

## FINAL MARKET RISK CAPITAL RULE— YET MORE CAPITAL REQUIRED

August 2, 2012

To Our Clients and Friends:

At the same time that the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (the “OCC”) and the Federal Deposit Insurance Corporation released three much-publicized joint notices of proposed rulemaking (“Banking Book NPRs”)<sup>1</sup> that fundamentally reset the current U.S. credit risk capital framework for virtually all U.S. banking organizations, the staff of the same agencies and the Department of the Treasury submitted for approval a joint final rule largely replacing the market risk capital rules applicable only to the largest U.S. banking institutions (as detailed below). In general, the final rule implements enhancements to the international market risk framework made by the Basel Committee on Banking Supervision (the “Basel Committee”) since 2005, commonly called “Basel II.5,”<sup>2</sup> under the U.S. capital framework in a manner consistent with requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”).<sup>3</sup> The final rule is largely consistent with the joint proposed rule published in January, 2011 (the “January 2011 NPR”) and amendment published in December, 2011 (the “December 2011 NPR”), save for some important changes discussed in this client update.

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<sup>1</sup> The three Banking Book NPRs, which we refer to as the “Capital NPR,” the “Risk-weighted Assets NPR” or “RWA NPR” and the “Advanced Approaches NPR,” each available at <http://www.federalreserve.gov/aboutthefed/boardmeetings/20120607openmaterials.htm>, are discussed at length in our prior client update, “The New Capital Framework Proposals: Enhanced Burdens Across the Banking Industry,” (June 13, 2012), available at <http://www.debevoise.com/newsevents/pubs/publications/detail.aspx?id=427d0f40-fc86-4b99-9f6f-812327356bdc>

<sup>2</sup> Basel Committee and International Organization of Securities Commissions, *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects* (April 2005), available at <http://www.bis.org/publ/bcbs111.pdf>; Basel Committee, *Enhancements to the Basel II Framework* (July 2009), available at <http://www.bis.org/publ/bcbs157.pdf>; Basel Committee, *Revisions to the Basel II Market Risk Framework*, (July 2009), available at <http://www.bis.org/publ/bcbs158.pdf>; Basel Committee, *Guidelines for Computing Capital for Incremental Risk in the Trading Book* (July 2009), available at <http://www.bis.org/publ/bcbs159.pdf>; and Basel Committee, *Changes to the Revisions to the Basel II Market Risk Framework* (June 2010), available at <http://www.bis.org/press/p100618/annex.pdf>.

<sup>3</sup> Public Law 111-203, 124 Stat. 1376 (2010).

As noted in the Debevoise & Plimpton client update addressing the Banking Book NPRs, one general theme of banking regulation since the 2008 financial crisis has been to make more burdensome the regulatory capital framework to which banks are subject, in order to ensure that banks have sufficient capital to withstand any future crisis. The new market risk capital rules are no different in that their application will result in increased regulatory capital and other requirements on affected banking institutions. In general, the amendments to the market risk rules set forth in the final rule will impact banking organizations with significant trading activity in two major respects: First, the changes reduce the universe of assets that will constitute trading assets to which the market risk capital rules (historically less burdensome than the banking book capital rules) apply. Second, they reduce or eliminate many of the future benefits of holding assets in the trading book as compared to the banking book, through changes in treatment that effectively will increase the risk weights applicable to many types of assets. Collectively, the changes under these new market risk rules and those proposed under the Banking Book NPRs will materially increase bank capital requirements for affected institutions.

### **SCOPE AND APPLICABILITY**

The final market risk capital rules apply to any U.S. banking organization with a “significant trading book,” meaning the bank must have combined trading assets and liabilities (as reported in its most recent Call Report (or equivalent filing)) equal to at least \$1 billion, or 10 percent of its total assets (as reported on its most recent Call Report (or equivalent filing)) (a “Trading Book Bank”). Under the Advanced Approaches NPR, if adopted as proposed, the market risk capital rules would be extended to apply also to savings associations and savings and loan holding companies having the same level of significant trading activity as Trading Book Banks.

The market risk capital rules intersect with the banking book capital rules by providing a required alternative calculation of capital requirements for certain trading book assets held by Trading Book Banks. To calculate the denominator of its risk-based capital ratio, the market risk rules require a Trading Book Bank to do the following:

**“Adjusted risk-weighted assets.”** Calculate its general risk-weighted assets (and, if applicable, its “advanced approaches” risk-weighted assets (see below)), as required by the banking book capital rules, and make certain adjustments to, among other things, exclude the risk-weighted asset amounts for covered positions.

**“Measure for market risk.”** Calculate the general (and, if applicable, the advanced approaches) measure for market risk applicable to the bank’s covered positions following the market risk rules (see Table 2 and related text below for a summary of this calculation).

**“Market risk-equivalent assets.”** Multiply the general (and, if applicable, the advanced approaches) measure for market risk by 12.5 to get the relevant market risk-equivalent assets.

**Denominator calculation.** Add the general market risk-equivalent assets to its general adjusted risk-weighted assets to get the bank’s general risk-based capital denominator. If an Advanced Approaches Bank (see below), add the advanced approaches market risk-equivalent assets to its advanced approaches adjusted risk-weighted assets to get the bank’s advanced approaches risk-based capital denominator.

As indicated above, the Banking Book NPRs and the final market risk rule each contain two sets of approaches to calculating risk-based capital requirements:

- the “general” risk-based capital rules (applicable to all U.S. banking institutions subject to the relevant capital rules); and
- the “advanced approaches” (applicable only to U.S. banking institutions with \$250 billion or more of consolidated total assets or \$10 billion or more in consolidated total on-balance sheet foreign exposure—“Advanced Approaches Banks”).

Pursuant to the Collins Amendment (Section 171 of the Dodd-Frank Act) as implemented in the Banking Book NPRs, an Advanced Approaches Bank would be required to calculate its risk-based capital requirements under both the general capital rules and the advanced approaches, and use the higher of the two results as its minimum capital requirement. Table 2 below shows applicability of the different components of the market risk rule to Trading Book Banks subject to the general and advanced approaches.

