

DEPARTMENT OF THE TREASURY**Office of the Comptroller of the Currency****12 CFR Part 3**

[Docket No. 97-25]

RIN 1557-AB14

FEDERAL RESERVE SYSTEM**12 CFR Parts 208 and 225**

[Regulations H and Y; Docket No. R-0996]

FEDERAL DEPOSIT INSURANCE CORPORATION**12 CFR Part 325**

RIN 3064-AC14

Risk-Based Capital Standards: Market Risk

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; and Federal Deposit Insurance Corporation.

ACTION: Joint interim rule with request for comment.

SUMMARY: The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies) are amending their respective risk-based capital standards for market risk applicable to certain banks and bank holding companies with significant trading activities. The amendment eliminates the requirement that when an institution measures specific risk using its internal model, the total capital charge for specific risk must equal at least 50 percent of the standard specific risk capital charge. The amendment implements a revision to the Basle Accord that permits such treatment for an institution whose internal model adequately measures specific risk. The rule will reduce regulatory burden for institutions with qualifying internal models because they will no longer be required to calculate a standard specific risk capital charge.

DATES: This interim rule is effective December 31, 1997. Comments must be received by March 2, 1998.

ADDRESSES: Comments should be directed to:

OCC: Comments may be submitted to Docket No. 97-25, Communications Division, Third Floor, Office of the Comptroller of the Currency, 250 E Street, S.W., Washington DC 20219.

Comments will be available for inspection and photocopying at that address. In addition, comments may be sent by facsimile transmission to FAX number (202) 874-5274, or by electronic mail to regs.comment@occ.treas.gov.

Board: Comments directed to the Board should refer to Docket No. R-0996 and may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington DC 20551. Comments addressed to the attention of Mr. Wiles may also be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or the security control room in the Eccles Building courtyard on 20th Street, N.W. (between Constitution Avenue and C Street) at any time. Comments may be inspected in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's Rules Regarding Availability of Information.

FDIC: Send written comments to Robert E. Feldman, Executive Secretary, Attention: Comments/OES, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, DC 20429. Comments may be hand-delivered to the guard station at the rear of the 17th Street Building (located on F Street), on business days between 7:00 a.m. and 5:00 p.m. (FAX number (202) 898-3838; Internet address: comments@fdic.gov). Comments may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, N.W., Washington, DC 20429, between 9:00 a.m. and 4:30 p.m. on business days.

FOR FURTHER INFORMATION CONTACT:

OCC: Roger Tufts, Senior Economic Advisor (202/874-5070), Capital Policy Division; Margot Schwadron, Financial Analyst (202/874-5670), Treasury and Market Risk; or Ronald Shimabukuro, Senior Attorney (202/874-5090), Legislative and Regulatory Activities Division.

Board: Roger Cole, Associate Director (202/452-2618), James Houpt, Deputy Associate Director (202/452-3358), Barbara Bouchard, Senior Supervisory Financial Analyst (202/452-3072), Division of Banking Supervision; or Stephanie Martin, Senior Attorney (202/452-3198), Legal Division. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202/452-3544).

FDIC: William A. Stark, Assistant Director (202/898-6972), Miguel Browne, Manager (202/898-6789), John J. Feid, Chief (202/898-8649), Division of Supervision; Jamey Basham, Counsel

(202/898-7265), Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington DC 20429.

SUPPLEMENTARY INFORMATION:**Background**

The Agencies' risk-based capital standards are based upon principles contained in the July 1988 agreement entitled "International Convergence of Capital Measurement and Capital Standards" (Accord). The Accord, developed by the Basle Committee on Banking Supervision (Committee) and endorsed by the central bank governors of the Group of Ten (G-10) countries (G-10 Governors), provides a framework for assessing an institution's capital adequacy by weighting its assets and off-balance-sheet exposures on the basis of counterparty credit risk.¹ In December 1995, the G-10 Governors endorsed the Committee's amendment to the Accord (effective by year-end 1997) to incorporate a measure for exposure to market risk into the capital adequacy assessment. On September 6, 1996, the Agencies issued revisions to their risk-based capital standards implementing the Committee's market risk amendment (61 FR 47358).

Under the Agencies' market risk rules, banks and bank holding companies (institutions) with significant trading activities must measure and hold capital for exposure to general market risk arising from fluctuations in interest rates, equity prices, foreign exchange rates, and commodity prices and exposure to specific risk associated with debt and equity positions in the trading portfolio. General market risk refers to changes in the market value of on-balance-sheet assets and off-balance-sheet items resulting from broad market movements. Specific risk refers to changes in the market value of individual positions due to factors other than broad market movements and includes such risks as the credit risk of an instrument's issuer.

Under the Agencies' current rules, an institution must measure its general market risk using its internal risk measurement model, subject to certain qualitative and quantitative criteria, to calculate a value-at-risk (VAR) based capital charge.² An institution may

¹ The G-10 countries are Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. The Committee is comprised of representatives of the central banks and supervisory authorities from the G-10 countries and Luxembourg.

