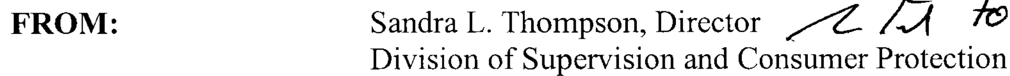
DATE: December 14, 2010

MEMORANDUM TO: Board of Directors

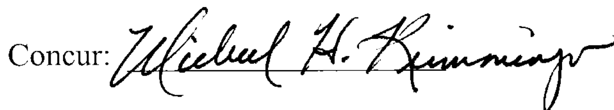
FROM: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection



SUBJECT: *Notice of Proposed Rulemaking Regarding Risk-Based Capital Standards: Market Risk*

Proposal: That the Board of Directors (Board) of the Federal Deposit Insurance Corporation (FDIC) approve publication of the attached Notice of Proposed Rulemaking titled, *Risk-Based Capital Standards: Market Risk* (NPR), in the *Federal Register* for a 90-day comment period. The NPR would be issued on an interagency basis by the FDIC, the Board of Governors of the Federal Reserve System (FRB), and the Office of the Comptroller of the Currency (OCC) (the agencies).

This NPR is based on a series of publications by the Basel Committee on Banking Supervision ("BCBS") that enhance the market risk capital framework by addressing default and credit risk migration, innovations in trading book exposures, and other deficiencies revealed during the recent financial crisis. Enhancements to the framework include requirements to compute capital for stressed Value-at-Risk, incremental default risk, standardized capital requirements for certain securitization positions, a capital floor for correlation trading exposures, and increased transparency through enhanced disclosures.

Concur: 

Michael Krimminger
Acting General Counsel

The agencies are not currently proposing to use credit ratings for the assignment of standardized charges for securitization and re-securitization positions as published by the BCBS in July, 2009. However, the NPR indicates that the agencies intend to implement these standardized charges in a subsequent rulemaking in a way that appropriately reflects the requirements of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Staff expects that these proposed enhancements would significantly increase capital requirements for trading activities.

The Office of Thrift Supervision (OTS) is not joining this rulemaking as there are currently no OTS-supervised institutions subject to the Rule.

Recommendation: That the Board approve publication of the NPR for a 90-day public comment period.

I. Introduction

The NPR would modify the existing market risk capital rule,[1] which was implemented by the FDIC, FRB, and OCC in 1997 and is based on the Market Risk Amendment released by the BCBS in 1996 (MRA). Since the implementation of the MRA, the BCBS and the IOSCO have published enhancements to the market risk framework, particularly with respect to the measurement and capitalization of specific risk. These enhancements were incorporated in a July 2005 joint publication of the BCBS and IOSCO titled, *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects* (2005 BCBS/IOSCO paper). In September, 2006 the OCC, FRB, and FDIC issued a joint notice of proposed rulemaking (2006 NPR)[2] seeking comment on proposed revisions to the market risk capital rule to implement the modifications provided in the 2005 BCBS/IOSCO paper with respect to specific risk.

The agencies did not finalize the 2006 NPR in view of work undertaken by the BCBS to further refine the market risk framework to address certain shortcomings revealed during the financial crisis. In July 2009, the BCBS published revisions to the framework in two documents titled, *Revisions to the Basel II market risk framework* and *Guidelines for computing capital for incremental risk in the trading book* (together, the "2009 BCBS revisions") This NPR generally incorporates the 2006 NPR as well as the 2009 BCBS revisions with the exception of more conservative capital requirements for securitization positions, which the agencies may not implement in their current form under section 939A of the Dodd Frank Wall Street Reform and Consumer Protection Act (the Act). The agencies intend to implement treatment for covered securitization positions through separate notice and comment rulemaking in a way that achieves the results intended by the 2009 BCBS revisions, and that appropriately reflects the requirements of Section 939A of the Dodd-Frank Act.

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[1] 12 C.F.R. part 325, appendix C.
[2] 71 FR 55958 (September 25, 2006),

II. Overview

The existing market risk capital rules of the FDIC, FRB, and OCC provide risk-based capital requirements for banks with significant trading activity to provide capital standards for these banks to support the risks arising from such exposures.

During the crisis, large financial institutions suffered significant, disproportionate losses in their trading books, which revealed material weaknesses in the existing regulatory capital treatment for market risk. For example, the existing market risk capital rule does not incorporate advances in risk measurement and management that set higher standards for risk control. In addition, the existing rule does not capture adequately the market risk of recently developed financial instruments such as correlation trading products. This NPR is designed to correct these deficiencies and impose a capital requirement for default risk in trading positions.