The agencies have made it clear in their discussion of the final rule that they have made a concerted effort to achieve consistency as to the treatment of various financial instruments across all U.S. bank regulatory regimes, in particular between the banking book capital rules and the market risk capital rules. This would minimize confusion and uncertainty as banks and regulators seek to apply the rules; it would also, as the agencies often note, limit banks’ ability to engage in “regulatory arbitrage” by characterizing the same position differently across regulations in order to receive the most favorable treatment under each regulation.

The final rule will become effective on January 1, 2013. This is one year after the December 31, 2011 deadline for European Union member states to transpose the EU directive implementing Basel II.5. The United States also lags a number of other countries in its implementation of Basel II.5, including, among others, Switzerland, Japan, Australia, Hong Kong, South Africa,

Korea, Brazil and India, all of which have already completed implementation of the new framework in their national regulations.

### **“COVERED POSITIONS”: NARROWING THE UNIVERSE OF TRADING ASSETS TO WHICH THE MARKET RISK RULES APPLY**

The market risk rules are applicable to all Trading Book Bank assets that fall within the definition of a “covered position.” The term is described immediately below and the types of instruments that may comprise “covered positions” are set forth in Table 1 below.

**Covered Position.** In the current market risk capital rules, a “covered position” is defined as all positions in a Trading Book Bank’s trading account, as well as all foreign exchange and commodity positions no matter whether they are in the trading account.

In order to limit Trading Book Banks’ ability to apply lower capital charges under the market risk rules to illiquid positions in the trading book, the final rule narrows the types of assets that constitute “covered positions” in several ways. To be a covered position, a position must (in addition to being in the bank’s trading account (as reported in the bank’s regulatory filings):

- either be a “trading position” (as defined below) or hedge another covered position, and
- be free of any restrictive covenants on tradability or the bank must be able to hedge its material risk elements in a “two-way market” (as defined below).

Foreign exchange or commodity positions are still included in the definition of “covered position,” excluding structural positions that the bank chooses to exclude with regulatory approval.

**Trading Position.** The definition of “trading position” now provides that the Trading Book Bank must hold the position for the purpose of short-term resale, or otherwise with the intent to benefit from short-term price movements or arbitrage (in other words, a position’s location in the trading book is not enough if it is held without the intent to trade). Moreover, in order to “hedge another covered position,” the position must be within the scope of the bank’s hedging strategy, which the rules require to be clearly delineated.

**Two-way Markets.** Under the proposed rule, the “two-way market” required under second bullet above meant that a price can be determined within one day and the transaction can be settled within five days. In response to comments that such a short required settlement period was more restrictive than Basel II.5 requirements and would place U.S. Trading Book Banks at a

competitive disadvantage to their foreign counterparts, agencies amended the final rule to provide for “a relatively short time frame conforming to trade custom.”

**Covered Position Exclusions.** The final rule also expressly excludes a number of items from the definition of “covered position.” These include (i) the current rule’s exclusion of any asset-backed commercial paper liquidity facility and, additionally (ii) any intangible asset; (iii) a hedge of a trading position that is outside the scope of the bank’s hedging strategy; (iv) a credit derivative that the bank treats as a guarantee under the advanced capital adequacy framework or the general risk-based capital rules (e.g., a credit default swap); (v) any equity position that is not publicly traded, other than a derivative that references a publicly traded equity; (vi) any position held with the intent to securitize; and (vii) any direct real estate holding.

**Other Requirements/Qualifications.** Further changes to the rules regarding “covered positions” are consistent with other regulatory revisions under Dodd-Frank. For example, the final rule sets out enhanced requirements that a Trading Book Bank must have clearly defined policies and procedures for identifying its trading positions, as well as clearly defined policies and procedures related to trading and hedging strategies and management and valuation of covered positions. These enhancements reflect agencies’ concern that banks are appropriately armed with strong internal procedures to ensure stability in all markets.

**Volcker Rule Relationship.** The agencies have also clarified that the definition of “trading position” is identical to the definition under the Volcker Rule. This alignment seeks to prevent any potential “regulatory arbitrage” where a Trading Book Bank would count a position as a trading position under the market risk capital rules but not under the Volcker Rule. As a result, as a practical matter, the use of an affected bank of the trading book in the future may be even more limited (because of Volcker Rule proprietary trading limitations, which will be effective (subject to a conformance period) July 21) than the new, narrower definition of covered position unto itself would suggest.

The following table sets out the four general types of covered positions under the final rule.

**Table 1: Types of Covered Positions**

<p><b>Debt positions</b></p>	<ul style="list-style-type: none"> <li>• Value reacts primarily to changes in interest rates or credit spreads, and</li> <li>• Not a securitization position or correlation trading position</li> </ul>
<p><b>Equity positions</b></p>	<ul style="list-style-type: none"> <li>• Value reacts primarily to changes in equity prices, and</li> </ul>

	<ul style="list-style-type: none"> <li>• Not a securitization position or correlation trading position</li> </ul>
<b>Securitization positions</b>	<ul style="list-style-type: none"> <li>• On-balance sheet or off-balance sheet credit exposure arising from a securitization (including a resecuritization); or</li> <li>• An exposure that directly references a position described above</li> </ul>
<b>Correlation trading positions</b>	<ul style="list-style-type: none"> <li>• Securitization position for which value of the underlying exposures is based on credit quality of a single company for which a 2-way market exists, or on indices based on such exposures for which a 2-way market exists on indices; or</li> <li>• Not a securitization position but that hedges a position described above; and</li> <li>• Does NOT include: resecuritization position, derivative of securitization position that does not provide <i>pro rata</i> share of tranche proceeds, or securitization position referencing retail, residential mortgage or commercial mortgage exposures</li> </ul>

### **THE NEW MARKET RISK CAPITAL FRAMEWORK: REDUCING THE BENEFITS OF THE TRADING BOOK**

As of the January 1, 2013 effective date, not only will fewer positions constitute “covered positions” under the final market risk capital rules, but banks with active trading books also will receive reduced capital advantages from including the positions as market risk capital rather than as general banking book capital when calculating overall risk-based capital ratios. In this section we discuss some of the key changes to the components of the market risk measure that will impact Trading Book Banks’ capital ratios.

