BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: June 4, 2012

To: Board of Governors

From: Governor Tarullo DKT

Subject: Final Market Risk Capital Rule

Attached are a memorandum to the Board and a draft *Federal Register* notice that would finalize changes to the Board's market risk capital rule. The draft final rule would revise the existing market risk capital rule to incorporate certain changes the Basel Committee on Banking Supervision made to its international capital standards for market risk between 2005 and 2010. The changes to the market risk capital rule would modify its scope to better capture positions for which application of the market risk capital rule is appropriate, reduce procyclicality in market risk capital requirements, enhance the rule's sensitivity to risks not adequately captured under current regulatory measurement methodologies, and increase transparency through enhanced disclosures. Additionally, consistent with the requirements of section 939A of the Dodd-Frank Act, the draft final rule includes methodologies that do not rely on credit ratings for calculating specific risk capital requirements for certain debt and securitization positions. The draft final rule would continue to apply to any banking organization that has trading assets and liabilities of at least $1.0 billion or 10 percent of its total assets.

Staff seeks the Board's approval of the attached draft final rule, and requests authority to make technical and minor changes to the document prior to publication in the *Federal Register*, such as to respond to comments from the *Federal Register,* or to incorporate changes requested by other federal banking agencies as part of the approval process. In addition, staff requests that the Board delegate authority to (1) the appropriate Reserve Bank, with the concurrence of the Board, to approve certain models under the final rule; and (2) the Director of the Division of Banking Supervision and Regulation or his or her designee to act (including concurrence or nonconcurrence with the appropriate Reserve Bank, where appropriate) under the final rule. Staff proposes to discuss any material changes with me, as Chairman of the Committee on Bank Supervision, to determine whether additional action by the Board is required or appropriate. The

draft final rule would be published jointly by the Board, FDIC, and OCC in the *Federal Register* after all agencies have adopted the final rule.

The Committee on Bank Supervision has reviewed the draft final rule and I believe it is ready for the Board's consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: June 4, 2012

To: Board of Governors

From: Staff[1]

Subject: Final Market Risk Capital Rule

ACTIONS REQUESTED: Staff seeks the Board's approval of the attached draft final rule that would revise the market risk measure in the Board's capital adequacy guidelines (market risk capital rule).[2] Staff also requests that the Board delegate authority to (1) the appropriate Reserve Bank, with the concurrence of the Board, to approve certain models under the final rule; (2) the Director of the Division of Banking Supervision and Regulation (Director) or his or her designee to act (including concurrence or nonconcurrence with the appropriate Reserve Bank, where appropriate) under the final rule; and (3) staff in order to make technical and minor changes to the attached draft notice of the final rule prior to publication in the *Federal Register*, such as to respond to comments from the *Federal Register*, or to incorporate changes requested by other federal banking agencies (agencies) as part of the approval process. Staff proposes to discuss any material changes with the Chairman of the Committee on Bank Supervision to determine whether additional action by the Board is required or appropriate. The draft final rule would be adopted by each of the Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency after all the agencies have completed their internal review and approval procedures. This market risk capital rule would continue to apply to any banking organization that has trading assets and liabilities of at least $1.0 billion or 10 percent of its total assets.[3]

[1] Messrs. Gibson, Lindo, Boemio, and Smith and Mmes. Hewko, Horsley, and Judge (Division of Banking Supervision and Regulation), and Messrs. Alvarez and McDonough and Mme. Snyder (Legal Division).

[2] 12 CFR parts 208 and 225, appendix E.

[3] Banking organization as used in this document and its appendices refers to bank holding companies, national banks, state member banks, and state nonmember banks, unless the context requires a different meaning.

INTRODUCTION: On January 11, 2011, the agencies issued a joint notice of proposed rulemaking (January NPR) that sought public comment on proposed revisions to the agencies' market risk capital rule.[4] The January NPR proposed to implement enhancements to international capital standards for market risk proposed by the Basel Committee on Banking Supervision (BCBS), other than changes that would have required use of credit ratings (BCBS enhancements).[5] The agencies amended the January NPR with a *Federal Register* notice published on December 21, 2011 (December amendment), to propose alternative standards of creditworthiness consistent with requirements of section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), in order to fully implement changes to the market risk capital framework in the United States.[6] Section 939A of the Dodd-Frank Act requires the agencies to remove all references to, and requirements of reliance on, credit ratings from their regulations and replace them with alternative standards of creditworthiness.[7]

In response to shortcomings in banking organizations' internal modeling practices for measuring capital requirements highlighted by the recent financial crisis, the BCBS enhancements placed additional prudential requirements on these internal models, strengthened non-modeled capital requirements for market risk, and required enhanced qualitative and quantitative disclosures.[8] The revisions include requiring banking organizations to take into account stressful conditions when modeling market risk capital requirements; reducing the opportunity for regulatory capital arbitrage between market risk and credit risk-based capital frameworks; and not using models to measure specific risk of securitization positions for regulatory capital purposes.[9] The agencies proposed to incorporate these revisions into their

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[4] 76 *Federal Register* 1890 (January 11, 2011).