² The VAR-based capital charge is the higher of (i) the previous day's VAR measure, or (ii) the average of the daily VAR measures for each of the preceding 60 business days multiplied by a factor

measure its specific risk through a valid internal model or by the so-called standardized approach. The standardized approach uses a risk-weighting process developed by the Committee that is applied to individual instruments and through which debt and equity positions in the institution's trading account are assessed a category-based fixed capital charge. However, the Agencies' current rules provide that an institution using an internal model to measure specific risk must hold capital for specific risk at least equal to 50 percent of the specific risk charge calculated using the standardized approach (referred to as the minimum specific risk charge). If the portion of the institution's VAR which is attributable to specific risk does not equal the minimum specific risk charge, the institution's VAR-based capital charge is subject to an add-on charge for the difference. The sum of these capital charges is factored into an institution's risk-based capital ratio.

When the Agencies included the minimum specific risk charge as part of the market risk rules, the Agencies recognized that dual calculations of specific risk—that is, calculating specific risk in the internal model as well as using the standardized approach to establish the minimum specific risk charge—would be burdensome. However, the Agencies' decision to include the minimum specific risk charge was consistent with the Committee's conviction, at the time the Committee adopted its market risk amendment, that a floor was necessary to ensure that modeling techniques for specific risk adequately measured that risk.

Since the Committee adopted the market risk amendment, many institutions have significantly improved their modeling techniques and, in particular, their modeling of specific risk. In September 1997 the Committee determined that sufficient progress had been made to eliminate the use of the minimum specific risk charge and the burden of a separate calculation. Accordingly, the Committee revised the market risk amendment to the Accord so that an institution using a valid internal model to measure specific risk may use the VAR measures generated by the model without being required to compare the model-generated results to the minimum specific risk charge as calculated under the standardized

of three. Beginning no later than one year after adopting the market risk rules, an institution is required to backtest its internal model. An institution may be required to apply a higher multiplication factor, up to a factor of four, based on backtesting results.

approach.³ The revisions specify that the specific risk elements of internal models will be assessed consistently with the assessment of the general market risk elements of such models through review by the relevant supervisor and backtesting.

To implement this revision to the market risk amendment, the Agencies are issuing an interim rule with a request for comment. As discussed in the section entitled "Interim Effectiveness of the Rule," the Agencies have found that good cause necessitates making the amendments herein effective immediately, without opportunity for public comment or a delayed effective date. Effectiveness of the amendments herein is on an interim basis, until the Agencies issue a final rule, following public comment on this interim rule, in accordance with the procedures specified in section 553 of the Administrative Procedure Act, 5 U.S.C. 553. The interim rule applies only to the calculation of specific risk under the market risk rules. All other aspects of the market risk rules remain unchanged.

Description of the Interim Rule

An institution whose internal model does not adequately measure specific risk must continue to calculate the standard specific risk capital charge and add that charge to its VAR-based capital charge to produce its total regulatory capital requirement for market risk. An institution whose internal model adequately captures specific risk may base its specific risk capital charge on the model's estimates.

The Agencies will review an institution's internal model to ensure that the model adequately measures specific risk. In order to clarify the risks that must be assessed in this regard, the rule contains a new definition that states that specific risk means the changes in market value of specific positions due to factors other than broad market movements, including such risks as idiosyncratic variation as well as event and default risk. In order to adequately capture specific risk, an institution's internal model must explain the historical price variation in the portfolio and be sensitive to changes in portfolio concentrations (both magnitude and changes in composition), requiring additional capital for greater concentrations. The Agencies will also take into account whether an internal model is robust to an adverse

³The revisions are described in the Committee's document entitled "Explanatory Note: Modification of the Basle Capital Accord of July 1988, as Amended January 1996" and is available through the Board's and the OCC's Freedom of Information Office and the FDIC's Public Information Center.

environment. The model's ability to capture specific risk must be validated through backtesting aimed at assessing whether specific risk is adequately captured. In addition, the institution must be able to demonstrate that its methodologies adequately capture event and default risk. An institution that has been able to demonstrate that its supervisor that its internal model adequately captures specific risk consistent with the preceding discussion may use its VAR-based capital charge as its measure for market risk. Such an institution will have no specific risk add-on.

An institution whose model addresses idiosyncratic risk but does not adequately capture event and default risk will continue to have a specific risk add-on. The specific risk add-on for such an institution may be calculated using either one of two approaches, both of which have the effect of subjecting the modeled specific risk elements of the institution's internal risk model to a multiplier of four.⁴

Under the first approach, an institution's internal model must be able to separate its VAR measure into general market risk and specific risk components. The institution's measure for market risk would equal the sum of the total VAR-based capital charge (typically three times the internal model's general and specific risk measure), plus an add-on consisting of the isolated specific risk component of the VAR measure. Alternatively, an institution whose internal model does not separately identify the specific and general market risk of its VAR measure, may use as its measure for market risk the sum of the total VAR-based capital charge, plus an add-on consisting of the VAR measure(s) of the subportfolios of debt and equity positions that contain specific risk. An institution using this approach normally would identify its sub-portfolio structures prior to calculating market risk capital charges and may not alter those sub-portfolio structures without supervisory consultation.