In general, the measure for market risk is calculated as the sum of: the VaR-based capital requirement, the stressed VaR-based capital requirement, specific risk add-ons, the incremental risk capital requirement, the comprehensive risk capital requirement, and the capital requirement for *de minimis* exposures. As discussed in Section I above, a Trading Book Bank that is also an Advanced Approaches Bank must calculate market risk under both the general measure and the advanced measure. The only potential difference between the components of each measure, however, is that under the general measure for market risk, a bank may not use the Basel II advanced approaches supervisory formula approach (“SFA”) for purposes of calculating the specific risk assigned to securitization positions. Instead, a bank only may use a simplified

version of the SFA developed by the agencies, dubbed the “SSFA,” or assign the securitization positions a risk weight of 100 percent for purposes of its general measure for market risk. (See **Standardized specific risk measurement methods: Securitization positions**, for further detail.)<sup>4</sup> Otherwise, the rules described in this Section III apply equally to all Trading Book Banks (whether or not an Advanced Approaches Bank).

All Trading Book Banks are required to calculate each of the following measurements (unless otherwise noted). A Trading Book Bank’s general measure for market risk or advanced measure for market risk, as applicable, is equal to the sum of items 1 through 6 (each of which is more fully detailed after the Table). The amount of the bank’s general or advanced market risk equivalent assets (*i.e.*, the amount to be added to the denominator of capital ratio calculations) is equal to the bank’s general or advanced measure for market risk, as applicable, multiplied by 12.5.

**Table 2: Components of General and Advanced Measures for Market Risk**

	<b>General Measure</b>	<b>Advanced Measure</b>
<b>1. VaR-based capital requirement</b> (internal models)	<ul style="list-style-type: none"> <li>• Calculated daily</li> <li>• Agency-approved internal models measure <b>general market risk</b> (described below) for <b>all covered positions</b> (and may also include certain term repo-style transactions provided consistent over time)                             <ul style="list-style-type: none"> <li>• Credit spread risk (new)</li> <li>• Interest rate risk</li> <li>• Equity price risk</li> <li>• Foreign exchange rate risk</li> <li>• Commodity price risk</li> </ul> </li> <li>• <b>May also reflect specific risk</b> (described below) for <b>debt or equity portfolios, only if</b> (otherwise, see 3 below) the internal models meets certain requirements, including capturing:                             <ul style="list-style-type: none"> <li>• Event risk and idiosyncratic risk</li> <li>• Sensitivity to material differences between similar positions</li> <li>• Not required to capture default and credit migration risk on a portfolio if incremental measure is calculated for that portfolio</li> </ul> </li> </ul>	

<sup>4</sup> Notably, a Trading Book Bank (whether or not an Advanced Approaches Bank) may not use the “gross-up” securitization approach permitted to banks not subject to the market risk rules.

	General Measure	Advanced Measure
	<p>(see below)</p> <ul style="list-style-type: none"> <li>• <b>May NOT be used to reflect specific risk for any securitization positions, EXCEPT:</b> <ul style="list-style-type: none"> <li>• <b>Must</b> reflect specific risk for any portfolios of <b>correlation trading positions that are modeled for comprehensive risk (see below)</b></li> </ul> </li> <li>• Equals the greater of: (A) previous day’s VaR-based measure or (B) average daily measure for past 60 business days multiplied by 3 (unless number of exceptions under backtesting requires use of another multiplication factor)</li> </ul>	
2. <b>Stressed VaR-based capital requirement</b> (internal models)	<ul style="list-style-type: none"> <li>• Calculated at least weekly</li> <li>• Same agency-approved internal model(s) used to calculate VaR-based measure (even if weighting scheme is used) (<i>i.e.</i>, <b>covers same risk/positions as VaR-based measure</b>)</li> <li>• Inputs reflect historical data from continuous 12-month period of significant financial stress (mitigates procyclicality)</li> <li>• Equals greater of: (A) most recent stressed VaR-based measure or (B) average of measures calculated over past 12 weeks multiplied by 3 (unless number of exceptions under backtesting requires use of another multiplication factor)</li> </ul>	
3. <b>Specific risk add-ons</b>	<ul style="list-style-type: none"> <li>• Calculated daily</li> <li>• Portfolios of <b>debt or equity positions: only if</b> bank’s VaR-based measure (see item 1 above) does not capture all material aspects of <b>specific risk</b></li> <li>• Standardized measure based on type of instrument - see Section III.B.</li> </ul>	
	<ul style="list-style-type: none"> <li>• <b>Securitization positions</b> not modeled for comprehensive risk: use <b>SSFA</b> or assign 100 percent risk-weighting factor</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Securitization positions</b> not modeled for comprehensive risk: Use <b>SFA</b> if bank and securitization position qualify. Otherwise, use SSFA or assign 100 percent risk-weighting factor</li> </ul>

