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RISK-BASED CAPITAL RULES

Proposed Rule on Risk-Based Capital Standards: *Market Risk*

Summary: The federal banking regulatory agencies (agencies) have jointly issued the attached notice of proposed rulemaking on possible modifications to the risk-based capital standards for market risk. The proposed rule would incorporate improvements to the current trading book regime as proposed by the Basel Committee on Banking Supervision in *Revisions to the Basel II Market Risk* Framework published in July 2009 and *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects*, published in July 2005.

Distribution:
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Chief Executive Officer
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Related Topics:
Risk-Based Capital Rules
12 CFR Part 325
Basel II
Market Risk

Attachment:
Joint Notice of Proposed Rulemaking, Risk-Based Capital Standards: Market Risk

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Highlights:

The proposed rule:

- Applies to banks with aggregate trading assets and liabilities equal to 10 percent or more of quarter-end total assets, or aggregate trading assets and liabilities equal to $1 billion or more.
- Establishes more explicit eligibility criteria for positions that receive market risk capital treatment; sets requirements for prudent valuation, robust stress testing and the control, oversight and validation mechanisms for models; and expects banks to have an internal capital adequacy assessment for market risk.
- Introduces a stress-value-at-risk requirement, which better captures market risk during periods of stress.
- Introduces an incremental risk charge, which captures default and migration risks at a 99.9 percent confidence level over a one-year horizon.
- Introduces a risk-based capital charge for correlation trading positions.

The proposed rule does not reference the use of credit ratings for the assignment of standardized charges for securitization positions. However, the agencies intend to implement these standardized charges in a subsequent rulemaking in a manner that appropriately reflects the requirements of Section 939A of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. The agencies intend to develop alternatives that will result in capital requirements for securitization positions that are comparable to the Basel Committee for Banking Supervision’s proposed charges for such positions.

KEY ASPECTS OF THE PROPOSED RULE ON RISK-BASED CAPITAL STANDARDS: *MARKET RISK*

I. Introduction

The attached interagency Notice of Proposed Rulemaking (Proposed Rule) explains how the banking agencies (the agencies) plan to adopt certain revisions to their current market risk capital rule, as detailed in *Revisions to the Basel II Market Risk and The Application of Basel II to Trading Activities and the Treatment of Double Default Effects*, which were published by the Basel Committee on Banking Supervision (Basel Committee) in July 2009 and July 2005, respectively. The Proposed Rule would be required for banks with worldwide consolidated trading activity equal to at least 10 percent of total assets or $1 billion. Further, the agencies reserve the authority to require any bank to adopt the framework to ensure the bank operates in a safe-and-sound manner.

II. Overview

The Proposed Rule is a modification of the existing risk-based capital treatment of market risk, which was published on September 6, 1996, and is based on the Market Risk Amendment of 1996 (MRA). The existing rule[1] was intended to provide risk-based capital requirements for banks with significant exposures to market risk to support the risks arising from such exposures.

Changes to the trading book rules are warranted because of changes in the markets and the large trading book losses banks suffered in 2007 and 2008. For example, the existing rule does not adequately capture the credit risk of positions held in banks' trading books. Among other changes, the Proposed Rule ensures that capital is held against these positions by applying credit risk capital charges to trading positions.

III. Minimum Risk-Based Capital Requirements under the Proposed Rule

The Proposed Rule defines covered positions, which are positions eligible for treatment under the market risk framework, and specifies how banks must calculate their capital requirement for the market risk on these covered positions. The capital requirement for market risk is determined by calculating capital requirements for general market risk and specific risk. Additionally, the Proposed Rule introduces several new capital requirements, including stressed-value-at-risk (SVaR), the incremental risk charge, and charges for correlation trading positions.

Covered Positions. The existing rule does not specify with sufficient clarity which positions are eligible for treatment under the market risk capital framework as opposed to the credit risk capital framework. As a result of this ambiguity, banks can arbitrage the capital standards for market and credit risk by calculating capital for a given position

[1] "Risk-Based Capital Standards: Market Risk," published in the ***Federal Register*** on September 6, 1996 (see FIL-84-96, dated October 10, 1996).

under the framework that resulted in the lowest capital requirement. The Proposed Rule addresses this concern by establishing specific criteria that define which positions can be designated as covered positions. In addition to all foreign exchange and commodity positions, covered positions include trading assets or liabilities held by the bank for the purpose of short-term resale or with the intent of benefiting from actual or expected price movements or to lock in arbitrage profits. To further reduce capital arbitrage opportunities, credit derivatives used to hedge banking book exposures (for example, loans) are not covered positions. Banks would have to establish clearly defined policies and procedures for identifying traded positions, factoring in the ability to hedge such positions with reference to a two-way market, and taking into account liquidity considerations; and have procedures to ensure prudent valuation of less liquid-traded positions. Finally, banks would have to establish a trading and hedging strategy, approved by senior management, which would articulate the expected holding period of the position and ensure sufficient controls are in place to preclude the use of capital arbitrage strategies.

