Our Ref.: B1/15C
B1/21C
G10/1/7C

30 December 2011

The Chief Executive
All Authorized Institutions

Dear Sir/Madam,

Supervisory Policy Manual (SPM)
CA-S-10 "Financial Instrument Fair Value Practices"

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

This module supersedes the previous module CA-S-9 "Use of the Fair Value Option for Financial Instruments". It reflects the recommendations in the *Supervisory guidance for assessing banks' financial instrument fair value practices* issued by the Basel Committee on Banking Supervision (BCBS) in April 2009 and the relevant enhancements to the Basel II capital framework which the BCBS issued in July 2009 to broaden the application of prudential valuation guidance to all positions (i.e. in both trading book and banking book). In developing this module, the HKMA has also drawn reference from relevant guidance issued by accounting and auditing standard setters and other international bodies, in response to the valuation challenges faced by financial institutions during the recent financial crisis when markets were no longer active.

In setting out the HKMA's supervisory expectations for sound practices to promote effective risk management, and maintain the integrity of regulatory capital measures, the guidance included in the module broadly covers:

- Governance structures, senior management oversight and controls to ensure the reliability of valuations;
- Processes for the design and validation of valuation methodologies;

- Independent price verification;
- Assessment of material valuation uncertainty;
- Valuation adjustments to reflect appropriate risks; and
- Disclosure of timely, relevant, reliable and decision-useful information.

AIs should adopt the principles and standards set out in the module into their own valuation processes and practices as soon as practicable (if they have not already done so), in a manner commensurate with the significance and complexity of the fair valued exposures which they hold. In line with the supervisory approach outlined in the module, the HKMA will evaluate the extent to which an AI's valuation process and practices are consistent with the standards described in the module in the course of its ongoing risk-based supervision and for the purposes of its capital assessment of locally-incorporated AIs.

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

Should you have any questions regarding this module, please feel free to contact Mr Richard Chu on 2878-8276 or Miss Theresa Kwan on 2878-1093.

Yours faithfully,

Karen Kemp
Executive Director (Banking Policy)

Encl.

c.c. The Chairman, The Hong Kong Association of Banks
The Chairman, The DTC Association
FSTB (Attn. Miss Natalie Li)