[5] The Basel capital framework includes capital requirements related to a banking organization's exposure to market risk associated with trading, foreign exchange, and commodity positions.

[6] 76 *Federal Register* 79380 (December 21, 2011).

[7] *See* note to 15 U.S.C. 78o-7.

[8] Revisions to the Basel II Market Risk Framework, Guidelines for Computing Capital for Incremental Risk in the Trading Book, and Enhancements to the Basel II Framework, BCBS, July 13, 2009, *available at* www.bis.org.

[9] The Board's credit risk-based capital rules are the general risk-based capital rule (12 CFR parts 208 and 225, appendix A) and the advanced approaches capital rule (12 CFR part 208, appendix F, and 12 CFR part 225, appendix G).

market risk capital rule in order to strengthen the market risk capital framework applicable to U.S. banking organizations, and maintain consistency with international capital standards.

The Board received six comment letters on the January NPR and 30 comment letters on the December amendment.[10] Commenters expressed specific concerns about various aspects of the changes and sought clarification on certain technical matters. With respect to the December amendment in particular, a number of commenters criticized various aspects of the proposal and suggested specific modifications to the proposed changes.

Staff has reviewed the comments on the January NPR and December amendment and recommends that the Board adopt the proposed revisions to the market risk capital rule with certain adjustments and modifications to address commenter concerns and to improve the functioning of the rule, as explained in further detail below. The final rule would have an effective date of January 1, 2013.

Staff continues to believe that the recommended revisions to the market risk capital rule would serve the important goals of enhancing capital requirements for banking organizations' trading positions to better reflect the risks of these positions (both to individual banking organizations and the banking system as a whole) and addressing shortcomings in banking organizations' internal models. While the Board and the other agencies continue to work with the BCBS to improve the Basel market risk framework, staff believes it is important to implement the recommended provisions to bring the Board's market risk capital rule into alignment with current international standards and address requirements under the Dodd-Frank Act.

DISCUSSION:

1. Overview of the draft final rule

A. Scope of application and covered positions

Consistent with the proposal and the current market risk capital rule, the draft final rule applies to any banking organization with aggregate trading assets and trading liabilities equal to or greater than either 10 percent of total assets, or $1 billion. These banking organizations would

[10] An overview of comments on the January NPR and the December amendment is provided in Appendix I.

be required to calculate a market risk capital requirement for foreign exchange and commodities positions and trading assets and liabilities subject to the draft final rule (covered positions).

Consistent with the January NPR, the draft final rule modifies the definition of a covered position to ensure that certain less liquid and difficult-to-value positions, and positions not held with the ability to trade (other than hedges of positions that qualify as covered positions), are subject to capital requirements under the credit risk-based capital rules rather than the market risk capital rule. These changes address some prior capital arbitrage practices whereby banking organizations included relatively illiquid assets in their trading accounts in order to apply a lower capital requirement under the models-based approach of the market risk capital rule. One of the criteria in the definition of covered position is that the banking organization must be able to hedge the material risk elements of the position in a two-way market. In response to comments regarding the definition of two-way market, staff recommends adopting a modified definition in the final rule that would provide more flexibility to account for variations in market settlement practices. (See pp. 15-27 of the draft *Federal Register* notice.)

Several commenters also expressed concern about the proposed requirement to consider future administrative costs in the valuation of a covered position, noting the difficulty and arbitrary nature of calculating such an estimate. Staff agrees that this calculation could be unduly burdensome and, accordingly, the draft final rule does not include this requirement. (See p. 29 of the draft *Federal Register* notice.)

B. VaR- and stressed VaR-based measures

Under the draft final rule, consistent with the January NPR, a banking organization must use internal models to calculate a daily value-at-risk (VaR)-based measure that reflects market risk for all covered positions.[11] The VaR-based measure may include specific risk for debt or equity positions if the banking organization's specific risk models meet certain requirements.[12]

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[11] The VaR-based measure uses a 10-business day, one-tail, 99.0 percentile confidence level soundness standard.

[12] Under the draft final rule, general market risk refers to the risk of loss that could result from broad market movements, such as changes in the general level of interest rates, credit spreads, equity prices, foreign exchanges rates, or commodity prices. Specific risk refers to the risk of loss on a position that could result from factors other than broad market movements and includes event risk, default risk, and idiosyncratic risk. If a banking organization does not meet the

The draft final rule also includes the stressed VaR-based measure proposed in the January NPR. This measure is designed to mitigate the procyclicality of a VaR-based capital requirement by adjusting the market risk capital calculations using model inputs calibrated to reflect a period of significant financial stress appropriate to the banking organization's current portfolio. Under the draft final rule, a banking organization must have policies and procedures that describe how it determines the relevant period of significant financial stress and must provide empirical support for the period used.