Similar to the Basel II capital framework for credit risk, the NPR is based on three pillars: minimum regulatory capital (Pillar 1), supervisory review (Pillar 2), and market discipline through enhanced public disclosure (Pillar 3). Through these three pillars, the NPR would establish a framework that will better align capital with risk, promote safe and sound banking practices, and create incentives for advancement in risk measurement and management processes.

III. Summary of the NPR

1. Scope

The applicability of the NPR would remain unchanged from the existing market risk capital rule. That is, the NPR would apply to a bank with aggregate trading assets and trading liabilities equal to at least 10.0 percent of total assets or $1 billion. The primary Federal supervisor of a bank may generally apply the market risk capital rule to a bank, or exempt a bank from application of the rule, if doing so is commensurate with the market risk profile of the bank and consistent with safe and sound banking practices. Two FDIC-supervised institutions are currently subject to the Market Risk Rule.

2. Reservation of Authority

The NPR contains a reservation of authority provision that affirms the authority of a bank's primary Federal supervisor to require a bank to hold an overall amount of capital greater than would otherwise be required under the rule if the supervisor determines that the bank's market risk-based capital requirements under the NPR are not commensurate with the market risk of the bank's covered positions. The NPR also would authorize a bank's primary Federal supervisor to include specific positions or portfolios in the market risk capital framework, or the agencies' other risk-based capital rules, as applicable, to more appropriately reflect the risks of the positions.

3. Modification of the Definition of Covered Position

The NPR modifies the definition of a covered position to include trading assets and trading liabilities (as reported on schedule RC-D of the Call Report or Schedule HC-D of the Consolidated Financial Statements for Bank Holding Companies) that are trading positions. Under the NPR, a trading position is defined as a position that is held by a bank for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits.

A covered position also would include trading assets and liabilities that hedge covered positions. Such a trading asset or liability must be free of any restrictive covenants on its tradability or the bank must be able to hedge its material risk elements in a two-way market. A trading asset or liability that hedges a trading position would be a covered position only if the hedge is within the scope of the bank's hedging strategy (discussed below). The agencies encourage the sound risk management of trading positions and, therefore, include hedges that offset their risk in the definition of covered position and, thus, in the measure for market risk. The agencies are concerned, however, that a bank could craft its hedging strategies in order to bring non-trading positions that are more appropriately treated under the credit risk capital rules into a bank's covered positions. The agencies will scrutinize each bank's hedging strategies to ensure that they are not being manipulated in this manner. For example, mortgage-backed securities that a bank

does not intend to trade, but that are hedged with interest rate swaps to mitigate interest rate risk, would be subject to the credit risk capital rules.

Consistent with the definition of covered position under the existing market risk rule, the NPR also would include as a covered position any foreign exchange or commodity position regardless of whether it is a trading asset or trading liability.[3]

4. Requirements for the Identification of Trading Positions and Management of Covered Positions

The NPR would require a bank to have clearly defined policies and procedures for determining which of its trading assets and trading liabilities are trading positions, as well as which of its trading positions are correlation trading positions. In identifying trading positions, a bank must consider (i) the extent to which a position (or a hedge of its material risks) can be marked-to-market daily by reference to a two-way market; and (ii) possible impairments to the liquidity of a position or its hedge.

5. General Requirements for Internal Models

In contrast to the existing market risk capital rule, the NPR proposes that a bank must receive the prior written approval of its primary Federal supervisor before using any internal model to calculate its market risk capital requirement. The NPR also would require a bank to promptly notify its primary Federal supervisor when the bank plans to extend the use of such an approved model to an additional business line or product type.

A bank also would be required to notify its primary Federal supervisor promptly if it makes any change to its internal models that would result in a material change in the bank's risk-weighted asset amount for a portfolio of covered positions or when the bank

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[3] Consistent with the existing market risk rule, the definition of a covered position would explicitly exclude (i) any position that, in form or substance, acts as a liquidity facility that provides support to asset-backed commercial paper; (ii) any intangible asset, including any servicing asset; (iii) credit derivative recognized as a guarantee for risk-weighted asset amount calculation purposes under the credit risk capital rules, and which is used to hedge a position that is not a covered position (for example, a credit derivative hedge of a loan that is not a covered position). In addition, under the NPR, a covered position would not include a direct real estate holding or asset held with an intent to securitize.

makes any material change to its modeling assumptions. The bank's primary Federal supervisor could rescind its approval, in whole or in part, of the use of any internal model and determine an appropriate capital requirement for the covered positions to which the model would apply if it determines that the model no longer complies with the market risk capital rule or fails to reflect accurately the risks of the bank's covered positions.

