



Supervisory Policy Manual

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Use of the Fair Value Option for Financial Instruments

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This module should be read in conjunction with the [Introduction](#) and with the [Glossary](#), which contains an explanation of abbreviations and other terms used in this Manual. If reading on-line, click on blue underlined headings to activate hyperlinks to the relevant module.

Purpose

To set out the minimum risk management and control standards which the HKMA requires AIs to have in place on the use of the fair value option for financial instruments for the purpose of determination of their capital base.

Classification

A non-statutory guideline issued by the HKMA as a guidance note which will take effect as of **1 January 2007**.

Previous guidelines superseded

This is a new guideline.

Application

To all locally incorporated AIs which use the fair value option in the measurement of financial instruments.

Structure

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Annex A: Summary of recommended 17 best practices regarding governance, control, price verification and audit practices from the Group of 30's report "Enhancing Public Confidence in Public Reporting"



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1. Introduction

1.1 Terminology

1.1.1 Abbreviations and other terms used in this module have the following meanings:

- “capital base”, in relation to an AI, means the capital base of the AI as defined in section 2(1) of the Banking Ordinance, and should be read with reference to “capital base” in the definition of “capital adequacy ratio” in that section;
- “Banking (Capital) Rules”, means the rules made by the MA under §98A of the Banking Ordinance as amended by the Banking (Amendment) Ordinance 2005;
- “Core Capital”, in relation to an AI, means the sum, calculated in Hong Kong dollars, of the book values of the AI’s capital items specified in Division 2, Part 3 of the Banking (Capital) Rules;
- “fair value option” or “FVO”, refers to the option under Hong Kong Accounting Standard 39 for an entity to designate a financial asset or financial liability as at fair value through profit or loss upon initial recognition subject to satisfying the prescribed criteria in HKAS 39, such that unrealized gains and losses arising from the change in fair value of the financial asset or financial liability are recognized in the profit or loss account;
- “HKAS” means Hong Kong Accounting Standard;
- “Hong Kong Financial Reporting Standards” or “HKFRSs”, mean standards of accounting issued by the Council of the Hong Kong Institute of Certified Public Accountants pursuant to section 18A of the Professional Accountants Ordinance (Cap. 50);
- “IAS” means International Accounting Standard;
- “IFRSs” means International Financial Reporting Standards;



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- “Supplementary Capital”, in relation to an AI, means the sum, calculated in Hong Kong dollars, of the book values of the AI’s capital items specified in Division 3, Part 3 of the Banking (Capital) Rules.

1.2 Purpose

1.2.1 The purpose of this module is to set out the minimum prudential standards that the HKMA will apply in determining whether or not an AI is eligible to include any unrealized fair value gains in its Core Capital. Accordingly, it contains:

1.2.1.1 the minimum standards in risk management and control practices that the HKMA requires an AI to put in place with regard to its use of the FVO; and

1.2.1.2 the supervisory process that the HKMA will use for the assessment of an AI’s risk management and controls relating to the use of the FVO.

1.2.2 In developing these standards the HKMA has closely followed the recommendations contained in the paper entitled “Supervisory guidance on the use of fair value option by banks under IFRS” issued by the Basel Committee on Banking Supervision in June 2006. The Basel Committee’s paper contains seven principles focusing on supervisors’ expectations relevant to the use of the FVO and on sound risk management, valuation and control practices that together would maintain the integrity of regulatory capital measures.

1.2.3 The HKMA emphasizes that this module is not intended to set out additional accounting requirements beyond those established by the accounting standards issued by the Council of the Hong Kong Institute of Certified Public Accountants. The module should also not be taken as indicating a preference by the HKMA for the use either of hedge accounting approaches or the FVO by an AI. The responsibility for compliance with the applicable accounting and disclosure standards rests with the AI’s senior management.



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1.3 Background

1.3.1 Section 40(2) of Part 3 of the Banking (Capital) Rules stipulates that, with the HKMA's prior consent, an AI may include any unrealized fair value gains arising from its holding of equities and debt securities designated as at fair value through profit or loss ("relevant gains") in its Core Capital for the purpose of determining capital base. The HKMA's consent is conditional on its being satisfied that the AI has demonstrated that its prudential controls in relation to the use of the FVO meet certain minimum standards.