The draft final rule includes the proposed requirements from the January NPR that a banking organization integrate its internal models into its risk management process and that its models be commensurate with the complexity and size of its covered positions. It also includes the proposed requirement that a banking organization constantly monitor and evaluate the validity of its model. The banking organization must compare model results with actual outcomes and retain sufficient information to allow for appropriate assessment of the quality of its VaR-based model, including through backtesting and adjustment of the VaR- and stressed VaR-based measures based on the backtesting results.

Commenters expressed concern about having sufficient historical data to accommodate the proposed changes for calculating trading losses for backtesting purposes and requested additional time to come into compliance with this requirement. In response, the draft final rule allows a banking organization up to one year from the later of the rule's effective date of January 1, 2013, or the date on which a banking organization becomes subject to the rule to meet the new backtesting requirement. (See p. 39 of the draft *Federal Register* notice.)

C. Incremental risk measure

The draft final rule includes the proposed requirement that a banking organization using an internal model to measure the specific risk of a portfolio of debt positions calculate an incremental risk measure to address risks not adequately captured in the VaR-based measure.[13]

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modeling requirements for specific risk, the banking organization must measure specific risk according to a standardized method as discussed below.

[13] With approval and subject to certain conditions, a banking organization may include equity positions in its incremental risk model.

Incremental risk includes a position's default risk and credit migration risk (price risk arising from significant changes in underlying credit quality).

Commenters expressed concern that the incremental risk measure's proposed liquidity horizon of the lower of three months or the contractual maturity of the position would be excessively long for certain highly liquid exposures. A three-month horizon is the minimum standard established by the BCBS for exposures with longer or no contractual maturities. Staff believes that it is important to establish a minimum default liquidity horizon to address risks associated with stressed market conditions. For these reasons, staff recommends adopting this requirement as proposed. (See p. 94 of the draft *Federal Register* notice.)

D. Standardized method for specific risk capital requirements

Consistent with the Basel capital framework, the January NPR, and the December amendment, the draft final rule would require the use of the standardized method to calculate specific risk capital requirements for debt positions for which a banking organization does not model specific risk, and for all securitization positions, with the exception of certain positions that are "correlation trading positions."[14] The specific risk capital requirements would be calculated using alternative standards of creditworthiness that do not reference credit ratings. The agencies received extensive comments on these alternatives that are discussed in detail in the following section.

E. Alternative standards of creditworthiness for standardized specific risk

Sovereign debt positions

In the December amendment, the agencies proposed to require banking organizations to generally determine the standardized specific risk capital requirement for sovereign debt positions based on the country risk classifications (CRCs) published regularly by the Organization for Economic Cooperation and Development (OECD). The CRCs are an analysis of the likelihood that a sovereign entity will service its external debt. In connection with this approach, the agencies proposed that positions that are exposures to the U.S. government and its agencies would be deemed to have the CRC that results in a standardized specific risk capital

[14] Correlation trading positions are tranched credit products with corporate debt positions as the underlying assets.

requirement of zero. In addition, the agencies proposed to apply a higher specific risk-weighting factor that is similar to a 150 percent risk weight to a sovereign position in the event the sovereign has defaulted during the previous five years, including through a voluntary or involuntary debt restructuring. The agencies also solicited comments on the use of market-based methodologies (including credit default swap and bond spreads) to supplement the use of CRC ratings.

Several commenters questioned the accuracy and objectivity of the OECD in evaluating relative sovereign risk and asserted that there is a lack of transparency around the CRCs. Some commenters also suggested that the agencies adopt market-based methodologies using credit default swaps or bond spreads.

Staff recommends that the Board adopt the CRC-based methodology and default adjustment as proposed and incorporated in the draft final rule. While lacking some risk sensitivity, this methodology provides greater risk differentiation than the current market risk capital rule treatment, and the draft final rule also includes a more appropriate treatment for sovereign defaults. Furthermore, staff notes that CRCs are recognized by the BCBS as an alternative methodology to credit ratings for this purpose. Staff does not recommend adopting alternative market-based methodologies at this time, as further study is needed to determine whether such methodologies would be feasible and result in appropriate market risk capital requirements. (See pp. 62-63 of the draft *Federal Register* notice.)

Public sector entity, depository institution, foreign bank, and credit union debt positions

For a debt position that is an exposure to a public sector entity (PSE), depository institution, foreign bank, or credit union, under the draft final rule, consistent with the December amendment, a banking organization generally would be required to calculate the standardized specific risk capital requirement using the CRC of the entity's sovereign of incorporation and the remaining contractual maturity of the position. The specific risk capital requirement applied to these positions would be one step higher than that applied to the entity's sovereign of incorporation. Accordingly, positions that are long-term exposures to U.S. PSEs and U.S. depository institutions would receive a maximum standardized specific risk-weighting factor that is similar to a risk weight of 20 percent under the credit risk-based capital rules, because of the relative risk associated with these exposures as compared to other exposure categories. Shorter-

term exposures to these entities would receive lower standardized specific risk capital requirements. This treatment is consistent with the agencies current treatment of long-term exposures to PSEs and depository institutions.

