

Supporting Statement for the Risk-Based Capital Standards: Market Risk (FR 4201; OMB No. 7100-NEW)

Summary

The Board of Governors of the Federal Reserve System, under delegated authority from the Office of Management and Budget (OMB), proposes to implement the Risk-Based Capital Standards: Market Risk (FR 4201; OMB No. 7100-NEW). The Paperwork Reduction Act (PRA) classifies reporting, recordkeeping, or disclosure requirements of a regulation as an information collection.¹ This information collection would be included in proposed amendments to Regulations H and Y.

The Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) (the agencies) are issuing a joint notice of proposed rulemaking (NPR) to revise the market risk capital rule (MRR), which was effective January 1, 1997. These revisions are based on the June 2004 Basel Committee of Banking Supervision's (BCBS's) document *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (hereafter referred to as the *New Accord*). The new framework described in the NPR recognizes developments in financial products, incorporates advances in risk measurement and management practices, and imposes capital requirements that are generally more sensitive to risk. The Federal Deposit Insurance Act (FDI Act) and the International Lending Supervision Act of 1983 (ILSA) require the agencies to have risk-based capital requirements and to ensure that banks maintain adequate capital.

The NPR is intended to produce risk-based capital requirements that are more risk-sensitive, with respect to market risk, than the agencies' existing risk-based capital rules and require public disclosure of certain qualitative and quantitative information about a bank or bank holding company's (BHCs) market risk. The NPR would require banks or BHCs with significant aggregate trading assets and liabilities to (1) clearly define policies and procedures for determining which trading assets and liabilities are trading positions and for actively managing all covered positions, (2) clearly define a trading and hedging strategy for trading positions approved by senior management (3) include specific items in the institution's internal models, (4) obtain prior written approval to model incremental default risk, and (5) develop a formal disclosure policy approved by the board of directors that addresses the bank or BHC's approach for determining the market risk disclosures it makes. The Federal Reserve's total annual burden for this information collection is estimated to be 14,960 hours for the twenty-two financial institutions it supervises that would be subject to the NPR. There are no required reporting forms associated with this information collection.

¹ 44 U.S.C. § 3501 *et seq.*

Background and Justification

Section 1831(o) of the FDI Act requires each Federal banking agency to adopt a risk-based capital requirement, which is based on the prompt corrective action framework in that section. The ILSA, 12 U.S.C. § 3907(a)(1), mandates that each Federal banking agency require banks to achieve and maintain adequate capital by establishing minimum levels of capital or by other methods that the appropriate federal banking agency may deem appropriate. Section 908 of the ILSA, 12 U.S.C. §3907(b)(3)(C), also directs the Chairman of the Federal Reserve Board and the Secretary of the Treasury to encourage governments, central banks, and regulatory authorities of other major banking countries to work toward maintaining and, where appropriate, strengthening the capital bases of banking institutions involved in international lending.

Current U.S. risk-based capital requirements are based on an internationally agreed upon framework for capital measurement that was developed by the BCBS and endorsed by the central-bank governors of the Group of 10 (G-10) Countries in 1988. This international framework (1988 Accord) accomplished several important objectives. It strengthened capital levels at large, internationally active banks and fostered international consistency and coordination. The 1988 Accord also reduced disincentives for banks to hold liquid, low-risk assets. Moreover, by requiring banks to hold capital against off-balance-sheet exposures, the 1988 Accord represented a significant step forward for regulatory capital measurement. Although the 1988 Accord has been a stabilizing force for the international banking system, the world financial system has become increasingly more complex over the past eighteen years. The BCBS has been working for several years to develop a new regulatory capital framework that recognizes new developments in financial products, incorporates advances in risk measurement and management practices, and more precisely assesses capital charges in relation to risk. On April 29, 2003, the BCBS released for public comment a document entitled, The New Basel Capital Accord (Proposed New Accord), that sets forth proposed revisions to the 1988 Accord.

In June 2004, the BCBS issued a final text of a revised regulatory capital framework for banks entitled, International Convergence of Capital Measurement and Capital Standards: A Revised Framework (New Accord), which was intended for use by individual countries as the basis for national consultation and implementation. For market risk, the New Accord generally retains the approach in the MRR. However, in releasing the New Accord, the BCBS announced that work would continue and that improvements to the MRR would be developed immediately, especially with respect to the treatment of specific risk. Given the interest of both banks and securities firms in this issue, the BCBS worked jointly with the International Organization of Securities Commissions (IOSCO) on this effort, which culminated in the July 2005 publication of The Application of Basel II to Trading Activities and the Treatment of Double Default Effects. The July 2005 publication is now incorporated in the New Accord and follows its three pillar structure. With respect to market risk, the Pillar 1 changes clarify the types of positions that are subject to the market risk capital framework and revise modeling standards; the Pillar 2 changes require banks to conduct internal assessments of their capital adequacy with respect to market risk, taking into account the output of their internal models, valuation adjustments, and stress tests; and the Pillar 3 changes require

banks to disclose quantitative and qualitative information on their valuation techniques for covered positions, the soundness standard they employ for modeling purposes, and the methodologies they use to make the internal capital adequacy assessment.

