Our Ref.: B1/15C
B1/21C
S4/3C
B4/1C
B4/9C

11 October 2012

The Chief Executive
All Authorized Institutions

Dear Sir / Madam,

Supervisory Policy Manual ("SPM")
CA-G-3 "Use of Internal Models Approach to Calculate Market Risk" (Revised)

I am writing to inform you that, following consultation with the industry, the HKMA is issuing the above module today as a technical note.

The recent global financial crisis revealed that certain risks associated with banks' trading book activities (including credit and liquidity risk in respect of trading exposures pertaining to complex and structured products) were not adequately captured by the Basel II regulatory capital framework. In particular, inherent weaknesses associated with the use of the internal models approach ("IMM approach") for market risk, based on VaR measures, were noted. In response, the Basel Committee on Banking Supervision released "Basel 2.5" (consisting of two documents entitled "Revisions to the Basel II market risk framework" and "Guidelines for computing capital for incremental risk in the trading book") to strengthen the market risk capital framework. In relation to the IMM approach Basel 2.5 imposed more stringent modelling requirements and introduced new market risk capital charges (in the form of a stressed VaR measure, an incremental risk charge and a comprehensive risk charge).

The HKMA revised the market risk capital framework in the Banking (Capital) Rules, by incorporating the Basel 2.5 enhancements, with effect from 1 January 2012. The SPM module CA-G-3 has been updated to reflect the changes made to the Banking (Capital) Rules that relate to the IMM approach, and to provide corresponding additional guidance or elaboration.

The major changes to CA-G-3 include:

(i) **Basel 2.5 terminology (subsection 1.1.2)** – The key new definitions under Basel 2.5 have been added, with elaboration where appropriate to facilitate understanding;

(ii) **Application for use of the IMM approach (subsections 1.3 and 1.4)** – New subsections explain the expanded requirements and transitional provisions relating to AIs' applications for approval to use the IMM approach to calculate VaR, stressed VaR, incremental risk charge and comprehensive risk charge in respect of their relevant market risk exposures;

(iii) **Qualitative and quantitative criteria (sections 2 and 3)** – Guidance is provided on the enhanced qualitative and quantitative criteria for use of the IMM approach, particularly as regards the calculation of the new market risk capital charges (i.e. stressed VaR, incremental risk charge and comprehensive risk charge); and

(iv) **Treatment of specific risk (section 4 and Annexes B to E)** – Guidance is provided on the enhanced modelling standards for specific risk for interest rate exposures and equity exposures (see section 4) and on the use of back-testing and stress-testing to ensure the accuracy and reliability of AIs' internal models (see Annex B and Annex C). Additional detailed guidance is provided in two new annexes (Annex D and Annex E) on the calculation of incremental risk charge and comprehensive risk charge, including general requirements, key supervisory parameters, and model validation and stress-testing requirements.

On-line access to the module is available under the icon for the "Supervisory Policy Manual" on the HKMA's public (http://www.hkma.gov.hk/) and private (http://www.stet.finnet.hk) websites.

Should you have any questions regarding the revised SPM module CA-G-3, please feel free to contact Ms Rita Yeung on 2878-1388 or Ms Echo Chan on 2878-1558.

Yours faithfully,

Karen Kemp
Executive Director (Banking Policy)

c.c. The Chairman, The Hong Kong Association of Banks
The Chairman, The DTC Association
FSTB (Attn. Mr Jackie Liu)