The standardized specific risk capital requirements for exposures to foreign PSEs and foreign banks would vary, depending on the CRC of their sovereign of incorporation. This approach differs from agencies' current treatment of exposures to foreign PSEs and foreign banks, which is based on whether the entity's sovereign of incorporation is an OECD member.

Some commenters expressed concern that the CRC-based methodologies would not allow for meaningful risk differentiation among depository institutions or PSEs in a given sovereign of incorporation. Although there is a lack of risk differentiation among these entities in a given sovereign of incorporation, this approach allows for a consistent, standardized application of capital requirements to these positions and, like the Basel capital framework and the current market risk capital rule, links the ultimate credit risk associated with these entities to that of the sovereign entity. In contrast to the current treatment, however, the CRC-based methodologies allow for greater differentiation of risk among exposures. Also, as discussed above, any market-based methodologies for depository institutions or PSEs would require further study to determine if they would be feasible for this purpose. Therefore, staff recommends implementing the CRC-based methodologies as proposed. (See pp. 67-70 of the draft *Federal Register* notice.)

Corporate debt positions

The December amendment proposed a methodology using several financial and market indicators for assigning standardized specific risk capital requirements to debt positions that are exposures to a publicly-traded non-financial corporation. The proposal also would have applied a standardized specific risk weighting factor that is similar to a risk weight of 100 percent under the credit risk-based capital rules, to exposures to financial institutions other than depository institutions, and non-publicly traded companies. Alternatively, the proposal would have allowed banking organizations to apply a standardized specific risk weighting factor that is similar to a risk weight of 100 percent to all corporate debt positions.

The agencies received significant negative comment on the proposed indicator-based methodology. Commenters expressed concern that the approach was punitive, would not apply to financial institutions, lacked risk sensitivity, would be pro-cyclical, was overly simplistic in

focusing on only three indicators, and would not recognize significant financial ratio variances among different industries. Staff shares commenters' concerns regarding this approach and also believes that there could be significant difficulties in implementing it. Therefore, staff recommends that the Board not adopt the indicator-based approach. (See pp. 70-74 of the draft *Federal Register* notice.)

The agencies solicited comment on alternatives to this approach, including using a qualitative assessment of whether or not an exposure is "investment grade," consistent with the standard recently proposed by the Office of the Comptroller of the Currency (OCC).[15] A position was proposed to be investment grade if the banking organization determines the counterparty to the transaction has adequate capacity to meet financial commitments for the projected life of the asset or exposure, that risk of default is low, and full and timely repayment of principal and interest is expected. Under the investment grade methodology, a banking organization would assign a standardized specific risk-weighting factor to all corporate debt positions of entities that have issued and outstanding publicly traded instruments, based on whether the position is investment grade or not, and for an investment grade position its remaining contractual maturity. A specific risk-weighting factor that is similar to a 100 percent risk weight would be assigned to corporate debt positions of entities that do not have issued and outstanding publicly traded instruments.

Commenters expressed mixed views on the alternative investment grade approach. Some commenters noted that the approach would be relatively simple to implement and would incorporate methodologies many banking organizations would be using to meet the requirements for investing in securities under the OCC's proposed rule. A few commenters expressed concern that the approach involves a high degree of subjective evaluation, and may not be applied uniformly by banking organizations or supervisors.

Staff shares some of these concerns, but believes that on balance, the investment grade methodology would allow banking organizations to calculate a more risk sensitive specific risk capital requirement for corporate debt positions, including those that are exposures to non-depository financial institutions. Staff observes that this approach should be straightforward to

[15] *See* 76 *Federal Register* 73526 (Nov. 29, 2011).

implement because many depository institutions would already be required to make similar investment grade determinations based on the OCC's revised investment permissibility standards. In addition, staff believes that concerns regarding potential disparate treatment would be addressed through ongoing supervision of banking organizations' credit risk assessment practices. Accordingly, staff recommends that the Board adopt the investment grade approach in the draft final rule, which requires banking organizations to apply the investment grade alternative approach to corporate debt positions that are exposures to entities that have issued and outstanding publicly traded instruments. (See pp. 71-76 of the draft *Federal Register* notice.)

Securitization positions

In the December amendment, the agencies proposed a methodology for calculating the standardized specific risk capital requirements for securitization positions. This methodology is a simplified version of the supervisory formula approach (SFA) in the agencies' advanced approaches rule. The simplified SFA (SSFA) is designed to apply higher capital requirements to more junior (and more risky) tranches of a securitization and lower requirements to the most senior (and less risky) positions. As proposed, a banking organization would need certain basic information on the securitization to use the SSFA, including the weighted-average capital requirement under the general risk-based capital rule for the underlying exposures (base capital requirement), the relative level of subordination and size of the position within the securitization, and the amount of realized losses on the underlying assets of the securitization.[16] The December amendment also proposed a "flexible floor" as part of the SSFA, which would raise capital requirements on securitization positions in response to increased cumulative losses on the underlying assets of a securitization.

