11 August 1997

Model Recognition for Market Risk Calculation

In March 1996 we wrote to introduce the Basle Committee's Amendment to the Capital Accord to Incorporate Market Risks ("Basle Amendment") into the capital adequacy framework, and set out our approach to develop a local regime based on the Basle proposals. Since then a reporting framework has been put in place with the implementation of a quarterly Return of Market Risk Exposures ("Return") on 31 December 1996. We also indicated our intention that the new market risk capital requirements shall take statutory effect by the end of this year, in line with the Basle proposals.

According to the Basle Amendment, banks are allowed to choose two broad approaches in calculating their market risk exposures, a standardised approach (which currently forms the basis of the Return) and an internal models approach. Specifically, the latter approach means the use of risk measures derived from institutions' own internal risk management models for capital adequacy purposes. The HKMA has indicated in its letter of March 1996 that institutions will be allowed to adopt the internal model approach subject to the HKMA's prior approval. In granting its approval, the HKMA must be satisfied that the use of models meets the qualitative and quantitative criteria as set out in Part B of the Basle Amendment. Against this background, the HKMA intends to start the formal model recognition process shortly. The process will cover internal value-at-risk ("VAR") models and other models used as part of the pre-processing techniques and the option pricing/valuation models under the standardised approach. However, the priority of the recognition process will be given to VAR models. Other models will be reviewed by the HKMA in due course although this does not affect the use of the results generated from them for reporting and compliance under the standardised approach for the time being.

The first step of our model review process is to identify institutions wishing to have their models reviewed for market risk capital purpose. A model recognition request form, which is attached, has been designed for this purpose. Institutions wishing to implement the internal models approach by the end of this year or to use models under the standardised approach are expected to return **the model recognition request form** to the HKMA by 30 August 1997.

The HKMA will be working with the institutions to satisfy itself the models themselves and the risk management practices surrounding the use of such models meet certain minimum standards. The model recognition process includes a questionnaire and an on-site visit to review both the technical details of the models and the risk management practices that govern the use of those models. The Return will also be amended in due course to cater for the reporting of the market risk capital charges under this approach.

If you have any enquiries on the internal models approach and the HKMA's model recognition process, please feel free to contact **Mr. Cho-hoi Hui (2878 1485)** or **Mr. Cedric Wong (2878 1626)** of this office.