General Market Risk. General market risk is the risk that arises from broad market movements, such as changes in the general level of interest rates, credit spreads, equity prices, foreign exchange rates, or commodity prices. Banks would measure general market risk using a value-at-risk (VaR) model.[2] Under the Proposed Rule, a bank would have to obtain approval from its primary federal regulator (PFR) before using its VaR model to calculate capital for general market risk, or before extending the use of its model to additional products. The model would be subject to ongoing validation requirements, and a bank's PFR has the authority to rescind approval if the model no longer accurately measures risk.

Stressed-Value-at-Risk (SVaR). The recent financial crisis demonstrated the need to have risk-based capital requirements for market risk that capture risk during a period of financial stress. The proposed SVaR requirement would be calculated using the same VaR model used to measure general market risk, but using inputs based on "historical data from a continuous 12-month period of significant financial stress." The proposed SVaR requirement would reduce procyclicality and ensure banks hold enough capital to survive a period of financial distress.

Specific Market Risk. Specific risk is the risk that arises from factors other than broad market movements and includes event risk, default risk, and idiosyncratic variations. Banks would calculate their risk-based capital requirement for specific risk using either an internal models approach or a standardized approach. Under the Proposed Rule, a bank must receive approval from its PFR before using an internal model to calculate capital for specific risk. Also under the Proposed Rule, banks would now be required to use the standardized approach to calculate the specific risk capital charge on all securitization positions that are not correlation trading positions.

Incremental Risk Charge. Banks have included certain types of positions in the market risk capital framework that contain significant levels of credit risk. This was not

[2] VaR is a statistical measure of a worst-case scenario loss and a standard for measuring market risk.

envisioned when the MRA was first implemented. To address this situation, the Proposed Rule establishes a new capital requirement, the incremental risk charge. Incremental risk is the default and migration risk that is not reflected in a bank's VaR-based measures. A bank must receive approval from its PFR before using its incremental risk model.

The incremental risk capital requirement must be consistent with a one-year horizon and a 99.9 percent confidence level, the measurement standard under the credit risk capital framework. This capital requirement would include losses arising from defaults and credit migrations in covered positions subject to specific interest rate risk.

Correlation Trading. A correlation trading position is a securitization position in which the underlying exposures are liquid and related to the credit quality of a single company, including positions that are liquid, commonly traded indices based on such exposures. Hedges of correlation trading positions are also considered correlation trading positions. Banks would model the risk-based capital charge for these correlation trading positions using a comprehensive risk model. The model must capture "all price risks" at a 99.9 percent confidence interval over one year. If a bank is unable to develop a comprehensive model for its correlation trading portfolio, it would instead calculate the capital charge for correlation trading positions using the standardized measurement method, which is the maximum of the standardized specific risk charges for all long correlation trading positions and the standardized specific risk charges for all short correlation trading positions. The Proposed Rule subjects the comprehensive risk model charge to an initial surcharge, which is set at 15 percent of the standardized measurement method. Eventually, the surcharge approach may be replaced by a floor approach, with the floor set to 8 percent of the standardized measurement method.

Securitization Positions**.** The Proposed Rule does not reference credit ratings for the assignment of standardized charges for securitization positions. Rather, the Proposed Rule states that the agencies intend to implement these standardized charges in a subsequent rulemaking in a manner that appropriately reflects the requirements of Section 939A of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. The agencies intend to develop alternatives that will result in capital requirements for securitization positions that are comparable to the Basel Committee's proposed charges for such positions.

IV. Supervision under the New Market Risk Capital Rule

The proposed supervisory review process stresses the need for banks to assess their capital adequacy positions relative to risk, and for PFRs to review and take appropriate actions in response to those assessments, such as requiring additional risk-based capital or requiring a bank to reduce its exposure to market risk. The Proposed Rule would require banks to have an internal capital adequacy program to address their capital needs for market risk and capture these and all material risks. The Proposed Rule provides requirements for the control, oversight, validation mechanisms, and documentation of internal models. However, the Proposed Rule recognizes that models can be limited in their ability to fully capture all material risks. Therefore, it requires that models be supplemented periodically by stress tests with particular emphasis on concentrations, illiquidity under stressed market conditions, and a view to risks arising from the bank's trading activities that may not be adequately captured in the bank's internal models.

V. Disclosures under the New Market Risk Capital Rule

Market discipline is a key component of Basel II. Under the third pillar of Basel II, disclosure requirements are established to allow market participants to assess key information about a bank's risk profile and its associated level of capital. Increased disclosures are intended to allow a bank's stakeholders to more fully evaluate the bank's financial condition, including its capital adequacy.