Financial Institution Letters

Key Aspects of The Proposed Rule on Risk-Based Capital Standards: *Market Risk*

I. Introduction

The attached interagency NPR (Proposed Rule) explains how the U.S. banking and thrift agencies (the Agencies) plan to adopt certain revisions to their current market risk capital rule, as detailed in "*The Application of Basel II to Trading Activities and the Treatment of Double Default Effects*," which was published by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions in July 2005. The Proposed Rule will be applied of banks with worldwide consolidated trading activity equal to at least 10 percent of total assets or $1 billion. Further, regulators reserve the authority to require any bank to adopt the framework to ensure that the bank operates in a safe and sound manner.

II. Overview

The Proposed Rule is a modification of the existing capital treatment of market risk, which came into effect in 1997 and is based on the Market Risk Amendment of 1996 (MRA). The existing rule sets forth risk-based capital requirements for banks with trading accounts with significant exposures to market risk to ensure that these banks maintain adequate capital to support the risks arising from such exposures.

While the MRA framework has promoted safe and sound banking practices, advances in risk measurement and management have set higher standards for risk control that need to be incorporated. Modifications are also warranted because of changes in the markets and new and innovative financial instruments that have evolved since the adoption of the MRA in 1996. The existing rule, for example, falls short of adequately capturing the various risks present in the relatively new and rapidly growing market for traded structured credit. The treatment of default risk in securitization positions, such as first loss positions that represent concentrated credit risk, is not fully captured under the existing rules. The Proposed Rule ensures that adequate capital is held against these positions by requiring a full deduction treatment, in line with their treatment under the securitization framework in Basel II NPR, which has been published by the Agencies simultaneously with this Proposed Rule.

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

The Proposed Rule first 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 requires banks to also calculate a capital requirement for incremental default risk.

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 Proposed Rule addresses this concern by establishing specific criteria that define what positions can be designated as covered positions. In addition to all foreign exchange and commodity positions, covered positions include trading assets or liabilities that are 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 in the existing rules, credit derivatives that are used to hedge banking book exposures (e.g. loans) and securitization exposures that are subject to deduction under the credit risk capital rules must be treated under the credit risk framework.

Further, banks are required to have 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, to have procedures to ensure prudent valuation of less liquid traded positions. Banks are also required to have in place a trading and hedging strategy, approved by senior management, which would articulate the expected holding period of the market risk of the position and ensure that sufficient controls are in place to preclude banks from engaging in 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 are required to measure general market risk by using a value-at-risk (VaR) model. VaR is a statistical measure of a worst-case scenario loss and a standard for measuring market risk. Under the Proposed Rule, a bank must receive approval from its supervisor 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 is subject to ongoing validation requirements and a bank's supervisor has the authority to rescind approval, if the model no longer accurately measures risk.

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 are required to calculate their capital requirement for specific risk using either an internal models approach or a standard approach. Under the Proposed Rule, a bank must receive approval from its supervisor before using an internal model to calculate capital for specific risk.

Incremental Default Risk. Banks have been including certain types of positions in the market risk capital framework that expose the banks to significant levels of credit risk. This was not envisioned when the MRA was first implemented. To address this situation, the Proposed Rule establishes an entirely new capital requirement, the incremental default risk requirement. Incremental default risk is the default risk that is not reflected in the bank's VaR-based measures. A bank must receive approval from its supervisor before using its incremental default risk model.

The incremental default risk capital requirement must be consistent with a one- year time horizon and a 99.9 percent confidence level, the measurement standard under the credit risk capital framework. This capital requirement will include losses arising from bankruptcies and losses in covered positions resulting from default of the underlying assets in a securitization pool.

The incremental default risk approach may be part of the bank's internal models or a surcharge from a separate calculation. The Proposed Rule directs banks to factor in liquidity, concentrations, optionality and hedging in modeling incremental default risk, but does not prescribe any particular approach. Banks are required to have an approach to model incremental default risk effective January 1, 2010.

IV. Supervision under the New Market Risk Capital Rule

The supervisory review process is designed to stress the need for banks to assess their capital adequacy positions relative to risk, and for supervisors to review and take appropriate actions in response to those assessments, such as requiring that additional buffer capital be held given the risk profile of the institution or that the bank reduce its exposure to market risk. The Proposed Rule expects banks to have an internal capital adequacy program to address their capital needs for market risk. The Proposed Rule requires models to capture these and all material risks, and brings attention to prepayment risk, basis risk and credit risk. These risks can be material, and have become more prominent with the advent of new types of traded products. The Proposed Rule sets 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, disclosure requirements are established to allow market participants to assess key information about an institution's risk profile and its associated level of capital. Increased disclosures are intended to allow an institution's private sector stakeholders to more fully evaluate the institution's financial condition, including its capital adequacy.