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.