	General Measure	Advanced Measure
4. Incremental risk capital requirement (internal models)	<ul style="list-style-type: none"> <li>• Calculated at least weekly</li> <li>• Measures the <b>default risk</b> and <b>credit migration risk</b> of a position</li> <li>• For <b>debt portfolios</b> for which bank measures specific risk using VaR-based models</li> <li>• With agency approval, may include <b>equity portfolios</b> provided consistent with bank’s internal management of portfolio</li> <li>• <b>May NOT include correlation trading positions or securitization positions</b></li> <li>• Measures potential losses due to incremental risk over one-year horizon under assumption of constant level of risk or constant positions (among other factors)</li> <li>• Includes default and credit migration risk</li> </ul>	
5. Comprehensive risk capital requirement (internal models)	<ul style="list-style-type: none"> <li>• Calculated at least weekly</li> <li>• Bank uses internal model (with agency approval) to measure <b>price risk</b> for <b>correlation trading positions</b> <ul style="list-style-type: none"> <li>• If comprehensive risk isn’t modeled, specific risk add-on approach is applied.</li> </ul> </li> <li>• Comprehensive risk measure equals either:                             <ul style="list-style-type: none"> <li>• Sum of: (A) modeled price risk for correlation trading positions per section requirements and (B) a surcharge equal to the total specific risk add-on for the modeled positions times 8 percent; OR</li> <li>• With agency approval after 1 year of modeling comprehensive risk, the greater of: (A) modeled price risk for correlation trading positions per section requirements and (B) total specific risk add-on for the modeled positions times 8 percent</li> </ul> </li> <li>• Requirement equals greater of: (A) most recent comprehensive risk measure or (B) average of measures calculated over past 12 weeks</li> </ul>	
6. Capital requirement for <i>de minimis</i> exposures	<p>Equals: (A) absolute value of market value of <i>de minimis</i> exposures not captured in VaR-based measure or under (B); and (B) with prior agency approval, capital requirement for any <i>de minimis</i> exposures using alternative techniques to measure market risk</p>	

**Internal Models: General Framework**

The new market risk capital rules rely on an integrated, largely models-based framework to measure market risk. All internal models require agency approval, and the relevant agency may rescind its approval of a model's use at any time and "determine an appropriate capital requirement for the covered positions to which the model would apply," if the agency determines the model does not comply with the rules or fails to accurately reflect the positions' risks.

**Models-based market risk components.** Table 2 above sets out the various components of a Trading Book Bank's measure for market risk, which includes both standardized and models-based components. As shown in Table 2, a Trading Book Bank must run (in each case, with agency approval): (1) VaR-based models measuring general market risk for all covered positions, and specific risk for certain positions (if requirements are met), (2) stressed VaR models (*i.e.*, the same models using stressed assumptions), (3) an "incremental risk" model measuring default and credit migration risk for certain debt and equity portfolios, and (4) a "comprehensive risk" model for specific risk corresponding to certain securitization positions called "correlation positions." (Each of these models-based measures is discussed in the relevant sections below.) Some commenters criticized that the overlap of rules under the various modeling requirements would create excessive capital burdens and "distortions" in risk management decisions. The agencies, however, chose to keep the internal models framework largely unchanged from that set forth in the proposed rule, stating they "believe that these provisions provide a prudent level of conservatism in the market risk capital rule."

**"Robust" models.** Consistent with the regulatory theme of enhanced internal controls, the final market risk capital rule, as with the proposed rule, contains additional requirements to ensure a Trading Book Bank's internal models measure all important types of risk and require a Trading Book Bank to integrate its internal models into its risk management process. As to general market risk, the final rule, like the proposed rule, adds credit spread risk on top of the interest rate risk, equity price risk, foreign exchange risk and commodity price risk that must be captured in a bank's VaR models. To measure specific risk appropriately under the rules, a bank's internal models must be sufficiently sensitive and robust to capture all aspects of specific risk, including event risk and idiosyncratic risk. In response to commenters' requests, the definition of "event risk" has been clarified in the final rule as the risk of loss on equity or hybrid equity positions as a result of a financial event, such as the announcement or occurrence of a merger, acquisition, spin-off or dissolution. In the agencies' words, "a bank's models must be commensurate with the complexity and size of its covered positions."

**Backtesting.** Like the current market risk capital rules, the final rule contains backtesting requirements that allow banks to compare projected to actual results and adjust their models as appropriate. The new rules, however, include more robust requirements for performing the backtesting, including the amount of historical data to be kept on file, prompting commenters to raise the operational challenges these changes would pose. The agencies kept the proposed backtesting requirements unchanged in the final rule, but provided an extra year (*i.e.*, until the later of January 1, 2014 or one year after a bank becomes subject to the market risk capital rules) for banks to come into compliance with the requirements. The agencies also assure banks in the rule's preamble that they will consider the operational challenges involved in meeting these requirements in their evaluation of a bank's compliance with them.

### **VaR and Stressed VaR**

**VaR.** The final market risk capital rules, like the current rules, seek to measure two different types of market risk: "general market risk" and "specific risk." General market risk relates to the risk of loss on a position that could result from broad market movements, such as changes in the level of interest rates, credit spreads, equity prices, foreign exchange rates, or commodity prices. Specific risk, on the other hand, is risk of loss on a position that could result from factors other than broad market movements, such as event, default and idiosyncratic risk. The final rule, as proposed, requires Trading Book Banks to calculate a daily VaR-based measure of general market risk for all covered positions using internal models approved by the relevant banking agency. The daily VaR-based measure also may reflect specific risk for a bank's debt or equity portfolio positions, so long as it meets certain requirements.

**Stressed VaR.** Regulators in the U.S. and abroad have concluded that deficiencies in banks' internal models left them insufficiently capitalized to withstand the financial crisis. Consistent with these concerns, which were expressed under Basel II.5 and Basel III<sup>5</sup> and also reflected in the Banking Book NPRs, the final rule also requires a bank to use its same internal models to calculate a weekly stressed VaR-based measure using inputs to reflect historical data from a 12-month period of significant financial stress. A bank must have policies and procedures, approved by its federal banking regulator, in place to determine the period of significant financial stress used to calculate the stressed VaR.

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<sup>5</sup> Basel Committee, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (December 2010, rev. June 2011), available at [www.bis.org/publ/bcbs189.pdf](http://www.bis.org/publ/bcbs189.pdf); and BCBS, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* (Dec. 2010), available at <http://www.bis.org/publ/bcbs188.pdf>.