Many commenters expressed concern that the SSFA methodology would provide insufficient risk differentiation among securitization exposures and would result in excessive capital requirements. Commenters stated that using the base capital requirement for the SSFA lacks risk sensitivity. Several commenters also criticized the flexible floor. Some of these commenters recommended an alternative methodology that adjusts the base capital requirement of the SSFA to reflect delinquencies on the underlying assets.

[16] 12 CFR parts 208 and 225, appendix A.

In view of comments on the proposed methodology, staff recommends that the Board adopt certain changes to the SSFA as reflected in the draft final rule. These changes are intended to be responsive to the most fundamental issues identified in the comments. The draft final rule replaces the proposed "flexible floor" of the SSFA with a revised formula that takes into account significant delinquencies on underlying assets, adjusting upward or downward from the base capital requirement as delinquencies increase or decrease, respectively. Under the final rule, the base capital requirement for the underlying exposures may never be lower than the weighted-average capital requirement of the underlying exposures under the general risk-based capital rule.

Staff recommends that the Board adopt these revisions to the SSFA. The revised formula increases the methodology's risk sensitivity, because it requires that more capital be held against junior tranches relative to senior tranches, even as the credit quality of the underlying assets declines. In addition, the revised formula is more forward-looking, as it adjusts SSFA capital levels using delinquencies instead of losses on the underlying assets. The draft final rule would continue to rely on the agencies' general risk-based capital rule to calculate the base capital requirement, which would adjust automatically to reflect any future changes to the agencies' general risk-based capital rule. (See pp. 76-86 of the draft *Federal Register* notice.)

In the December amendment, the agencies solicited comment on whether banking organizations using the market risk capital rule that are also subject to the advanced approaches rule should be allowed to use the advanced approaches rule's SFA to calculate specific risk-weighting factors for securitization positions. Because banking organizations using the SFA under the draft final rule would already have had to meet the standards for calculating capital requirements using the SFA under the advanced approaches rule, staff recommends this modification to the proposal and believes it would be appropriate for banking organizations that already use the SFA.

As defined in the January NPR, a securitization position would include nth-to-default credit derivatives, which provide credit protection only for the first or subsequent (nth) defaulting reference exposure in a group of reference exposures. The Basel capital framework includes a distinct treatment for these positions that does not involve ratings because such positions are typically unrated. The January NPR included this approach; however, staff does

not believe that such a distinct approach would be necessary for nth-to-default derivatives, because they could be assigned specific risk capital requirements using the other methodologies for securitization exposures described above. To simplify the overall framework for securitizations and provide a more uniform treatment for determining the standardized specific risk capital requirements for all securitization positions, the draft final rule incorporates conforming changes for nth-to-default credit derivatives to align their treatment with that applicable to other securitization positions. This treatment should reduce the complexity of calculating specific risk capital requirements across a banking organization's securitization positions, while aligning these requirements with the market risk of the positions in a consistent manner. (See pp. 86-88 of the draft *Federal Register* notice.)

F. Comprehensive risk measure

Consistent with the January NPR, the draft final rule permits a banking organization to measure all material price risks using a comprehensive risk model for securitization positions that are correlation trading positions. To address prudential challenges regarding sole reliance on a banking organization's comprehensive risk model, the January NPR also proposed a 15 percent capital surcharge in addition to the modeled capital requirement, which would apply until the banking organization's comprehensive risk model has been approved by its primary federal supervisor and the banking organization has met relevant requirements of the draft final rule for at least one year.

Several commenters criticized the interim surcharge and recommended that the agencies adopt only the 8 percent floor contained in the Basel capital framework. These commenters asserted that the surcharge is excessive, risk insensitive, inconsistent with the customary practice of phasing in capital requirements, and could eliminate a banking organization's incentive to hedge its risk. Notwithstanding these concerns, many banking organizations continue to have a limited ability to perform robust validation of their comprehensive risk model using standard backtesting methods. Staff continues to believe it is appropriate to include some surcharge as an interim prudential measure until banking organizations have an improved ability to validate their comprehensive risk models, and as an incentive for a banking organization to make ongoing model improvements. Accordingly, staff recommends that the Board maintain a surcharge in the rule, but at a lower level of 8 percent. Staff believes that a surcharge at this level would help to

strike a balance between the concerns raised by commenters regarding the proposed 15 percent surcharge, and concerns about current deficiencies in comprehensive risk models mentioned above.