6. Capital Requirement for Market Risk

As under the existing market risk capital rule, the NPR would require a bank to calculate its risk-based capital ratio denominator as the sum of its adjusted risk-weighted assets and market risk equivalent assets. To calculate market risk equivalent assets, a bank must multiply its measure for market risk by 12.5.

The current market risk rule requires a VaR-based capital requirement and an add-on for specific risk. In contrast, the NPR would require a bank to capture a broader set of risks by requiring calculation of a VaR-based capital requirement, stressed VaR-based capital requirement, any specific risk add-ons, any incremental risk capital requirement, any comprehensive risk capital requirement, and any capital requirement for de minimis exposures (each according to the requirements of the NPR and as discussed further below). No adjustments are permitted to address potential double counting among any of these components of a bank's measure for market risk.

With regard to a bank's total risk-based capital numerator, the proposed rule eliminates tier 3 capital and the associated allocation methodologies. As no US banks currently have tier 3 capital outstanding or plan to issue tier 3 capital, this aspect of the proposal would have no impact on the financial condition of banks subject to the Market Risk Rule.

i. VaR-based Capital Requirement

A bank must use one or more internal models to calculate a daily VaR-based measure that reflects general market risk for all covered positions. The NPR includes the same quantitative requirements for the daily VaR-based measure as the current rule. These

include a one-tail, 99.0 percent confidence level; a ten-business-day holding period; and, a historical observation period of at least one year. The daily VaR-based measure may also reflect the bank's specific risk for one or more portfolios of debt or equity positions.[4] In addition to interest rate risk, equity price risk, foreign exchange rate risk, and commodity price risk, the NPR adds credit spread risk to the list of risk categories a bank must include in its VaR-based measure.

Also, consistent with the current rule, the NPR would set a bank's VaR-based capital requirement equal to the greater of (i) the previous day's VaR-based measure, and (ii) the average of the daily VaR-based measures for each of the preceding 60 business days multiplied by three, or a higher multiplication factor based on backtesting results.

ii. Stressed VaR-based Capital Requirement

The NPR would require a bank to calculate at least weekly a stressed VaR-based measure using the same internal model(s) used to calculate its VaR-based measure. The stressed VaR-based measure supplements the VaR-based measure, which due to inherent limitations, proved inadequate in producing capital requirements appropriate to the level of losses incurred at many banks during the financial market crisis that began in mid-2007. The stressed VaR-based measure mitigates the procyclicality of the minimum capital requirements for market risk and more appropriately captures the risks of a bank's covered positions.

Under the NPR, a bank's stressed VaR-based measure would equal the greater of (i) the most recent stressed VaR-based measure; or (ii) the average of the weekly VaR-based measures for each of the preceding 12 weeks multiplied by three, or a higher multiplication factor based on backtesting results. The multiplier for the stressed-VaR based measure is based on the backtesting results for its VaR-based measure; there is no

[4] However, a bank that does not model specific risk in its general VaR-based measure would be required to calculate a separate specific risk capital charge in accordance with this proposal.

separate backtesting requirement for the stressed VaR-based measure for purposes of calculating a bank's measure for market risk.

iii. Revised Modeling Standards for Specific Risk

Compared to the current market risk rule, the NPR more clearly specifies the modeling standards for specific risk and would eliminate the optional provision that allows a bank to model some but not all material aspects of specific risk for an individual portfolio of debt or equity positions. As under the current market risk capital rule, a bank may use one or more internal models to measure the specific risk of a portfolio of debt or equity positions.

iv. Standardized Specific Risk Capital Requirement

The NPR would require a bank to calculate a total specific risk add-on for each portfolio of debt and equity positions for which the bank's VaR-based measure does not capture all material aspects of specific risk. The NPR also would require a bank to use standardized specific risk capital requirements for all securitization positions that are not correlation trading positions. The standardized specific risk capital requirements for securitization positions are left unchanged from the Market Risk Rule due to the Dodd-Frank Act's prohibition on the agencies' requiring the use of external credit ratings to compute capital requirements. The agencies plan to develop an alternative treatment for securitizations that does not require reliance on external ratings at a later date and request comment on alternative creditworthiness standards for purposes of the market risk capital rules.

v. Incremental Risk Capital Requirement

Under the NPR, a bank that measures the specific risk of a portfolio of debt positions using internal models would calculate an incremental risk measure for that portfolio using an internal model (incremental risk model). Incremental risk consists of the default risk

of a position[5] and the credit migration risk of a position (that is, price risk that arises from significant changes in the underlying credit quality of the position).