**Special case: Term repo-style transactions.** Consistent with the January 2011 proposed rule, the final rule allows banks to include certain “term repo-style transactions” in the VaR-based calculations, even though these types of positions do not fit under the definition of “covered position,” so long as the bank consistently includes these types of positions in the VaR-based measure over time. A “term repo-style transaction” includes principal and indemnified agency securities borrowing and lending positions, repos and reverse repos, provided that they are market-to-market daily, among other requirements. Although term repo-style transactions are effectively treated as covered positions for the calculation of the denominator of the risk-based capital ratio under this provision, these transactions are still subject to the capital requirements for calculating counterparty credit risk under the banking book capital rules.

#### **Standardized specific risk measurement methods**

When a Trading Book Bank’s VaR-based models do not properly measure specific risk associated with its covered positions (and in any event in the case of securitization positions that are not correlation positions), the market risk capital rules continue to provide that the bank must apply standardized risk charges to each position based on the type of instrument and maturity. The final rule, consistent with the Basel framework and in a similar fashion as the Banking Book NPRs, increases the number of categories of standardized risk weights for various types of debt and securitization positions from three to seven in order to assign risk more granularly to different instruments. Whereas the Basel II.5 framework makes use of rating agencies’ credit ratings to assign risk weighting factors to many instruments, Section 939A of the Dodd-Frank Act prohibits reliance on credit ratings to determine capital requirements. After considering a number of methods to categorize obligations without reference to credit ratings, agencies settled on a framework relying on the “Country Risk Classification,” or “CRC,” assigned by the Organization for Economic Development (“OECD”) to assign specific risk-weighting factors to sovereign, public sector and certain financial entity debt, an “investment grade” methodology for other corporate debt and the SSFA (for the general measure for market risk) or the SFA (for the advanced measure for market risk, if the bank and the position each qualify) for securitization positions. In many cases, the result is a higher specific risk measurement than what would have been applied under the current rules and, in some cases, higher than what may be required under Basel II.5. Changes to the specific risk measures from the current rules for each category are discussed in turn below.

**When reviewing the following sections, keep in mind that, in each case other than Section III.C.6 (Securitized positions), the standardized methodologies for applying risk-weighting factors discussed below are applicable only if the Trading Book Bank’s VaR and Stressed VaR internal models do not appropriately measure the specific risk of the relevant covered positions.**

- **Sovereign debt**

Under the current market risk capital rules, all “government” debt, consisting of obligations of OECD countries and instruments in the local currency of non-OECD countries, to the extent the organization has liabilities booked in that currency, are given a zero percent specific risk-weighting factor. Other non-OECD country debt would fall in the “other” category and receive an eight percent risk-weighting factor.

As set forth in Table 3, the final rule, consistent with the proposed rule as well as the joint RWA NPR, instead relies on the CRC assigned by the OECD as a proxy for the credit rating of individual sovereigns, and assigns specific risk-weighting factors ranging from zero (for CRCs 0-1) to 12 (for CRC 7) depending on the CRC and, in some cases, the maturity of the instrument.<sup>6</sup> Where no CRC is assigned to the relevant sovereign, the instrument receives an eight percent risk-weighting factor, just as it would have under the current rules. Obligations backed by the full faith and credit of the United States are automatically treated as having a CRC of 0, ostensibly even if the U.S. is downgraded by the OECD. However, in any case where the sovereign has defaulted on its obligations, it will immediately and for the next five years receive a 12 percent risk-weighting factor, no matter what the current CRC of the country. The agencies tweaked the definition of “sovereign default” in the final rule to ensure that sovereign debt restructurings are also covered. This enhanced risk weighting upon defaults is consistent with the Banking Book NPRs.

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<sup>6</sup> *The distribution of CRCs for European countries and territories is as follows: 49% Classification 0; 12% No Classification; 8% Classification 4; 8% Classification 5; 8% Classification 6; 8% Classification 7; 0% Classification 1; 0% Classification 2.*

**Table 3: Specific Risk-weighting Factors for Sovereign Debt Positions**

CRC of Sovereign		Specific Risk-weighting Factor (in percent)	
		Final Rule	Current Rule (in general)
0-1		0.0	0.0
2-3	<b>Remaining Contractual Maturity:</b> 6 months or less	0.25	If OECD member country (without default in past 5 years): 0.0 <sup>7</sup> Otherwise: 8.0
	Greater than 6 and up to and including 24 months	1.0	
	Greater than 24 months	1.6	
4-6		8.0	OECD: 0.0 <sup>8</sup> Otherwise: 8.0
7		12.0	8.0
No CRC		8.0	8.0
Default by the Sovereign Entity		12.0	8.0

<sup>7</sup> According to the OECD's website at the time of print, as of June 29, 2012, Chile (CRC 2) and Mexico (CRC 3) are the only OECD member states with CRCs in this category (OECD, *Country Risk Classifications of the Participants to the Arrangement on Officially Supported Export Credits*, available at [http://www.oecd.org/document/49/0,2340,en\\_2649\\_34171\\_1901105\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/49/0,2340,en_2649_34171_1901105_1_1_1_1,00.html)).

<sup>8</sup> According to the same document referenced above, as of June 29, 2012, Turkey (CRC 4) is the only OECD member state with a CRC in this category.

- **Supranational Entity and Multilateral Development Bank Debt**

Under the final rule, obligations of the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund or certain multilateral development banks will be assigned a zero percent specific risk-weighting factor. As one small bit of positive news, this actually could result in a lighter market risk capital burden than under the current rules, as these institutions would be considered “Qualifying” or “Other” debt under the current rules, with risk-weighting factors ranging from 0.25 percent to 1.6 percent for “Qualifying” institution debt (including debt of multilateral development banks), or 8 percent for “Other” debt.