Under the draft final rule, once a banking organization has received approval and met all other requirements, it would be permitted to use the floor approach, where capital requirements are the greater of either the capital calculated using the comprehensive risk model, or 8 percent of the total standardized specific risk capital requirement for correlation trading positions. (See pp. 97-100 of the draft *Federal Register* notice.)

G. Enhanced disclosure requirements

The draft final rule adopts the quantitative and qualitative disclosures proposed in the January NPR, which align with the Basel capital framework 2009 revisions. These disclosure requirements are designed to increase transparency and improve market discipline on the top-tier legal entity that is subject to the rule. Mandatory disclosures cover components of a banking organization's market risk capital requirement, modeling approaches, and qualitative and quantitative disclosures relating to securitization activities. Several commenters expressed concerns about a proposed requirement to disclose the median value for various risk measures, exceeding those required under the BCBS enhancement to their international capital standards. Upon consideration of such concerns, staff agrees with commenters, and the draft final rule does not include this requirement.

Commenters also raised concerns that the required disclosures could force a banking organization to release proprietary information, such as information about stress scenarios. The draft final rule, like the proposed rule, would allow a banking organization to withhold from disclosure any information that is proprietary or confidential if the banking organization believes that disclosure of the information would seriously prejudice its position. Instead, the banking organization must disclose more general information about the subject matter of the requirement, together with the fact that, and the reason why, the specific items of information that have not been disclosed. In interpreting this requirement, staff recommends that the Board work with banking organizations on a case-by-case basis to address any questions about the types of more general information that would satisfy the rule. For these reasons, staff also recommends that the Board adopt the disclosure requirements as proposed, except for the proposed requirement to

disclose the median value for various risk measures. (See pp. 103-108 of the draft *Federal Register* notice.)

H. Other comments

Some commenters asserted that the proposed VaR-based, stressed VaR-based, and incremental risk measures would result in duplicative capital requirements overall. Commenters encouraged the agencies to complete the fundamental review of the market risk framework currently underway through the Basel Committee on Banking Supervision (BCBS) before revising the current market risk capital rule.

Certain provisions in the draft final rule may result in capital requirements that account for the same set of risks, such as the requirement for both a VaR- and a stressed VaR-based measure. However, staff believes the provisions provide a prudent level of conservatism to address factors such as modeling uncertainties, and does not recommend adjustments to the draft final rule to attempt to address concerns about overlapping capital requirements.[17] Staff believes that continued improvement of the market risk framework through work on the BCBS's fundamental review is important, but also that the changes to the market risk capital rule outlined above are necessary to address significant shortcomings in banking organizations' measurement and capitalization of market risk.

Several commenters asserted that the capital requirement for a given covered position should not exceed the maximum loss a banking organization could incur on that position. To address commenter concerns, the draft final rule clarifies the calculation of maximum specific risk capital requirement for individual debt or securitization positions that are purchased or sold credit protection.

2. Delegated authority

Staff recommends that the draft final rule include a delegation of certain model approval and supervision authority to the appropriate Reserve Bank, with the concurrence of the Board. Staff also recommends that the Board delegate authority under the rule to act (including concurrence or nonconcurrence with the appropriate Reserve Bank, where appropriate) to the

[17] Staff notes that the Basel capital framework does not allow for adjustments to address potential duplication in capital requirements.

Director or his or her designee, except for the authority under section 1 of the rule to apply it to a banking organization not subject to the rule and to exclude a banking organization subject to the rule from application of the rule. The draft final rule includes a reservation of authority in section 2 under which the Board may require a banking organization subject to the rule to (1) hold an additional amount of capital in the aggregate, (2) assign a different risk-based capital requirement to one or more positions or portfolios or covered positions, and (3) calculate the risk-based capital requirement for specific positions or portfolios subject to the rule under the advanced approaches rule or the general risk-based capital rule. Staff recommends that, in exercising delegated authority under section 2 of the rule, the Director consult with the General Counsel. Appendix II provides a detailed list of proposed delegations to the Director. The proposed delegations to the appropriate Reserve Bank are embedded in the draft final rule.

RECOMMENDATIONS: For the reasons discussed above, staff recommends that the Board adopt the attached draft final rule. Staff also recommends that the Board delegate authority to the Director of BS&R or his or her designee to act (including concurrence or nonconcurrence with the appropriate Reserve Bank, where appropriate) under the final rule. Finally, staff recommends the Board delegate to staff the authority to make technical and minor changes to the attached materials prior to publication in the *Federal Register*, such as to respond to comments from the *Federal Register*, or to incorporate changes requested by other federal banking agencies as part of the approval process. Staff proposes to discuss any material changes with the Chairman of the Committee on Bank Supervision to determine whether additional action by the Board is required or appropriate.

Attachments

APPENDIX I

Overview of Comments on the January NPR

The Board received six comment letters on the January NPR. Commenters included financial trade associations, financial institutions, and public advocacy groups.

General comments:

Commenters expressed general support for the proposed revisions, but many noted that the BCBS's market risk framework required further improvement in certain areas, and some encouraged the agencies to continue work on the fundamental review of the market risk framework currently underway through the BCBS.

