Supporting Statement
Market Risk Capital Requirements
New Collection

A. Justification

This statement supports a request for OMB to approve the collections of information contained in a Notice of Proposed Rulemaking that would amend the market risk capital requirements of the FDIC. The NPRM is sponsored jointly by the FDIC, the Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (the agencies). The amendments are based on the June 2004 Basel Committee of Banking Supervision's (BCBS's) final paper "International Convergence of Capital Measurement and Capital Standards: A Revised Framework." This framework recognizes developments in financial products, incorporates advances in risk measurement and management practices, and assesses capital requirements that are generally more sensitive to risk.

1. Circumstances and Need

The proposed collection will enhance market risk modeling requirements consistent with advances in risk management and modify the definition of "covered position" to better capture positions for which the market risk capital rule is appropriate. The objective of enhancing the risk sensitivity of the market risk rule reflects the growth in traded credit products, such as credit default swaps and tranches of collateralized debt obligations, other structured products, and less liquid products. The risks of these products are not adequately captured in current value-at risk (VaR) models and are not fully reflected in a 10-business-day, 99 percent confidence level soundness standard.

The growth in traded credit products has given rise to an increase in default risks that should be captured in a capital requirement for specific risk but have proved difficult to capture adequately with current specific risk models. Other structured and less liquid products may give rise to risks that were not entirely contemplated when the market risk capital rule was first adopted ten years ago. Moreover, concentration risk may not be adequately reflected in a VaR-based framework, especially when banks rely on proxies to capture the risks of actual holdings. Therefore, the agencies propose to implement an incremental default risk capital requirement for a bank that models specific risk for one or more portfolios of covered positions and to require the consideration of liquidity and concentration risks in that requirement and in the bank's stress tests and internal assessment of capital adequacy. In addition, to address the agencies' concerns about appropriate treatment of covered positions with limited price transparency, the agencies propose to require banks to have a well-defined valuation process for all covered positions.

2. Use of the Information

The FDIC will use the data in this proposed collection to assess the adequacy of a bank's capital held to cover exposure to market risk associated with foreign exchange and commodity positions and positions located in the trading account.

3. Use of Technology to Reduce Burden

Respondents may use any available technology to reduce burden.

4. Efforts to Identify Duplication

For a number of reasons, including a desire to identify possible duplication in this collection, the agencies sought comment for an extended period of time (120 days). The agencies believe the information in this collection is not otherwise available.

5. Minimizing the Burden on Small Entities

This collection of information does not affect small entities; only the largest institutions will be affected.

6. Consequence of Less Frequent Collections

Less frequent collection would prevent the agencies from adequately monitoring capital levels in affected institutions.

7. Special Circumstances

The proposed recollection does not involve any special circumstances.

8. Consultation with Persons Outside the FDIC

The agencies participated with other members of the Basel Committee during the development of the Basel Committee's 2004 final paper. In addition, the NPR containing the collection for which we are currently seeking approval will have an extended public comment period (120 days) to assure full public participation in the development of the collection.

9. Payment to Respondents

None.

10. Confidentiality

Information deemed confidential is exempt from public disclosure under the Freedom of Information Act (5 U.S.C. 552).

11. Information of a Sensitive Nature

None.

12. Burden Estimate

Summary
Frequency of response: annual.
Number of respondents: 2.
Average number of burden hours: 680.
Total annual burden: 1,360 burden hours.

Cost per response: $100 per hour.
Estimated annual cost: $136,000.

Discussion (section numbers refer to sections of the NPRM containing the collection)
The collection requires respondents to (1) clearly define policies and procedures for determining which trading assets 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 approvals for 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 for Trading Positions (Sections 3(a)(1)(i) and **3(a)(2)).**
Section 3(a)(1)(i) requires clearly defined policies and procedures for determining which trading assets and trading 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(a)(2) requires a covered bank's senior management to approve a clearly defined trading and hedging strategy for trading positions. 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.

Policies and procedures for actively managing covered positions (Section 3(b)(1)).
This section requires covered banks to develop and maintain clearly defined policies and procedures for actively managing all covered positions and specifies minimum standards. 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.

Requirements for specific risk modeling (Section 5(b)(1). This section specifies what internal models must include and address. 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 approval for incremental default risk (Section 6). Sections 6(a) and 6(b) require prior written approvals for 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.

Approval of disclosure policy (Section 9(b)). Section 9(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.

Section Number	Description	Estimated Burden Hours
3(a)(1)(i), 3(a)(2)	Policies and procedures for trading positions	56
3(b)(1)	Policies and procedures for actively managing covered positions	16
5(b)(1)	Requirements for specific risk modeling	88
6	Prior written approval for incremental default risk	480
9(b)	Approval of disclosure policy	40
Total		680

13. Capital, Start-Up and Maintenance Costs

Covered institutions already have established systems to accumulate data and produce reports for the internal calculation of capital held against market risk. Therefore, no additional capital, start-up or maintenance costs are involved.

14. Estimated Annual Cost to the Federal Government

No new costs to the Federal government are anticipated; current bank examination resources will be used to collect and review the information.

15. Reason for Change in Burden

The entire change in burden hours, an increase from zero to 1,360 hours, is a program change due to the creation of a new collection.

16. Publication

No publication is made of the information.

17. Display of Expiration Dates

Not applicable.

18. Exceptions to Certification

None.

B. Statistical Methods

Not applicable.