1.3.2 In the event that an AI fails to satisfy the HKMA that it meets the prescribed minimum prudential standards, or deficiencies are found in an AI's risk management and control systems pertaining to the use of the FVO, the AI shall exclude any relevant gains from its Core Capital and include such relevant gains in Supplementary Capital, subject to a 55% haircut pursuant to section 42(1)(b) of Part 3 of the Banking (Capital) Rules.

1.3.3 In addition, an AI shall also:

1.3.3.1 exclude from its Core Capital any unrealized fair value gains or losses on (i) loans designated as at fair value through profit or loss; and (ii) financial liabilities arising from changes in the AI's own creditworthiness;

1.3.3.2 seek the HKMA's prior approval for inclusion in Supplementary Capital of fair value gains on any other financial assets not held for trading purposes, including such assets (other than unrealized gains or losses on loans) that are available-for-sale or designated as at fair value through profit or loss.

2. Supervisory approach to the use of fair value option

2.1 Objectives and principles

2.1.1 The HKMA expects an AI to conduct its FVO activities for financial assets and liabilities, on both an individual and



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portfolio basis, in a manner that is consistent with both the applicable accounting standards and the minimum prudential standards for risk management and controls as specified in this module. An AI is expected to implement risk management practices and controls for its FVO activities that are integrated in its overall system of risk management and controls; to ensure that the effect of using the FVO is understood; and that the use of the FVO is managed, monitored and reported in a sound manner.

- 2.1.2 As part of the risk management and controls, the HKMA strongly encourages AIs that utilize the FVO to adopt the 17 best practices outlined in the December 2003 Report by the Group of 30 entitled “Enhancing Public Confidence in Public Reporting” (summarized at [Annex A](#)). These are intended to ensure more reliable fair value estimates through governance, control, price verification, and internal and external audit practices.
- 2.1.3 The HKMA will keep under review AIs’ use of the FVO in practice and, where necessary, will consider the need for enhancements to this module as circumstances require.

3. Minimum standards in risk management, monitoring and reporting

3.1 Application of the FVO in form and in substance

- 3.1.1 The HKMA expects an AI to meet the criteria¹ set out in HKAS 39 both in form and in substance in designating any financial asset or liability to be measured as at fair value through profit or loss.
- 3.1.2 When considering alternative treatments available under the applicable accounting standards (including the FVO) for categorizing financial instruments, an AI should be fully cognisant of the implications its choice may have for its economic hedging strategies. The HKMA expects an AI to make such choices in a fully informed and disciplined manner.

¹ The criteria are set out in paragraph 9 or 11A of the amendment to HKAS 39.



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3.1.3 An AI is required to provide specific disclosures related to the FVO in compliance with HKFRS 7 and with the Banking (Disclosure) Rules. An AI should maintain documentation that supports its public disclosures about the use of the FVO in a manner that permits the HKMA to conduct a supervisory review of the adequacy and accuracy of the disclosures. In the course of its review of an AI's policies and practices for using the FVO, the HKMA may also discuss with the AI's management and external auditor any issues relating to these disclosures.

3.2 Risk management systems, policies, procedures and controls

3.2.1 Overview

3.2.1.1 An AI is expected to conduct economic hedging and other risk management activities, including the use of the FVO, in accordance with the sound risk management policies specified in SPM module IC-1 on General Risk Management Controls.

3.2.1.2 Within the overall framework provided by IC-1, an AI should have well documented risk management policies and valuation policies for financial assets and liabilities designated as at fair value through profit or loss. Such policies should be in place prior to the initial application of the FVO for a particular activity or purpose and should be maintained on an ongoing basis. In addition, an AI's risk management policies should address any potential for residual or increased earnings volatility associated with its use of the FVO.

3.2.1.3 Paragraphs 3.2.2 to 3.2.4 summarize the key aspects of sound risk management policies that should be in place to underpin an AI's use of the FVO.



