New Market Risk Capital Rules Adopted

On June 7, 2012, the Federal Reserve Board (the "Board") adopted a joint final rule governing the calculation of capital requirements to cover market risk (the "Market Risk Rule").[1] The portion of the Market Risk Rule that relates to entities supervised by the Board will appear as Appendix E to Regulation Y. The Federal Deposit Insurance Corporation added its approval of the joint rule at a meeting of its Board on June 12, and the Office of the Comptroller of the Currency should publish its approval shortly. The purpose of the Market Risk Rule is to capture the capital risks associated with trading positions, in contradistinction to the capital risks associated with changes in the creditworthiness of assets held for other purposes. In part by the Market Risk Rule's use of the same definition for "trading position" as that contained in the proposed regulations for section 13 of the Bank Holding Company Act (the "Volcker Rule"), this kind of risk is the subject of more than one regulatory effort. Given the ways in which changes in the value of trading positions can affect a financial company, the various liquidity rules proposed by the Board[2] and by the Basel Committee on Banking Supervision[3] are, not surprisingly, another such effort. Achieving consistency and coherence among all these efforts will likely be an important and ongoing task. Since the banks and bank holding companies to which the Market Risk Rule applies will be subject to the Volcker Rule, which limits proprietary trading, the practical effects of the interaction between the Volcker Rule limits on trading and the requirements of the Market Risk Rule will also be worth observing.

The Market Risk Rule will apply, beginning January 1, 2013, to banks and bank holding companies with aggregate trading assets equal to the lesser of $1 billion or 10 percent or more of their quarter-end total assets. In addition to specifying what kinds of positions will be covered, the Market Risk Rule will subject the covered companies to two basically different kinds of standards, a computational standard and a governance standard. The computational standard sets out in detail the manner in which the necessary market risk capital is to be calculated and how much there must be, whereas the governance standard sets forth procedural standards for establishing, validating and changing the methods and models that are used in the calculations and for disclosing to the public various kinds of quantitative and qualitative information about the covered company's market risk capital requirements and exposures.

The trading accounts that are covered by the Market Risk Rule are called "covered positions." A "covered position" includes assets and liabilities "held ... for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits."[4] It includes trading positions that hedge other trading positions, and it must be the case that either (i) the position is freely tradable or (ii) the relevant company "is able to hedge the material risk elements of the position in a two-way market."[5] It also includes most foreign exchange and commodity positions,[6] but it

[1]Available at http://www.federalreserve.gov/aboutthefed/boardmeetings/market_risk_capital_final_FR_draft_20120607.pdf.
[2] Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, Federal Register Vol. 77, No. 3, Jan. 5, 2012, pp. 594-663.
[3] *See*, for example, Basel Committee on Banking Supervision, Basel III: International framework for liquidity risk measurement, standards and monitoring, available at http://www.bis.org/publ/bcbs188.htm.
[4] Market Risk Rule, p. 91, section 2 of the common rules, definition of "trading position."
[5] *Id*., p. 85, definition of "covered position."
[6] The foreign exchange and commodity positions would not necessarily be subject to the prohibition on proprietary trading contained in the Volcker Rule. Market Risk Rule, p. 15.

does not include intangible assets, hedges that the regulator finds to be outside the company's hedging strategy, positions that function as liquidity facilities for asset-backed commercial paper, credit derivatives serving as guarantees for other capital rules, equity positions that are not publicly traded (other than derivatives that reference publicly traded equities), positions held for securitization, or direct real estate holdings.[7] Despite the relative precision of these descriptions, the regulators retain, for purposes of safety and soundness, the right to apply the market risk capital requirements to institutions with covered positions that are smaller than those set out in the Market Risk Rule, to exclude any institution from the rule, to require more capital than would otherwise be required by the rule or to require the calculations to be carried out using a different method.[8] Furthermore, at various places in the adopting release, the regulators make clear that certain formulations in the final version of the Market Risk Rule were chosen to reduce the risk of regulatory arbitrage between the market risk capital requirements and the other risk-based capital rules.

The primary calculational requirement is that a bank or bank holding company "must use one or more internal models to calculate daily a [value-at-risk]-based measure of the general market risk of all covered positions."[9] At least weekly, these daily tests must be supplemented by the calculation of a stressed value-at-risk measure, which is intended to indicate the performance of the covered positions in a period of significant financial stress.[10] Separate calculations must be made of specific risk, which is defined as "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."[11] "Idiosyncratic risk," not surprisingly, refers to the "risk of loss in the value of a position that arises from changes in risk factors unique to that position."[12] If a company measures the specific risk of a portfolio of debt positions, it must also calculate an incremental risk amount weekly.[13] Special measures are available to calculate risk for correlation trading positions, which are securitization positions "for which all of the value of the underlying exposures is based on the credit quality of a single company for which a two-way market exists, or on commonly traded indices based on such exposures for which a two-market exists on the indices" as well as for non-securitization positions that hedge the kinds of positions just described.[14] The following positions are excluded from the definition of correlation trading position: resecuritizations, derivatives of securitization positions that do not provide a pro rata share in the proceeds of a tranche, and securitizations with underlying retail, residential mortgage or commercial mortgage exposures.[15] If the value-at-risk measure that is employed fails to "capture all material aspects of specific risk" or if the bank or bank holding company holds securitization positions that are not modeled under the correlation trading position rules, then a "specific risk add-on" must be calculated.[16] Calculating these add-ons involves the use of specific risk-weighting factors for sovereign debt, debt issued by US and non-US banks and US credit unions, general obligation and revenue obligation debt issued by public sector entities, and corporate debt. Special calculation methods are also provided for securitizations, certain credit derivatives and equities.

[7] *Id*., pp. 85-86.
[8] See Section 1 of the common rules.
[9] Section 5(a) of the common rules.
[10] Section 6 of the common rules.
[11] Market Risk Rule, p. 90.
[12] *Id*., p. 87.
[13] Section 8 of the common rules.
[14] Section 9 of the common rules.
[15] Definition of "correlation trading position" in Section 2 of the common rules.
[16] Section 10 of the common rules.

The governance requirements, which, as noted above, include procedures for creating, validating and maintaining models and methods, may in some respects be even more important than the calculations themselves. They require attention and commitment at multiple levels of an organization, not just at the level of mathematical or statistical expertise. For example, banks and bank holding companies that are subject to the Market Risk Rule must establish trading and hedging strategies for all of their trading positions, and these strategies must be approved by senior management. They must establish policies and procedures for monitoring, assessing and periodically reassessing the value of positions and the observance of positional limits. They must, among other things, develop models, review their models, obtain regulatory approval both before using any model and whenever they materially change it, ensure that the models adequately reflect their business, and integrate their models into the management of their business. A risk control unit must be established that is independent of the business trading units and must report directly to senior management.[17] The numerous public disclosure requirements also, in effect, subject both the risk information and the system that produces the information to scrutiny by people other than regulators. Since the Volcker Rule and other rules themselves impose similar governance conditions, it will be important for institutions to integrate all of the different requirements into a coherent system.

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[17] Section 3 of the common rules.