- **Government-Sponsored Entity (“GSE”) Debt**

Under the historical rules, all debt instruments of GSEs are assigned specific risk-weighting factors ranging from 0.25 percent to 1.6 percent, depending on the maturity of the instrument. Under the new rule, U.S. GSEs whose obligations are not explicitly backed by the full faith and credit of the United States, such as Fannie Mae and Freddie Mac, will be given a specific risk-weighting factor of 1.6 for all maturities, consistent with the proposed rule. Preferred stock of these entities, however, will be given an 8 percent specific risk-weighting factor. Some commenters had requested that exposures to GSEs be treated as if they were effectively backed by the U.S. government, particularly given that they currently are under U.S. conservatorship. The agencies declined, noting that even while the entities are in U.S. government conservatorship, obligations of Fannie and Freddie are still not explicitly guaranteed by the government.

- **Depository Institution, Foreign Bank, Credit Union and Public Sector Entity (“PSE”) Debt**

Under the final rule, as set forth in Tables 4 and 5, consistent with the proposal as well as the joint credit risk capital NPRs, the specific risk-weighting factors assigned to debt instruments of banking institutions and PSE (*i.e.*, states and other governmental subdivisions below sovereigns) debt are generally about one level higher than the specific risk-weighting factors assigned to the relevant sovereign, based on the CRC of the relevant sovereign, and, if applicable, the maturity of the instrument. These specific risk-weighting factors range from 0.25 percent to 12 percent. Consistent with the treatment of sovereigns, where the relevant sovereign entity is not assigned an OECD CRC, any instrument described above is given a specific risk-weighting factor of 8 percent. Any such instrument is given a 12 percent specific risk-weighting factor if the sovereign has defaulted within the past 5 years, regardless of its CRC. This represents an increase in capital burdens compared to the current rules, under which the same bank debt and all OECD

PSE general obligation debt is assigned specific risk-weighting factors ranging from 0.25 percent to 1.6 percent, depending on the maturity of the instrument.

**Table 4: Specific Risk-weighting Factors for Depository Institution, Foreign Bank, and Credit Union Debt Positions**

CRC of Sovereign		Specific Risk-weighting Factor (in general) (in percent)		
		Final Rule	Current Rule	
0-2	Remaining Contractual Maturity: 6 months or less	0.25	If U.S. or OECD bank, or investment grade debt (No matter what CRC):	0.25
	Greater than 6 and up to and including 24 months	1.0		1.0
	Greater than 24 months	1.6		1.6
3		8.0	If does not fit category above:	8.0
4-7		12.0		
No CRC		8.0		
Default by the Sovereign Entity		12.0		

**Table 5: Specific Risk-weighting Factors  
for PSE General Obligation Debt Positions**

CRC of Sovereign		Specific Risk-weighting Factor (in general) (in percent)		
		Final Rule	Current Rule	
0-2	Remaining Contractual Maturity: 6 months or less	0.25	If investment grade debt (No matter what CRC):	0.25
	Greater than 6 and up to and including 24 months	1.0		1.0
	Greater than 24 months	1.6		1.6
3		8.0	If does not fit category above:	8.0
4-7		12.0		
No CRC		8.0		
Default by the Sovereign Entity		12.0		

- **Corporate debt**

Under the final rule, as set forth in Table 6, portfolios of corporate debt positions for which a bank’s VaR-based internal models do not reflect the positions’ specific risk must be assigned specific risk add-ons calculated based on maturity and investment quality. This section sets out certain key aspects of the new method of calculating specific risk add-ons for corporate debt under the final rule.

**Current framework and Basel II.5 changes.** The current rules assign certain investment-grade corporate debt positions (other than those under the categories described in Section III.C.4 above) specific risk-weighting factors of 0.25 percent to 1.6 percent depending on maturity of the instrument, and an 8 percent specific risk-weighting factor for non-investment grade (or unrated) debt. Basel II.5 added another tranche to the standardized specific risk framework to

provide that corporate debt that is rated more than two categories below investment grade will receive a 12 percent specific risk-weighting factor. Both the current rule and Basel II.5 employ credit ratings assigned by rating agencies to determine the category into which a public debt instrument falls.

**“Investment grade” methodology.** In the December 2011 NPR, the agencies sought to incorporate the Basel II.5 changes while adhering to the Dodd-Frank Act requirement not to use rating agencies’ ratings as a basis for capital adequacy requirements. Agencies considered a number of alternative methodologies, including an indicator-based methodology and a market-based methodology using bond spreads, as well as an “investment grade” methodology based on whether the position is deemed “investment grade” according to newly finalized revisions to OCC regulations (*i.e.*, the issuer has adequate capacity to meet financial commitments under the security for the projected life of the security).<sup>9</sup> While the agencies expressed some concern that the “investment grade” approach lacks the granularity of the other approaches, they conceded under the final rule that concerns about the feasibility and efficacy of the indicator and market-based methodologies raised by commenters outweigh the granularity considerations. Thus, under the final rule, the agencies have determined to use the “investment grade” methodology, and have also incorporated that methodology in the Banking Book Advanced Approaches NPR for credit risk weightings.

**More capital intensive than Basel II.5.** Although the “investment grade” methodology will require banks to perform a less burdensome analysis than other alternatives considered, as set forth in Table 6, the final rule will assign specific risk-weighting factors to corporate debt positions that are effectively higher than those applied under Basel II.5. “Investment grade” debt will be assigned factors ranging from 0.5 percent to 4 percent depending on the instrument’s maturity, and debt not deemed “investment grade” will receive a 12 percent risk factor, no matter how close to “investment grade” it may be. Exposures to non-public companies for which banks are unable to perform the “investment grade” analysis will receive an 8 percent specific risk-weighting factor. In addition, interest-only mortgage backed securities that are not “securitizations” must be assigned a risk-weighting factor of 8 percent or higher, consistent with the proposed rule. The agencies also decided not to offer under the final rule the so-called “simple methodology” considered in the December 2011 NPR, which would assign a specific risk weighting of 8 percent to all corporate positions, as an alternative to mitigate banks’ calculation burden, because agencies determined this was not necessary given the simplicity of the “investment grade” methodology.