With the prior approval of its primary Federal supervisor, under the NPR a bank may also include portfolios of equity positions in its incremental risk model, provided that it consistently includes such equity positions in a manner that is consistent with how the bank internally measures and manages incremental risk at the portfolio level.

vi. Comprehensive Risk Capital Requirement

The NPR would permit a bank, with the approval of the primary Federal supervisor, to measure all price risk (comprehensive risk measure) of one or more portfolios of correlation trading positions[6] using an internal model (comprehensive risk model). If the bank does not use a comprehensive risk model to calculate the price risk of a portfolio of correlation trading positions, it must calculate the specific risk add-on for the portfolio using the standardized measurement method provided in the proposed rule, and as described below.

A bank's comprehensive risk model would be required to measure comprehensive risk consistent with a one-year time horizon and at a one-tail, 99.9 percent confidence level, under the assumption of either a constant level of risk or constant positions. The capital requirement for a correlation trading position would be the greater of (i) the average of the comprehensive risk measures over the previous 12 weeks; or (ii) the most recent comprehensive risk measure.

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[5] Default risk is generally defined as the risk of loss on the position upon an event of default (for example, the failure of the obligor to make timely payments of principal or interest), including bankruptcy, insolvency, or similar proceeding.

[6] The NPR defines a correlation trading position as (i) a securitization position for which all or substantially all of the value of the underlying exposures is based on the credit quality of a single company for which a two-way market exists, or on commonly traded indices based on such exposures for which a two-way market exists on the indices; or (ii) a position that is not a securitization position and that hedges a position described in clause (i) above.

A bank would initially have to add a capital surcharge to the capital requirement for correlation trading positions calculated under the comprehensive model to address any uncertainty in modeling all price risks for these positions while providing an incentive for sound risk management practices. The initial capital surcharge will be set at 15.0 percent of the total specific risk add-on for such positions while banks and supervisors gain experience with banks' comprehensive risk models. Over time, however, with approval from its primary Federal supervisor a bank may be permitted to use a floor approach to calculate its capital requirement for correlation trading positions. The floor would be the higher of the comprehensive risk measure and 8.0 percent of the total specific risk add-on for such positions. A bank would be permitted to use the floor approach to calculate its surcharge provided the bank has met the comprehensive risk modeling requirements in the proposed rule for a period of at least one year and can demonstrate the effectiveness of its comprehensive risk model through the results of ongoing validation efforts, including robust benchmarking.

A bank that does not have approval to use a comprehensive risk model would calculate the total specific risk add-on for correlation trading positions using the standardized measurement method. Under this method, capital requirements for correlation trading positions are the higher of: (i) the sum of the bank's standardized specific risk capital requirements for each net long correlation trading position; or (ii) the sum of the bank's standardized specific risk capital requirements for each net short correlation trading position.

7. Disclosure Requirements

The NPR would impose quantitative and qualitative disclosure requirements designed to increase transparency and improve market discipline. A bank would have to disclose certain components of its market risk capital requirement, information on its modeling approaches, and information relating to its securitization activities.

The NPR would require a bank, at least quarterly, to disclose publicly for each portfolio of covered positions (i) the high, low, median, and mean VaR-based measures over the

reporting period and at period-end; (ii) the high, low, median, and mean stressed VaR-based measures over the reporting period and at period-end; (iii) the high, low, median, and mean incremental risk capital requirements over the reporting period and at period-end; (iv) the high, low, median, and mean comprehensive risk capital requirements over the reporting period and at period-end; (v) separate measures for interest rate risk, credit spread risk, equity price risk, foreign exchange rate risk, and commodity price risk used to calculate the VaR-based measure; and (vi) a comparison of VaR-based measures with actual results and analysis of important outliers. In addition, the bank must publicly disclose the following information at least quarterly: (i) the aggregate amount of on-balance sheet and off-balance sheet securitization positions, broken down by exposure type; and (ii) the aggregate amount of correlation trading positions.

A top-level bank also would have to make qualitative disclosures at least annually, or more frequently in the event of material changes, on various aspects for each portfolio of covered positions. The qualitative disclosures would include portfolio composition, valuation policies, methods and assumptions, model characteristics, model validation approach, stress test descriptions, liquidity horizon, as well as credit risk mitigation policy.

IV. Recommendation

Staff recommends that the Board approve for publication in the *Federal Register* the attached interagency NPR, which seeks comment on proposed revisions to the market risk capital rules of the FDIC, FRB, and OCC that are consistent with the modifications to the Basel II market risk capital framework provided in the BCBS/IOSCO paper and the 2009 BCBS revisions.

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