Some commenters expressed concerns about duplications in capital requirements and other short-comings of the proposed capital regime, asserting that the duplicative requirements would result in distortions in risk management at banking organizations. Examples given of duplicative capital requirements included the requirement for both a VaR-based measure and a stressed VaR-based measure; and the comprehensive risk measure being duplicative of the VaR-based measure, stressed VaR-based measure, and the modeled specific risk calculations.

Commenters also expressed concern that the proposed rule differs from revisions to the BCBS Enhancements, and such differences could pose a competitive disadvantage for U.S. banking organizations relative to their counterparts in other jurisdictions. Examples given of such differences included excluding covered positions a hedge that is not within the scope of the banking organization's hedging strategy, providing a more restrictive definition of two-way market, and including a surcharge for modeled correlation trading positions equal to 15 percent of the specific risk capital requirements for such positions.

Technical issues:

- Commenters asked numerous specific questions regarding what should be considered covered positions, in order to fully determine the extent of positions subject to the draft final rule. For instance, whether a position required a two-way market for it be a covered position, concern that the requirement for settlement within five business days would exclude a number of markets as covered positions, and a question whether positions held as available-for-sale would be considered covered positions.
- Commenters suggested that certain hedges should qualify as covered positions, as exclusion of such hedges from market risk capital requirements could incent banking organizations to allow certain positions to remain unhedged. For instance, commenters suggested allowing a hedge to be treated as a covered position though it is outside of the banking organization's hedging strategy.
- Commenters expressed concern that they would not have sufficient data to calculate trading loss net of certain excluded components and asked for more time to come into compliance with the draft final rule.
- Commenters asked for flexibility to organize significant sub-portfolios as part of the sub-portfolio backtesting exercise, as such groupings can be subjective and subject to change in response to revisions in trading strategy. Commenters also urged agencies to be sensitive to various operational challenges associated with meeting sub-portfolio back-

testing requirements, which could be caused by changes in business lines or model enhancements.

- As the term "event risk" was not entirely clear to some commenters, they asked for guidance or examples regarding the types of events captured by the definition of event risk.
- Commenters requested the agencies to clarify in the draft final rule that capital requirements for a position should not exceed the maximum loss a banking organization could incur on that position, as it is not reasonable for a banking organization to hold capital in excess of that amount.
- Commenters had several questions and comments regarding whether certain credit derivative hedges of debt and securitization positions qualify for exact match treatment. For instance, commenters noted that credit derivatives are traded on market conventions based on standard maturity dates, whereas debt or securitization instruments may not be traded on market conventions based on standard maturity dates. Therefore, the draft final rule should allow some difference in such maturity dates in such circumstances.
- Commenters criticized the interim surcharge as excessive compared to the 2009 revisions, not risk sensitive, and could eliminate the incentive to hedge risk in some circumstances. Accordingly, one commenter recommended immediate adoption of the floor instead.
- Several commenters expressed concerns that certain disclosure requirements exceeded those in the 2009 BCBS enhancements, and had questions regarding certain disclosures.

Overview of Comments on the December Amendment:

The Board received 30 comment letters on the December amendment. In addition, certain commenters met with Board staff to discuss the proposed changes. Commenters included collective trade associations, financial institutions, and organizations providing financial market services, and individuals.

General comments:

Most commenters generally did not support the December amendment, noting that the alternatives are not risk sensitive, do not strike a reasonable balance between accurate measurement of risk and implementation burden, and requested the agencies conduct further analysis regarding the impact of this proposal. Application of these alternatives would result in significantly increased capital levels, which exceeds the intent of the Dodd-Frank Act and will result in adverse economic impact. The alternatives could be especially burdensome for community banking organizations if they are eventually incorporated into the general risk-based capital rule.

Sovereign Debt Positions:

Regarding the proposed CRC-based methodology, commenters expressed concern that CRCs may not accurately reflect sovereign risk as they are not specifically designed for this purpose. Further, CRCs do not allow for risk differentiation between OECD members designated as high income countries. Some expressed concern that the OECD is not independent and that the CRC rating process lacks transparency. For positions that are exposures to PSEs and depository institutions, specific risk capital requirements would be based on their sovereign of

incorporation. Several commenters expressed concern that the CRC-based methodology does not recognize differences in relative risk between individual depository institutions or PSEs under a given sovereign CRC.

Corporate Debt Positions:

Commenters expressed significant reservations about the proposed three-indicator methodology for publicly-traded corporate debt positions. Commenters indicated that the methodology is not risk sensitive and that it would result in the vast majority of investment-grade positions being treated as if they were non-investment grade. Others expressed a concern that a banking organization in another jurisdiction that uses the MRA's ratings-based approach would only be required to hold 20 percent of the capital required under the proposed approach. Others indicated that using only three indicators would ignore other valid measures of creditworthiness.