<sup>9</sup> See *Alternatives to the Use of External Credit Ratings in the Regulations of the OCC*, 77 Fed. Reg. 35,253 (June 13, 2012).

**Table 6: Specific Risk-Weighting Factors for Corporate Debt Positions Under the Investment Grade Methodology**

Category		Specific Risk-weighting Factor (in general) (in percent)		
		Final Rule	Current Rule	Basel II.5
Investment Grade (as determined under applicable rule)	Remaining Contractual Maturity: 6 months or less	0.5	0.25	0.25
	Greater than 6 and up to and including 24 months	2.0	1.0	1.0
	Greater than 24 months	4.0	1.6	1.6
One to two categories below Investment Grade		12.0	8.0	8.0
More than two categories below Investment Grade				12.0
Unrated		N/A		8.0

- **Securitization positions**

**New securitization framework under Basel II.5.** The final rule includes a new framework for the treatment of securitization positions corresponding to the 2009 revisions under the Basel II.5 framework. Whereas the historical rules allowed banks to either model specific risk for securitizations or calculate a specific risk add-on under a standardized approach, the new (international and U.S.) rules will not permit banks to model specific risk for securitization positions, with the exception of certain correlation trading positions, discussed below.

Under Basel II.5 (*i.e.*, the international standard), in general, banks must instead assign specific risk-weighting factors to securitization and re-securitization exposures based on the external credit rating of the position. Unrated positions under the Basel II.5 securitization framework generally may be assigned specific risk capital charges based on the Basel II advanced approaches supervisory formula approach (SFA) (if certain requirements are met). Otherwise, depending on certain factors, they must be deducted from capital or assigned a standardized

charge. In order to implement this new Basel II.5 framework in a manner that complies with Dodd-Frank's credit ratings prohibition, the U.S. banking agencies developed a simplified version of the SFA<sup>10</sup> to assign specific risk-weighting factors to securitization positions under the general measure for market risk, dubbed the "SSFA." (See *SFA/SSFA methods* below.) Key changes to the framework are briefly discussed in this section.

**Definition of securitization.** In the final rule, as in the proposal, "securitization" is generally defined as a transaction in which (1) all or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties; (2) the credit risk associated with the underlying exposures has been separated into at least two tranches that reflect different levels of seniority; (3) performance of the securitization exposures depends upon the performance of the underlying exposures; and (4) all or substantially all of the underlying exposures are financial exposures, among other requirements. N<sup>th</sup>-to-default credit derivatives and resecuritization positions are considered securitization positions.

Some commenters suggested aligning the definition with the Basel II definition, such as by excluding from the definition of a securitization exposures that do not resemble what is customarily thought of as a securitization. The agencies declined, noting that the definition under the final rule is consistent with the definition of securitization contained in the advanced approaches credit risk rules.

**SFA/SSFA methods.** As noted above, the only difference between the calculation of a Trading Book Bank's measure for market risk under the general and advanced approaches lies on the calculation of specific risk for securitization exposures. Under the advanced approaches measure for market risk, a bank must use the SFA to determine the specific risk-weighting factor for a securitization position, provided it has sufficient information. The final market risk rule cross-references the provisions of the advanced approaches framework implementing the SFA for rules on calculation. Under the general measure for market risk (and under the advanced approaches measure for securitization positions that do not qualify to use the SFA), the bank must use the SSFA to determine the specific risk-weighting factor of a securitization position (or, if a bank cannot, or chooses not to, employ the SSFA, assign a specific risk-weighting factor of 100 percent, roughly equivalent to a risk weight of 1,250 percent). As noted above, the preceding sentences describe the only difference between the general and advanced approaches methods of calculating a bank's market risk capital requirements. Maintaining consistency across

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<sup>10</sup> The SFA is implemented Section 45 of the advanced approaches capital adequacy framework (see 12 CFR part 3, appendix C, Section 45 (OCC); 12 CFR part 208, appendix F, Section 45 (Board); and 12 CFR part 325, appendix D, section 45 (FDIC)).

rules, the Banking Book NPRs also propose to require banks to employ the SSFA methodology to assign risk weights to most securitization and resecuritization positions under the general capital rules, and to use the SFA methodology (if possible) under the advanced approach.<sup>11</sup>

Under the SSFA, which is similar in construct to the SFA, the risk weight for a securitization position is determined by a formula and is based on a number of inputs, including, among others, the risk weight applicable to the underlying exposures (through the parameter  $K_G$ , or the weighted-average total capital requirement of the underlying exposures calculated using the general risk-based capital rules) and the relative position of the securitization position in the structure (subordination). The proposed rule included a 20 percent specific risk-weighting factor “floor” for all securitization and resecuritization positions, and a “flexible floor” that began at 1.6 percent but increased to up to 100 percent based on cumulative losses on the underlying assets of the position. Based on commenters’ input, the “flexible floor” has been replaced in the final rule with an adjustment to  $K_G$ , called “ $K_A$ ”; however, the 20 percent minimum “floor” remains in the final rule.

**Due diligence requirements.** The final rule, as proposed, requires a bank to perform due diligence on all securitization positions in a manner commensurate with the complexity of the position and the materiality of the position in relation to the bank’s capital. The rule contains a number of factors that must be analyzed, documented and re-evaluated on an ongoing basis as part of its due diligence review. The requirements are meant to ensure that banks do not place undue reliance on credit ratings in their due diligence, though banks are not precluded from considering credit ratings in their analysis. Based on comments as to the difficulty in documenting due diligence prior to the acquisition of a position, the agencies revised the final rule to allow banks up to three business days to document due diligence. Positions acquired prior to the final rule’s effective date will not be subject to the due diligence requirements.

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<sup>11</sup> As stated in footnote 4 above, the Banking Book “gross-up” approach to securitizations is not available to banks using the market risk rules.