The current NPR recognizes developments in financial products, incorporates advances in risk measurement and management practices, and imposes capital requirements that are generally more sensitive to risk. The NPR seeks to build on improvements to risk assessment approaches that a number of large banks have adopted over the last decade. In particular, the NPR requires banks to assign risk parameters to exposures and provides specific risk-based capital formulas that would be used to transform these risk parameters into risk-based capital requirements. The collection of information contained in the NPR is necessary to ensure that the new risk-based regulatory capital framework is implemented in the United States in a safe and sound manner.

Description of Information Collection

The NPR would apply to any bank or BHC with aggregate trading assets and liabilities equal to 10 percent or more of total assets, or \$1 billion or more. The proposed revisions would apply to a bank or BHC meeting the market risk capital rule applicability threshold regardless of whether the institution would adopt the proposed advanced capital adequacy framework or remain under the general risk-based capital rule.

The Federal Reserve may apply the market risk capital rule to a bank or BHC that does not meet the threshold criteria if it deems it necessary or appropriate given the level of market risk of the bank or to ensure safe and sound banking practices. Also, a bank or BHC that does not meet the threshold criteria may request that its primary Federal supervisor apply the market risk capital rule to it. Finally, the Federal Reserve may also exclude a bank or BHC that meets the threshold criteria from the rule if appropriate based on the level of market risk of the bank or BHC and provided such exemption would be consistent with safe and sound banking practices.

The NPR requires respondents to (1) clearly define policies and procedures for determining which trading assets and liabilities are trading positions and for actively managing all covered positions, (2) clearly define a trading and hedging strategy for trading positions approved by senior management (3) include specific items in the institution's internal models, (4) obtain prior written approval to model incremental default risk, and (5) develop a formal disclosure policy approved by the board of directors that addresses the bank's approach for determining the market risk disclosures it makes. These requirements are described in Sections 3, 5, 6, and 8 of the NPR. Details of the requirements in each section are provided below.

Policies and Procedures (Section 3). Section 3(a)(1)(i) requires clearly defined policies and procedures for determining which trading assets and liabilities are trading positions. These policies and procedures must take into account the extent to which a position, or a hedge of its material risks, can be marked-to-market daily by reference to a two-way market and possible impairments to the liquidity of a position or its hedge.

Section 3(b)(1) requires clearly defined policies and procedures for actively managing all covered positions and specifies the minimum that they must require. At a minimum, these policies and procedures must require:

- (1) Marking positions to market or to model on a daily basis;
- (2) Daily assessment of the bank's ability to hedge position and portfolio risks, and of the extent of market liquidity;
- (3) Establishment and daily monitoring of limits on positions by a risk control unit independent of the trading business unit;
- (4) Daily monitoring by senior management of certain information;
- (5) At least annual reassessment of established limits on positions by senior management; and
- (6) At least annual assessments by qualified personnel of the quality of market inputs to the valuation process, the soundness of key assumptions, the reliability of parameter estimation in pricing models, and the stability and accuracy of model calibration under alternative market scenarios.

Trading and Hedging Strategy. Section 3(a)(2) requires a clearly defined trading and hedging strategy for trading positions approved by senior management. The trading strategy must articulate the expected holding period of, and the market risk associated with, each portfolio of trading positions. The trading strategy must also articulate whether the purpose of each portfolio of trading positions is to accommodate customer flow, to engage in proprietary trading, or to make a market in the positions. The hedging strategy must articulate for each portfolio the level of market risk the bank is willing to accept and must detail the instruments, techniques, and strategies the bank will use to hedge the risk of the portfolio.

