1. This paper summarises the latest efforts of the HKMA to enhance the effectiveness of its risk-based supervisory approach.

Risks and challenges to the supervisory process

2. In an effort to make banking supervision more risk-focused and effective, in 2004 the HKMA conducted a Risk and Challenges Study with a view to identifying the risks and challenges that would have a material impact on banking supervision in the medium term. The Study identified a number of areas where the HKMA believed risks might be rising and where a reprioritisation of supervisory resources and focuses was deemed necessary.

3. In the light of the results of the Study, the HKMA re-organised its Banking Supervision Department by assigning specific responsibilities to individual divisions within the department to manage one or more of the risks identified in the Study. The HKMA believes that such a functional “ownership” structure will improve accountability, help minimise any possible overlaps or gaps in tackling these risk factors and facilitate the accumulation of a strong knowledge base on the identified risks.

4. As far as the institutional supervisory function is concerned, the HKMA has adopted a “clustering approach” whereby institutions with similar risk characteristics are grouped together and supervised by the same supervision division. This arrangement will help to build up the HKMA’s supervisory knowledge base in the longer run, thereby improving the effectiveness and efficiency of its supervisory process.

5. Following this approach, in late 2004 the HKMA re-organised its Banking Supervision Department into five divisions as follows:

- **Division for Large and Systemically Significant Institutions**

  With consolidation among local banks and the subsidiarisation of the local operations of major foreign retail banks, the banking sector in Hong Kong has become increasingly polarised in terms of size. Coupled with the fact that the Deposit Protection Scheme (to be launched in 2006) will help reduce the potential contagion arising from the failure of small or medium-sized institutions, the HKMA considers that large banks should be given a higher priority in the allocation of supervisory resources given the broad systemic implications involved. Apart from banks chosen on the basis of sheer size considerations, this division will also supervise institutions whose failure may give rise to significant systemic implications.

  This division also develops general guidance on best industry practices for risk management based on experience gained from the institutions it supervises. These practices will be used as benchmarking references for other institutions.

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1 The key risk areas identified in the Study include technology risks, issues arising from the increasing presence of Hong Kong banks in the Mainland Chinese market and vice versa, increased compliance risks as banks become more involved in selling wealth management products, growing complexity of banking operations, work in relation to the implementation of Basel II and new accounting standards, and a structural shift of the Hong Kong banking sector with smaller local banks becoming more vulnerable to competitive pressure.

2 These include, for example, an institution that issues and manages a widely circulated stored value card for payment of transport service charges, an institution which acts as the agent settlement bank for a major credit card, and an institution which has a significant volume of in-sourced processing of trade financing documentation from other banks.
China Division

It is anticipated that more Hong Kong banks will establish a business presence in the Mainland market in the next few years. As the financial market and banking regulations in Mainland China evolve, one of the challenges that individual banks will face will be the need to ensure that they have the requisite expertise to analyse properly the business and regulatory risks associated with their business expansion. The HKMA will also need to strengthen its knowledge base about the banking supervisory practices and requirements of Mainland China in order to ensure that the most effective and efficient supervisory process is deployed.

The China Division was established to supervise institutions with Mainland Chinese connections and to monitor developments in banking regulations, financial market infrastructure, and economic and financial policies in Mainland China as well as assessing the implications of these developments for the HKMA’s supervisory work. The Division also coordinates with the Mainland authorities on banking supervisory matters.

Division for Locally Incorporated Institutions

This division is mainly responsible for supervising medium-sized to small local retail banks and other locally incorporated authorised institutions specialising in niche lending businesses, such as car loans, hire-purchases, personal loans and sub-prime lending activities. These institutions are generally more vulnerable to competitive pressure. Grouping them together will help focus our supervisory efforts on common weaknesses and risk factors associated with such institutions. Furthermore, given that smaller banks are generally more susceptible to contagion arising from the failure of another institution of the same kind, this arrangement should facilitate more coherent and effective management of potential banking crises caused by the failure of a small local bank.

Division for Overseas Incorporated Banks

The scale of operations of overseas incorporated institutions is usually small with limited scope of activities and should therefore have limited systemic implications for the banking sector. Given that the primary responsibility for supervising these institutions rests with the relevant home supervisors, our focus is to ensure an effective exchange of information with these authorities so that any supervisory concerns can be dealt with promptly. To facilitate this, the HKMA has so far entered into Memorandum of Understanding or other formal arrangements with 12 supervisory authorities in 10 countries.

Technical Supervision Division

The increasing use of and reliance on technology by banks will shift their risk profile increasingly towards operational risks. In addition to IT risks, the ongoing pressure on profitability will also result in more banks seeking to outsource their operations to low cost overseas centres. Such outsourcing, if not managed properly, will increase banks’ operational risks. At the same time, pressure on interest income in recent years has driven banks in Hong Kong to diversify their sources of income to fee-based activities, such as the sale of wealth management products to investors. This gives rise to a need to supervise the business conduct of intermediaries. To improve management of these new activities and risks and to facilitate the accumulation of relevant expertise, the Technical Supervision Division was set up to tackle specialised areas of supervision.

The above institutional structure enables the HKMA to tackle various risks and challenges faced by the banking sector in a more coherent and homogeneous manner. With the building-up of expertise in specific challenge areas over time, the HKMA will also be better positioned to sharpen its supervisory focuses on different types or segments of banking institutions, thus moving towards a more genuine risk-based supervisory approach.

Enhanced supervisory contacts with overseas supervisors

In addition to introducing institutional changes, the HKMA places great emphasis on the need to strengthen supervisory cooperation with overseas banking supervisors given the increasing
globalisation of banking operations. The impending implementation of Basel II will necessitate more effective supervisory contacts with the home supervisors of foreign institutions operating in Hong Kong. In order to prioritise better the supervisory resources and formulate appropriate supervisory objectives for institutions with international operations, in 2005 the HKMA developed a framework for maintaining supervisory contacts with overseas banking supervisors in a more structured manner. Details of the framework are set out below:

<table>
<thead>
<tr>
<th>Type of country</th>
<th>Supervisory contact frequency</th>
<th>Forms of contact</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type A country</strong></td>
<td>Ongoing</td>
<td>Phone, meetings and correspondence</td>
</tr>
<tr>
<td>- Total market share of institutions beneficially owned by interests in the country represents over 4.5% of aggregate deposits or over 8% of aggregate assets before provisions</td>
<td></td>
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<tr>
<td><strong>Type B country</strong></td>
<td>At least annually</td>
<td>Formal meetings</td>
</tr>
<tr>
<td>- Total market share of institutions beneficially owned by interests in the country represents over 1% but not exceeding 4.5% of aggregate deposits</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Type C country</strong></td>
<td>2-4 year cycle</td>
<td>Informal exchange of views</td>
</tr>
<tr>
<td>- Countries other than Type A and Type B</td>
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Enhanced monitoring of “macro” risks

8. The HKMA has also taken steps to strengthen its ability to monitor trends and emerging risks on a system-wide basis. It recently started to prepare a semi-annual Banking Risk Report that adopts a macro prudential perspective regarding the performance of the banking system and monitors key performance and financial stability benchmarks. The report will aid us in identifying key emerging risks in the banking system, such as excessive risk concentration or emerging areas of vulnerability. The results of this assessment provide a “macro” risk assessment perspective and will feed into the planning and prioritisation of the supervisory process. This will help the HKMA to ensure that its supervisory resources are properly allocated to the main areas of risk or vulnerability in the banking system.