Commenters generally supported market-based solutions using bonds or CDS spreads, but also acknowledged the challenges associated with implementing such approaches. Regarding the investment grade alternative, one commenter acknowledged that while the approach would be simpler, this approach would be subjective and could result in different banking organizations arriving at different assessments of creditworthiness for similar exposures. Another commenter supported this approach as long as such an approach could be done in an equitable and non-burdensome manner.

Securitization Positions:

Several commenters stated that the short-comings of the SSFA methodology result in significant and unwarranted capital increases with several broad consequences. Commenters expressed the opinion that the SSFA calculation results in a much higher capital requirement for the collective tranches of a securitization, versus simply holding the underlying assets on the balance sheet. Higher capital required by the SSFA would constrict available credit, resulting in subdued economic activity, particularly the already weakened real estate sector. The SSFA effectively puts securitizations in a market risk category equivalent to the highest risk securities.

Commenters noted several perceived flaws in the SSFA that cause it to be risk insensitive and results in punitive capital requirements in many circumstances. Commenters expressed concern that the standardized capital requirement for underlying assets (or K_G) is risk insensitive, because it only distinguishes between mortgages and all other assets. The flexible floor approach results in higher capital requirements with relatively low losses. Cumulative loss should be defined using losses on the positions of the securitization and not on underlying assets, to allow recognition of the securitization's structural features. For calculation of K_G, delinquencies should replace realized losses (a lagging indicator). The SSFA does not recognize write-downs or acquisition discounts, which result in holding significantly more capital than is reasonable on positions.

Commenters did not support use of a credit spread-based measure, but did express strong support for allowing use of the SFA, which is permitted under the advanced approaches rule, especially for correlation trading positions.

APPENDIX II

Delegations of Authority

(A) In consultation with the General Counsel, the authority for the Director of the Division of Bank Supervision and Regulation (Director) to require a banking organization to:

(1) Hold an amount of capital greater than otherwise required under this appendix upon a determination that the banking organization's capital requirement for market risk as calculated under the rule is not commensurate with the market risk of the banking organization's covered positions under section 1(c)(1) of the rule;

(2) Assign a different risk-based capital requirement to one or more covered positions or portfolios that more accurately reflects the risk of the positions or portfolios under section 1(c)(2) of the rule; and

(3) Calculate risk-based capital requirements for specific positions or portfolios under this appendix, or under the Board's advanced capital adequacy framework or general risk-based capital rules, as appropriate, to more accurately reflect the risks of the positions under section 1(c)(3) of the rule.

(B) The authority for the Director, or his or her designee, to act (including concurrence or nonconcurrence with the appropriate Reserve Bank, where appropriate) regarding whether to:

(1) Exclude from trading assets or liabilities structural foreign currency positions of a banking organization or any hedge of a covered position that is outside the scope of the banking organization's hedging strategy under section 2 of the rule;

(2) Approve under section 3(c)(1) of the rule a banking organization's internal model(s) to calculate its risk-based capital requirement;

(3) Rescind under section 3(c)(3) of the rule approval of a banking organization's internal model(s) to calculate its risk-based capital requirement;

(4) Establish under section 3(c)(4) of the rule standards for model approval;

(5) Approve under section 4(a)(2)(vi)(B) of the rule a banking organization's use of alternative techniques to measure the risk of de minimis exposures;

(6) Establish supervisory expectations for backtesting in connection with section 4(b) of the rule;

(7) Require a banking organization to use a different adjustment of its VaR-based measure under section 4(b)(2) of the rule;

(8) Review the appropriateness of a banking organization's omission of risk factors under section 5(a)(4) of the rule and the use of proxies under section 5(a)(5) of the rule;

(9) Review the appropriateness of any conversions of VaR to other holding periods by a banking organization under section 5(b)(1) of the rule;

(10) Review the appropriateness of a banking organization's alternative weighting schemes under section 5(b)(2)(ii) of the rule;

(11) Approve any requirements relating to a banking organization's division of subportfolios under section 5(c) of the rule;

(12) Approve any changes to a banking organization's policies and procedures that describe how the banking organization determines the period of significant financial stress used to calculate its stressed VaR-based measure under section 6(b)(3) of the rule;

(13) Require a banking organization to use a different period of significant financial stress in the calculation of the stressed VaR-based measure in connection with section 6(b)(4) of the rule;

(14) Approve a banking organization to include certain portfolios of equity positions in its incremental risk model under section 8(a) of the rule;

(15) Approve a banking organization to use the comprehensive risk approach for one or more portfolios of correlation trading positions under section 9(a)(1) of the rule and the related approval under section 9(a)(2)(ii) of the rule regarding a banking organization's comprehensive risk capital requirement;

(16) Review the appropriateness of a banking organization's selection of an index under section 10(e)(3) of the rule; and

(17) Review the appropriateness of a banking organization's due diligence under section 10(f) of the rule.