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3.2.2 Risk management policies, procedures and systems

3.2.2.1 Before availing itself of the FVO, an AI must have risk management systems, policies and procedures to ensure that:

- (a) sound risk management objectives consistent with the risk management framework and overall risk appetite approved by the board of directors (or a committee of the board) are being met when the FVO is used;
- (b) appropriate valuation methods are being used;
- (c) fair values are reliable for instruments in the FVO category;
- (d) risk management and control policies pertaining to the use of the FVO and related valuation methodologies are being consistently applied and complied with; and
- (e) appropriate information is provided periodically to the AI's senior management and the board of directors (or committees of the board) about the use of the FVO and its impact on the AI's financial condition and performance.

3.2.2.2 An AI should capture assets and liabilities designated as at fair value under the FVO in its risk measurement systems. The resulting exposure amounts should be included in internal reports that compare actual overall exposure to approved overall risk management limits.

3.2.2.3 An AI should establish procedures for approving the use of the FVO for new products or transactions, as well as the related controls. When determining whether to apply the FVO to a particular new instrument or class of



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instruments, the AI should ascertain whether reliable fair values can be determined for those instruments (see section 3.3 on the critical element of the control framework for reliable fair values). An AI should consider the need to revise or expand its existing risk management policies, procedures, and controls (including those related to valuation) to address the characteristics and risks of the new products or transactions to which the FVO will be applied. The procedures must ensure that new approvals are consistent with the established policies for using the FVO.

3.2.3 Valuation policies and independent verification of valuation models

3.2.3.1 The policies for measurement and management of risk and reliable valuation should be well documented and approved by the AI's senior management.

3.2.3.2 Assets and liabilities designated as at fair value under the FVO should be subject to the same rigorous valuation policies and practices applicable to other financial assets and liabilities measured at fair value².

3.2.3.3 An AI should take into account the liquidity of the assets and liabilities referred to in paragraph 3.2.3.2 when determining their fair value. The valuation of less liquid assets and liabilities should, where practicable, consider the following factors:

- (a) The amount of time an AI would take to hedge out the assets and liabilities or the risk within the assets and liabilities;

² For example, the fair values of assets and liabilities designated as at fair value under the FVO should be verified by an appropriately qualified unit which is independent of the business unit with the same frequency that the fair values of any related assets or liabilities are independently verified.



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- (b) The average volatility of bid/offer spreads;
- (c) The availability of independent market quotes (i.e. number and identity of market makers);
- (d) The average and volatility of trading volumes;
- (e) The extent of any market concentrations;
- (f) The aging of assets and liabilities;
- (g) The extent to which valuation relies on marking-to-model; and
- (h) The impact of other model risks.

3.2.3.4 Models used to value financial instruments designated as at fair value under the FVO should be independently verified by an appropriately qualified and experienced unit as part of a regular cycle of model validation. The validation process should include monitoring of model stability and back-testing that occurs at regular intervals with regular reporting to the AI's senior management. An AI should retain at least enough data to verify model performance under a variety of conditions and to maintain supporting documentation on its models, model validation process and verification of model performance.

3.2.4 Independent monitoring

3.2.4.1 An AI should ensure that staff independent of those responsible for originating transactions monitor the application of the FVO to ensure that it is in conformity with the accounting and disclosure requirements set by the applicable accounting standards. Such monitoring typically should be undertaken by individuals outside the risk taking functions (e.g. by financial / accounting control staff).



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3.2.4.2 The independent monitoring of an AI's use of the FVO should encompass the review of accounting policies for consistency with the requirements of the applicable accounting standards and the testing of individual transactions to verify that policies are being adhered to in practice³.

3.3 Reliable fair values and independent price verification procedures

3.3.1 The HKMA requires that AIs will not apply the FVO to instruments for which they are unable reliably to estimate fair values.

3.3.2 Where an AI obtains fair values directly from observable market prices it should ensure that the market in question is reasonably liquid and that the observable prices are representative of actual trades.

3.3.3 Where an AI makes use of valuation models to obtain fair values, it should adopt the relevant best practices contained in the December 2003 Report by the Group of 30 entitled "Enhancing Public Confidence in Financial Reporting", including those pertaining to model development and validation, price verification and both internal and external audit review. When possible, the fair value of illiquid instruments should be based on the closest available proxies for which there is a liquid market⁴. In all cases AIs should document the reliability of the valuation in the process for estimating fair value.