Internal Models. Section 5(b)(1) requires either the use of internal models or the standard method set forth in section 7 to measure the specific risk of each of its portfolios of covered debt and equity positions. If a bank uses internal models to measure the specific risk of a portfolio of covered debt or equity positions, the internal models must:

- (1) Explain the historical price variation in the portfolio;
- (2) Be responsive to changes in market conditions;
- (3) Be robust to an adverse environment, including signaling rising risk in an adverse environment; and
- (4) Capture all material components of specific risk for the covered debt and equity positions in the portfolio, except as permitted under the transitional rule. Specifically, the internal models must:
 - (a) Capture default risk, event risk, and idiosyncratic variations, including, for debt positions, migration risk, and for equity positions, events that are reflected in large changes or jumps in prices;
 - (b) Capture material basis risks and demonstrate sensitivity to material idiosyncratic differences between positions that are similar but not identical; and
 - (c) Capture concentrations (magnitude and changes in composition) and demonstrate sensitivity to changes in portfolio composition or concentrations.

Prior Written Approvals (Section 6). Sections 6(a) and 6(b) require prior written approvals for models measuring incremental default risk. On and after January 1, 2010, a bank that models specific risk for one or more portfolios of covered debt or equity positions must use one of the methods in this section to measure the incremental default risk of those portfolios. With the prior written approval of the Federal Reserve, a bank may adjust its incremental default risk capital requirement to minimize double-counting of default risk. Also, with prior written approval of the Federal Reserve, a bank may use one or more internal models to measure its incremental default risk capital requirement.

Disclosure Policy (Section 8). Section 8(b) requires a formal disclosure policy approved by the board of directors that addresses the bank's approach for determining the market risk disclosures it makes. The bank must have a formal disclosure policy approved by the board of directors that addresses the bank's approach for determining the market risk disclosures it makes. The policy must address the associated internal controls and disclosure controls and procedures. The board of directors and senior management must ensure that appropriate verification of the disclosures takes place and that effective internal controls and disclosure controls and procedures are maintained. The chief financial officer of the bank must certify that the disclosures required by this section are appropriate, and the board of directors and senior management are responsible for establishing and maintaining an effective internal control structure over financial reporting, including the disclosures required by this section.

Time Schedule for Information Collection

This information collection contains both reporting and recordkeeping requirements, as mentioned above. The creation of policies and procedures, a trading and hedging strategy, internal models, and a disclosure policy are mandatory one-time requirements, with mandatory updates that are on-occasion. The prior written approvals are all on-occasion.

Sensitive Questions

This collection of information contains no questions of a sensitive nature, as defined by OMB guidelines.

Consultation Outside the Agency

The agencies participated with other members of the BCBS during the development of its Basel II final paper, which was issued in June 2004. Finally, the Federal Reserve has published the NPR for comment in the *Federal Register*.

Legal Status

The Board's Legal Division has determined that 12 U.S.C. 324 and 12 U.S.C. 1844 (c) authorize the Board to require the information collection. Under the Freedom of Information Act (FOIA), 5 U.S.C. 552, Board records generally must be disclosed unless they are determined to fall, in whole or in part, within the scope of one or more of the

FOIA exemptions from disclosure. See 5 U.S.C. § 552(b)(1)-(9). The exempt categories include, but are not limited to, “trade secrets and commercial or financial information obtained from a person and privileged or confidential”(exemption 4). A submitter of information to the Board may request confidential treatment for any portion of the information collected that the reporter believes is exempt from disclosure under FOIA. The submitter must follow the steps outlined in the Board’s Rules Regarding Availability of Information. See 12 CFR Part 261. Additionally, to the extent that such information may be contained in an examination report such information maybe also be withheld from the public. See 5 U.S.C. 552 (b)(8).

Estimate of Respondent Burden

The total annual burden for the FR 4201 is 14,960 hours, as shown in the table below. The Federal Reserve estimates that it will take each respondent 56 hours to create its policies and procedures, 16 hours to define its trading and hedging strategy, 88 hours to specify what the internal models must include, 480 hours to submit prior written approvals, and 40 hours to develop a disclosure policy. Most of the burden associated with this information collection will only occur during the first year of implementation or once a bank or BHC meets the qualification criteria. This burden represents less than 1 percent of the total Federal Reserve System paperwork burden.

	<i>Number of respondents</i>	<i>Estimated annual frequency</i>	<i>Estimated response time</i>	<i>Estimated annual burden hours</i>
Policies and Procedures	22	1	56 hours	1,232
Trading and Hedging Strategy	22	1	16 hours	352
Internal Models	22	1	88 hours	1,936
Prior Written Approvals	22	1	480 hours	10,560
Disclosure Policy	22	1	40 hours	880
<i>Total</i>				14,960

Based on a rate of \$100 per hour, the estimated cost to the public for this information collection is \$1,496,000.

Estimate of Cost to the Federal Reserve System

Estimates of cost to the Federal Reserve System will be obtained.