- **Equity positions**

Consistent with the proposed rule, the final rule provides that a portfolio of equity positions (the specific risk of which a Trading Book Bank's VaR-based models do not adequately measure) will be assigned a specific add-on equal to the sum of the specific risk add-ons of the individual equity positions in the portfolio. The equity specific risk add-on is determined by multiplying the absolute value of the current market value of each net long or short equity position by a risk-weighting factor. This factor, consistent with Basel II.5, will be 2 percent for index contracts that are part of a "well-diversified" portfolio of equities, or 8 percent for all other equity positions. The final rule will not change the current rule's treatment of certain futures contract-related equity positions.

**Incremental risk measure**

The final rule adopts the proposed requirements for "incremental risk" internal modeling without change. In general, the rule provides that banks must model incremental risk, or the default risk and credit migration risk of a position, for all debt positions other than securitization and correlation trading positions, and may also include equity positions in the model with agency approval. Incremental risk models must meet a number of requirements, including a liquidity horizon of the shorter of three-months (the minimum under Basel Committee standards) or the contractual maturity of the position. A bank may choose a constant risk or constant position assumption; however, it should use the same assumption consistently across portfolios and over time.

**Comprehensive risk measure**

With approval from its regulator, a Trading Book Bank may use a new comprehensive risk modeling method under the final rule to measure comprehensive risk, or all price risk, for one or more of its portfolios of correlation trading positions. Models approved to measure comprehensive risk for correlation trading positions must meet a number of requirements; in addition, as previously noted, the bank's VaR-based models must measure specific risk for all portfolios of positions that are modeled for comprehensive risk. If the bank does not use a comprehensive risk model for any portfolio of correlation trading positions, it must calculate a specific risk add-on for the portfolio in accordance with the applicable specific risk add-on rules (*e.g.*, for securitization positions) discussed above. Correlation trading positions include securitization positions for which 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-way market exists, as well as any position that is not a securitization position but that hedges any of the foregoing. Excluded from this definition are resecuritization positions, certain derivatives and retail, residential mortgage and commercial mortgage-backed securities.

A comprehensive risk model must measure comprehensive risk consistent with a one-year time horizon at a one-tail, 99 percent confidence level, under either a constant risk level or constant positions assumption (such assumption should be consistent with the assumption used in the bank's incremental risk model), among other requirements. Under the proposed rule, a bank approved to use the comprehensive risk method must calculate a comprehensive risk measure for its correlation trading portfolios at least weekly, in addition to using its internal models to measure the specific risk of those portfolios. The comprehensive risk measure is calculated as the sum of the output of the bank's comprehensive risk model plus, under the proposed rule, a surcharge of 15 percent. The agencies envision the surcharge eventually being replaced with a comprehensive risk measure "floor" of the higher of the model's output or 8 percent, upon approval of the bank's regulator. In response to several comments criticizing the 15 percent surcharge as unduly punitive, the agencies determined to lower the interim surcharge to 8 percent in the final rule.

#### **Disclosure requirements**

The January 2011 NPR proposed that the consolidated parent entity subject to the market risk capital rule must make a number of quarterly, annual or, in the event of a material change, more frequent disclosures designed to increase transparency and improve market discipline. These public disclosures would include, among other things, (i) the high, low and median measures for each of its internal models over the reporting period and the measure at period end, (ii) a comparison of VaR-based measures with actual results, (iii) the aggregate amounts of securitization positions (by exposure type) and correlation trading positions, (iv) the composition of material portfolios of covered positions and (v) descriptions of various policies, methodologies and procedures of the bank. Despite much criticism from commenters, the final rule retains the disclosure requirements as proposed, save for the removal of the requirement to disclose the median measures described in (i) above.

### **FURTHER POTENTIAL CHANGES TO THE MARKET RISK CAPITAL RULES**

#### **Conforming changes under Banking Book NPRs**

As noted above, the final rule was published concurrently with the three Banking Book NPRs implementing the Basel III framework and largely revising and replacing the agencies' current capital rules. The third of these, the Advanced Approaches NPR, includes certain further proposed revisions to the market risk capital rules that will further conform it to the new capital framework proposed in the Banking Book NPRs. Such revisions include extending the rules to apply also to savings associations and savings and loan holding companies that meet the same thresholds of trading activity as banks subject to the current rules.

**Further Potential Changes**

The BCBS published a trading book review in May that proposed significant revisions to market risk modeling requirements under the Basel II.5 framework.<sup>12</sup> The consultative document proposes a move from VaR-based modeling methods to the “expected shortfall” methodology, which purportedly better captures so-called “tail risk” that statistically outlying scenarios will occur in times of stress. Some commenters to the proposed market risk capital rules argued that U.S. agencies should wait for the outcome of the May proposals before finalizing the new rule. Of course, the agencies determined to finalize the rule in order to address perceived deficiencies in the current rule; however, the agencies affirmed they are “committed to continued improvement of the market risk capital framework.”

Even as the final rule is published, the U.S. risk capital framework is being shaped by several developing factors. In addition to potential changes to the Basel market risk framework discussed above, the credit risk capital rules are currently undergoing an overhaul as significant as the one the market risk capital rules just underwent, and the Banking Book NPRs already provide for some conforming changes to the market risk capital rules, as noted above. The joint credit risk capital NPRs will almost certainly receive far more comments than the 36 letters received on the proposed market risk capital rules, as the credit risk capital framework affects a much broader universe of banks. If the credit risk capital rules are amended significantly in the final rule, it is likely that such changes would require conforming revisions to be made to the market risk capital rules. It is safe to say, however, that, no matter what the outcomes of the Basel Committee study and the joint NPR comment period, heightened capital burdens on banks are here to stay.

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<sup>12</sup> *Basel Committee, Fundamental Review of the Trading Book (May 2012), available at <http://www.bis.org/publ/bcbst19.pdf>*

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Please do not hesitate to contact us if you have any questions.

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