3.3.4 The HKMA expects AIs to conduct back-testing of valuations, particularly those pertaining to illiquid

³ For example, assume an AI utilizes the FVO pursuant to paragraph 9(b)(ii) of HKAS 39 on the basis that the group of financial instruments are managed in accordance with a documented risk management or investment strategy, then the AI's financial control unit (or persons with similar responsibilities) should assess whether the FVO is being used in accordance with the documented risk management or investment strategy. In conducting such assessments, the financial control unit should ensure that sufficient documentation exists to support the use of the FVO.

⁴ Examples include where there exists a very similar financial instrument that trades in a liquid market, or where an illiquid financial instrument can be rigorously decomposed into components for which prices can be obtained from liquid markets or from appropriate valuation approaches.



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instruments. An AI should refrain from expanding the use of the FVO for instruments for which the valuation methodology has proven in practice to be unreliable.

3.4 Internal and external audit review

- 3.4.1 An AI's internal audit department should review at least annually the independent price verification procedures and control processes. Based on its risk assessment, the internal audit department should also conduct periodic reviews of the appropriateness of the AI's use of the FVO against the applicable accounting standards.
- 3.4.2 As part of their routine audit work, an AI's external auditors should devote considerable resources to reviewing the AI's control environment, including the price verification processes, and performing valuations of transactions, especially in those situations where fair value is a critical component of reported results.
- 3.4.3 An AI should promptly address any deficiencies identified in the use of the FVO by internal and external auditors.

4. Supervisory process for HKMA's assessment and approval

4.1 Evaluation of an AI's risk management and control practices

- 4.1.1 The HKMA will require an AI periodically to provide it with information on its use of the FVO, related risk management and valuation policies and practices (including economic hedging strategies and new applications of the FVO) together with the supplementary information as required in section 4.2 below. The HKMA will assess whether the AI has maintained policies, practices and controls that are consistent with the minimum prudential standards prescribed in this module and the applicable accounting standards.
- 4.1.2 The HKMA's assessment will also include the impact of the use of the FVO on the AI's financial condition, financial performance and capital adequacy, in particular



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the impact of the AI's use of the FVO on the quality of its earnings and hence on its capital position.

- 4.1.3 In assessing the quality of an AI's risk management and control policies and practices (including valuation policies and practices) with respect to the FVO the HKMA may require an AI to commission a report from its external auditors concerning its use of the FVO, and the related control environment.

4.2 Provision of supplementary information for HKMA's assessment

- 4.2.1 The HKMA may require an AI to provide such supplementary information as is deemed appropriate to assist the HKMA in assessing the impact of the FVO on an AI's risk, earnings and capital adequacy. This may include, but is not limited to, information that:

- 4.2.1.1 assists the HKMA in understanding the credit risk implications of the FVO;
- 4.2.1.2 covers a sufficiently long period (as a minimum 6 months but in some cases up to 12 months) to explain the impact of utilizing the FVO on earnings or risk components, including information on the related economic hedging strategies, if the use of the FVO has a large impact on the disclosed earnings components or risk measures; and
- 4.2.1.3 allows the HKMA to assess the amount of unrealized gains or losses attributable to financial instruments held at fair value under the FVO. In particular, the HKMA may request the cumulative unrealized gains reported by category of financial instruments and monitor the cumulative unrealized gains of financial instruments designated at fair value under the FVO in relation to equity and regulatory capital. Such information should be adjusted for transactions that have matured or have been terminated;



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4.2.1.4 assists the HKMA in understanding the impact of the AI's use of the FVO on its net interest margin;

4.2.1.5 assists the HKMA in understanding the extent to which the FVO is being used by the AI for financial instruments with embedded derivatives under HKAS 39.

4.3 Supervisory assessment and approval

4.3.1 For the grant of approval to an AI as referred to in paragraph 1.3.1, the AI is required to demonstrate to the HKMA's satisfaction that its risk management and control policies and practices are consistent with the minimum prudential standards prescribed in this module.

