



Federal Deposit Insurance Corporation
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Financial Institution Letter

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RISK-BASED CAPITAL RULES

Final Rule on Risk-Based Capital Standards: Market Risk

Summary: The federal bank regulatory agencies (agencies) have jointly issued the attached final rule modifying the risk-based capital standards for market risk. The final rule incorporates improvements to the current trading book capital 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.

Statement of Applicability to Institutions Under \$1 Billion in Total Assets: The final rule applies only to banks with aggregate trading assets and trading liabilities equal to 10 percent or more of quarter-end total assets, or aggregate trading assets and liabilities equal to \$1 billion or more.

Distribution:

FDIC-Supervised Banks (Commercial and Savings)

Suggested Routing:

Chief Executive Officer
Chief Financial Officer
Chief Risk Officer

Related Topics:

Risk-Based Capital Rules
12 CFR Part 325
Basel III
Market Risk

Attachment:

[Joint Notice of Final Rulemaking, Risk-Based Capital Standards: Market Risk \(PDF Help\)](#)

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Highlights:

The final rule:

- Establishes more explicit eligibility criteria than the current market risk capital rules 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 requires 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.
- Removes references to external ratings from the standardized specific risk capital charges consistent with Section 939A of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.

Key Aspects of the Final Rule on Risk-Based Capital Standards: Market Risk

I. Introduction

The attached interagency final rule sets forth the agencies' implementation of the Basel Committee on Banking Supervision (Basel Committee) revisions to the market risk capital framework, 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 final rule applies to all banks with worldwide consolidated trading assets and liabilities equal to at least 10 percent of total assets or \$1 billion. Further, under the final rule the agencies have reserved the authority to require any bank to adopt the rule for safety and soundness purposes.

II. Overview

The final rule modifies the existing risk-based capital requirements for market risk, which are based on the 1996 Basel Committee Market Risk Amendment (MRA). The agencies' current market risk capital rule ¹ was intended to provide risk-based capital requirements for banks with material trading assets and liabilities.

The agencies believe the modifications to the market risk capital framework adopted under the final rule are warranted because of the large trading book losses suffered by banking organizations during the recent economic crisis. For example, the current rule does not adequately capture the credit risk of trading positions and provides significant arbitrage opportunities to move such positions between the current general risk-based capital rules and the current market risk capital rule to lower capital requirements. Accordingly, among other changes, the final rule minimizes regulatory arbitrage by applying a credit risk capital charge, that is, the incremental risk charge, to trading positions.

The final rule also removes references to credit ratings for calculating standardized specific risk capital charges for certain assets, consistent with section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. In place of credit rating-based approaches, the final rule provides methodologies for determining standardized specific risk capital charges covered positions, including securitization positions.

III. Minimum Risk-Based Capital Requirements Under the Final Rule

The final rule applies to a bank's "covered positions," and specifies how each bank must calculate its capital requirement for the market risk for these covered positions. The capital requirement for market risk is determined by calculating capital requirements for general market risk and specific risk. Additionally, the final rule introduces several new capital requirements, including a stressed-value-at-risk (SVaR) capital requirement, an 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 under the framework that resulted in the lowest capital requirement. The final 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. Under the final rule a bank is required 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, as well as procedures to ensure prudent valuation of less liquid-traded positions. Finally, the final rule requires a bank to establish a trading and hedging strategy, approved by senior management, which articulates the expected holding period of the position and ensures 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 measure general market risk using a value-at-risk (VaR) model. ² Under the Final rule, a bank must 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 positions. The model is subject to ongoing validation requirements, and a bank's PFR has the authority to rescind its 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. Under the final rule, the SVaR requirement is 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 SVaR requirement reduces 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 calculate their risk-based capital requirement for specific risk using either an internal models approach or a standardized approach. Under the final rule, a bank must receive approval from its PFR before using an internal model to calculate capital for specific risk. If a bank does not model specific risk it must use the standardized specific risk approach to calculate the specific risk capital charge for all debt positions and for all securitization positions that are not correlation trading positions.

Incremental Risk Charge. To address default and migration risks, the final 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 covers 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. Hedges of correlation trading positions are also considered correlation trading positions. Under the final rule a bank is required to model the market risk-based capital charge for correlation trading positions using a comprehensive risk model. The model must capture "all price risks" at a 99.9% 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 final rule subjects the comprehensive risk model charge to an initial surcharge, which is set at 8 percent of the standardized measurement method.

Standardized Specific Risk Weights. The final rule does not reference credit ratings for the assignment of standardized charges. The final rule implements non-ratings-based standardized specific risk capital charges for:

- Government, agency, and government-sponsored entity positions;
- Depository institution and credit union positions;
- Public sector entities positions;
- Corporate positions; and
- Securitization exposures.

Simplified Supervisory Formula Approach (SSFA). The final rule incorporates the SSFA for purposes of calculating standardized capital charges for securitization exposures. The SSFA uses the following inputs:

- The weighted average risk weight of the underlying assets, determined in accordance with the general risk-based capital rules, as well as an adjustment which reflects the observed credit quality of the underlying pool of exposures;

- The amount of collateral provided to the underlying asset pool, relative to the amount of assets that have experienced delinquency or some other credit impairment;
- The attachment point of the relevant tranche;
- The detachment point of the relevant tranche; and
- The securitization surcharge. This is a supervisory input which is set at 0.5 for securitization exposures and 1.5 for resecuritization exposures.

IV. Supervision Under the New Market Risk Capital Rule

The supervisory review process emphasizes 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 final rule requires banks to have an internal capital adequacy program to address their capital needs for market risk and capture these and all material risks. The final rule provides requirements for the control, oversight, validation mechanisms, and documentation of internal models. However, the final rule also recognizes that models can be limited in their ability to fully capture all material risks. Therefore, under the final rule the use of any model must be supplemented periodically by a stress test that emphasizes risk concentrations, illiquidity under stressed market conditions, and 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. The third pillar of Basel II establishes disclosure requirements 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.

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

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