17 Sep 2004

Supervisory Policy Manual (SPM): TA-2 Foreign Exchange Risk Management

Our Ref: S4/8C
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17 September 2004
The Chief Executive
All Authorized Institutions
Dear Sir / Madam,

Supervisory Policy Manual (SPM): TA-2 Foreign Exchange Risk Management

I am pleased to inform you that, following consultation with the industry, the Monetary Authority is issuing the above SPM module today. This new module supersedes the guideline issued in 1990.

This module aims to further enhance our supervisory approach to foreign exchange risk and to provide more guidance to AIs on the key elements of effective foreign exchange risk management. In drawing up the module, we have made reference to international standards, the range of practices currently adopted by AIs, some recommendations made by the IMF during the last FSAP assessment, as well as the experience of the 1997-98 Asian Crisis. Consistent with our risk-based supervisory approach, we have placed increased focus on the adequacy of AIs' internal systems and controls for managing foreign exchange risk. Other than the risk management aspects of foreign exchange operations, specific guidance is given in respect of the monitoring and control of foreign exchange settlement risk and the exposures of borrowers to exchange rate risk. We have also revised the approach to supervising AIs' foreign exchange positions, the key features of which are highlighted below:

i. Review of AIs' structural positions - We will seek information from individual AIs on how their structural foreign exchange positions are defined and managed, and review whether there is sufficient justification to exclude such positions from an AI's foreign exchange limits. AIs are expected to notify us of any significant changes in their structural positions and the reasons behind the changes. Where an AI anticipates a change in its structural positions due to factors other than those cited in paragraph 2.1.2 of the module (e.g. a change in the hedging strategy for such positions), the HKMA would expect to be consulted in advance.

ii. Monitoring of AIs' open position limits - We have removed the existing guideline limits on foreign currency positions and have placed more reliance on AIs' internal risk management systems. Nevertheless, AIs are expected to set internal overnight limits for each individual currency and the aggregate position for all foreign currencies, and to notify us of such limits (at the institution-wide level only). In reviewing the limits of locally incorporated AIs, we will pay particular attention to those with relatively large aggregate open positions (say, exceeding 25% of their capital base), which may reflect a concentration of foreign exchange risk. Such AIs will be asked to provide justification for setting such limits. This does not, however, mean that we will not allow AIs to maintain higher limits due to business needs or other justifications.

iii. Use of stress-testing results for setting of limits on currencies with low volatility - In the light of experience during the Asian Crisis where the volatility of some currencies could increase dramatically, AIs are expected to make more use of stress tests to control foreign exchange risk. Where AIs have material exposures to currencies with low historical volatility, particularly in emerging markets, they should conduct stress tests on those exposures to measure foreign exchange risk. In setting the limits of those exposures, AIs should have regard to the stress-testing results and should not rely solely on the historical volatility of the currencies.

AIs are expected to put in place the necessary systems and procedures to comply with the relevant requirements of this module within a period of nine months (i.e. not later than 18 June 2005). We will monitor the progress of AIs in enhancing their systems and procedures to meet the new standards in our on-going supervision.

On-line access to the module is available under the icon of "Supervisory Policy Manual" in the HKMA's public (http://www.info.gov.hk/hkma) and private web-sites.

Should you have any questions relating to the module, please feel free to contact Ms Rita Yeung on 2878 1388 or Mr Cho-hoi Hui on 2878 1485.

Yours faithfully,

Simon Topping

Executive Director (Banking Policy)

c.c. The Chairman, The Hong Kong Association of Banks
The Chairman, The DTC Association
FSTB (Attn: Mr Danny Leung)