4.3.2 In the event that an AI's risk management and control practices relating to the use of the FVO fall short of the minimum prudential standards prescribed in this module, even if the AI applies the FVO in consistency with the applicable accounting standards, the HKMA will prohibit the AI from including any relevant gains in its Core Capital. Such unrealized fair value gains will only be included in Supplementary Capital subject to 55% haircut as referred to in paragraph 1.3.2 above. As the prudential standards contained in this module must be met on a continuing basis, the HKMA may withdraw a previously granted approval in the event that an AI's systems and controls for the use of the FVO cease to meet the standards set out in this module.

4.3.3 Where the HKMA identifies any risk management and/or control deficiencies regarding the use of the FVO it will also consider other supervisory measures, where appropriate, to ensure that such deficiencies receive appropriate attention from the AI's management and are corrected in a timely manner.

4.3.4 The range of supervisory measures may include but is not limited to the following:



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- 4.3.4.1 factoring into the supervisory risk management rating any concerns with respect to the AI's FVO practices;
 - 4.3.4.2 requiring the AI's management and board of directors to remedy the deficiencies in a specified timeframe and to provide the HKMA with periodic written progress reports;
 - 4.3.4.3 requiring the AI to hold additional capital in relation to its overall risk exposure under the Pillar 2 Supervisory Review Process Framework.
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Annex A

Summary of recommended 17 best practices regarding governance, control, price verification and audit practices from the Group of 30's Report "Enhancing Public Confidence in Public Reporting"

Governance

1. A clear and delineated governance structure should exist including provision for appropriate segregation of duties as well as documented procedures for the escalation of issues and exceptions to the board of directors or the audit committee.
2. A senior management grouping should have responsibility for the management and oversight of control and valuation policies and procedures. This group should report the results of its work directly to the board of directors or the audit committee.
3. Initial responsibility for the determination of fair value should reside with the risk taking business. Ultimate responsibility for determining the fair values incorporated into financial statements must be outside the risk taking functions.
4. Senior management should ensure that there are adequate resources, with the appropriate experience, training and reward to ensure that control, risk management and independent price verification functions are performed to the highest standards.

Control

5. Risk limits (for both market and credit) should be established, approved and monitored within a framework and overall risk appetite approved by the board of directors or the audit committee.
6. For financial assets and liabilities measured at fair value, organizations should disclose information in their financial statements that is consistent with the way they measure and manage risk. Any significant differences between the day-to-day measurement and management of risk and accounting standards should be well documented and approved by senior management and appropriate board-level committees. The same



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practice should be sought for other financial assets and liabilities to the extent that risk oversight and management reporting is not based on accounting principles. This recommendation is not intended to limit the use of risk management information based on non-accounting principles (e.g. value-at-risk, etc).

7. There should be a procedure for the approval of new transaction types and markets (New Product Approval) and related controls and risk management approaches. This is a critical element of the control framework.
8. An appropriately qualified and experienced independent price verification (IPV) unit should be responsible for the fair values used in the financial statements.
9. There should be a group dedicated to model verification, independent of risk taking activities, employing highly experienced and qualified quantitative professionals.
10. Valuation models or changes to a valuation model must be reviewed and approved by the Model Verification Group. Details of model approvals and changes thereto should be recorded in an inventory.
11. There should be procedures for the timely review of highly structured, complex trades independent of the persons responsible for their design and execution.
12. For institutions using hedge accounting, the documentation, valuation and control requirements should be managed by financial control.

Price verification procedures

13. Institutions should undertake a rigorous process, at least monthly, to verify fair values. The results should be reported to senior management. Where fair value is a critical component of reported results, senior management should report the price verification results to the board of directors or the audit committee.
14. An independent group should be responsible for approving and monitoring valuation adjustments for consistency and appropriateness. The group's findings and any changes to the method of determining such adjustments should be reported to senior management. A report of price verification differences and valuation adjustments should be distributed throughout senior management and, where fair value is a



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critical component of reported results, to the board of directors or the audit committee.

15. In addition to a rigorous monthly independent price verification process there should be a process for the review and explanation of daily profit and loss (and for non-traded financial assets/liabilities the relevant periodic profit and loss), which should be reported to senior management on a daily basis.

Audit

16. Internal audit departments should review at least annually the independent price verification procedures and control processes.
17. External audit should devote considerable resources to reviewing the control environment, including the price verification processes, and performing valuations of transactions, especially in those institutions where fair value is a critical component of reported results.