections may also be performed on an institution where its financial position is considered vulnerable. In this case, an on-site inspection will be arranged as soon as practicable to assess its latest financial and liquidity positions, as well as

determine if customer/investor/insurer interests may be at risk.

- **Thematic inspections:** These are used to assess the scale and nature of a particular sector-crossing risk, which may be triggered upon the regulator identifying trends, emerging risks and compliance lapses that require a prompt regulatory response. A sample of institutions of a similar nature will be selected for review in each round of thematic inspection. The review steps are normally tailor-made and typically revolve around analysing certain sector-specific business aspects, activities or practices (e.g. review of due diligence work performed by sponsors in the preparation of listing documents in IPO, review of the selling practices adopted by institutions, etc.).

3. What are the risks that the regulators will look at and evaluate during the inspection process?

Broadly speaking, there are two major categories:

- **Financial risk:** This is associated with institutions that have inadequate liquidity, ineffective credit management systems, unsustainable business models or high leverage. Financial risks typically include credit / counterparty risk, liquidity risk and market risk where institutions may be exposed to losses caused by default by clients / counterparties, inadequate liquid funds, and adverse market movements.
- **Business conduct risk:** This covers the risk of loss to the institution, its clients and / or counterparties stemming from inappropriate or undesirable business conduct or violation of

applicable laws and regulations by an institution.

4. What are the procedures performed by the regulators during a routine inspection?

Both a “top-down” and a “bottom-up” approach will be adopted by the regulators, which normally involve the performance of the following procedures:

- The inspection team will usually review the information collected and analysis prepared (at the regulator’s offices) prior to fieldwork.
- On the day fieldwork starts, the inspection team will normally hold an opening meeting with senior management to gain a high-level understanding of the institution’s business activities, operations, systems and controls; in the case of a thematic inspection, the opening meeting will normally cover the same aspects for the specific areas/businesses covered under the theme of the inspection.
- Based on the objective of the inspection (i.e. a routine inspection vs a thematic inspection) and the understanding by the regulator of the institution, the inspection team will normally tailor an inspection program to reflect the intended inspection focus on the institution.
- Using the inspection program, the inspection team will perform detailed examination procedures in order to check and confirm how the institution’s systems and controls have been implemented in practice. Those examination procedures usually comprise:

- Interviewing relevant personnel (e.g. business lines, operations, compliance, risk management, etc.) to assess the control environment of the institution;
 - Performing walk-through tests on key control procedures and processes;
 - Reviewing selected underlying documentation; and
 - Performing detailed transaction / compliance testing on a sample basis.
- A well planned and delivered opening meeting creates a positive first impression with the inspection team which helps drive a favourable inspection outcome.
 - Be proactive in communicating with the regulator during and after the inspection; ask for a closing meeting before the inspection team leaves your premises.

5. What are the top tips to prepare for an upcoming inspection?

- Keep your regulator updated about your business activities to avoid surprises during the inspection.
- Know the “strengths” and “weaknesses” of your institution from the regulator’s perspective; anticipate the areas that the inspection team are most interested in.
- Anticipate and communicate with the inspection team about the document request list prior to the inspection; manage the documents provided and follow up with the inspection team on additional documents / information.
- Co-ordinate the different departments, functions, and personnel within your institution to be involved during the inspection; get your key personnel prepared (rehearsed) for interview with the inspection team.

How can Mazars help?

At Mazars, we have extensive experience working with the diversity of financial services players. We assist central banks, national regulators, major financial institutions, and small and mid-size entities in dealing with the implementation of complex issues with multiple impacts, domestic and international.

Depending on the scope, coverage and specifics of your needs, our services with regard to preparation for regulators' inspections would typically involve one or more of the following:

A. Regulatory health-checks and reviews

- I. Perform regulatory health-check and provide advice on your institution's:
 - governance and internal controls,
 - policies and procedures,
 - risk management framework and controls,
 - compliance with rules and regulations, and
 - operational capabilities.
- II. Provide observations and recommendations to assist you in complying with regulators' requirements/expectations.

B. Provide pre-inspection advice

- I. Advise on the process of a regulatory inspection and how to handle the enquiries and requests from the inspection team, including requests for information and documents about specific transactions or clients.
- II. Advise on the preparation for an upcoming regulatory inspection, managing communications with the regulator and providing regulatory advice before, during and after a regulatory inspection.
- III. Assist your institution to understand the regulatory concerns underlying specific enquiries or requests for information from regulators, manage the flow of information to be provided to the regulator to address any concerns before they become the subject of the regulator's findings, and to anticipate and/or mitigate risks of any further investigation or disciplinary action by the regulator.
- IV. Assist your institution to identify potential breaches of regulatory requirements or deviations from regulators' expectations, prior to the regulatory inspection.
- V. Advise on current enforcement trends and disciplinary actions.

C. Perform mock inspections

- I. Perform mock inspections and provide recommendations on the relevant controls, policies, and procedures to assess whether they comply with the relevant regulatory requirements promulgated by the regulators. The mock inspection procedures will normally include:
 - mock interviews / discussions with management and staff members of the institution to understand the relevant business activities and workflows,
 - reviewing the relevant written policy and procedure documentation which exists within the institution,
 - walkthrough of the key processes and controls relevant to the regulatory inspection to assess the design effectiveness of the relevant internal control procedures, and
 - testing of sampled transactions covering the key processes and controls to assess the operating effectiveness of the relevant internal control procedures.

We are flexible in our approach and offerings. Please feel free to contact us with any enquiries.

Contacts

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Mazars is an internationally integrated partnership, specialising in audit, accountancy, advisory, tax and legal services*. Operating in over 90 countries and territories around the world, we draw on the expertise of 40,400 professionals – 24,400 in Mazars' integrated partnership and 16,000 via the Mazars North America Alliance – to assist clients of all sizes at every stage in their development.

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