An institution using its internal model for specific risk capital purposes must backtest its internal model to assess whether observed price variation arising from both general market risk and specific risk are accurately

⁴The multiplier applicable to the modeled general market risk elements will not be affected. Thus, the multiplier for general market risk will continue to be three, unless a higher multiplier is indicated by virtue of the institution's backtesting results for general market risk, or unless no multiplier is applied because the previous day's VAR for general market risk is higher than the 60-day average times the multiplier.

explained by the model. To assist in model validation, the institution should perform backtests on subportfolios containing specific risk, i.e., traded debt and equity positions. The institution should conduct these backtests with the understanding that subportfolio backtesting is a productive mechanism for assuring that instruments with higher levels of specific risk, especially event or default risk, are being accurately modeled. If backtests of subportfolios reflect an unacceptable internal model, especially for unexplained price variation that may be arising from specific risk, the institution should take immediate action to improve the internal model and ensure that it has sufficient capital to protect against associated risks.

The Agencies, based on information available to them, presently feel that the industry is making significant progress in developing methodologies for modeling specific risk, although progress relating to measurement of event and default risk lags somewhat. The Agencies' consultation over the past two years with other national supervisors on the Committee has supported this view. The Agencies expect institutions to continue improving their internal models and particularly to make substantial progress in measuring event and default risk for traded debt and equity instruments. The Agencies intend to work with the industry in these efforts and believe that, over time, market standards for measuring event and default risk will emerge. As individual modeling methodologies are improved and become accepted within the industry as effective measurement techniques for event and default risk, the Agencies will consider permitting all internal models based on that methodology to be applied without any add-on charge. The Basle Supervisors Committee may issue general guidance for capturing event and default risk for trading book instruments. Until such time as standards for measuring event and default risk are established within the industry, the Agencies intend to cooperate with each other and communicate extensively with other international supervisors to ensure that the market risk capital requirements are implemented in an appropriate and consistent manner.

The Agencies request comment on all aspects of these amendments to their market risk rules.

Interim Effectiveness of the Rule

The Agencies' amendments to their market risk rules are effective on December 31, 1997, but only on an

interim basis during the Agencies' full notice and comment rulemaking process. Section 553 of the Administrative Procedure Act permits the Agencies to issue a rule without public notice and comment when the agency, for good cause, finds (and incorporates the finding and a brief statement of reasons therefore in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest. 5 U.S.C. 553(b)(B). Section 553 also permits the Agencies to issue a rule without delaying its effectiveness for thirty days from the publication if the agency finds good cause and publishes it with the rule. 5 U.S.C. 553(d)(3). In addition, section 302 of the Riegle Community Development and Regulatory Improvement Act of 1994, 12 U.S.C. 4802(b), permits the Agencies to issue a regulation which takes effect before the first day of a calendar quarter beginning on or after the date on which the regulations are published in final form when the agency determines for good cause published with the regulation that the regulation should become effective before such time. The Agencies have found that good cause exists, for several reasons.

First, the amendments are extremely limited in scope. The number of institutions subject to the Agencies' market risk rules, and consequently to the amendments, is very small, in both absolute and relative terms. The amendments will serve only to reduce regulatory burden, by eliminating the need for institutions that model specific risk to make dual calculations under the standardized approach in order to determine their minimum specific risk charge. Such calculations, while not necessarily difficult from an analytical standpoint, are a voluminous and detailed operation to execute.

Second, immediate effectiveness of the amendments is necessary. The market risk rules become mandatory for certain institutions in January of 1998, and the Agencies will not be able to complete the full rulemaking process by that time. Institutions covered by the market risk rule that model specific risk would be needlessly forced to commit significant internal resources to implement the dual calculation approach potentially on a temporary basis. Contrary to the public interest, they could also be placed at a competitive disadvantage vis a vis their competitors (internationally-active banks in other G-10 countries) who, because of the recent G-10 Governors' endorsement of the Committee's new approach, will not be subject to any dual calculation requirement.

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Agencies have determined that this interim final rule would not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). The Agencies' comparison of the applicability section of the rule to which these amendments pertain to Consolidated Reports of Condition and Income (Call Report) data on all existing institutions shows that the rule will rarely, if ever, apply to small entities. Accordingly, a regulatory flexibility analysis is not required.

Paperwork Reduction Act

The Agencies have determined that the interim final rule does not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*).

OCC Executive Order 12866 Determination

The OCC has determined that the interim final rule does not constitute a "significant regulatory action" for the purpose of Executive Order 12866.

OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. As discussed in the preamble, this interim rule eliminates the minimum specific risk charge for institutions that use internal models that adequately capture specific risk. The effect of this rule is to reduce regulatory burden by no longer requiring institutions to make dual calculations under both the institution's internal model and the standardized specific risk model. The OCC therefore has determined that the effect of the interim rule on national banks as a whole will not result in expenditures by State, local, or tribal governments or by the private sector of \$100 million or more. Accordingly, the OCC has not prepared a budgetary impact statement or specifically

addressed the regulatory alternatives considered.

List of Subjects

12 CFR Part 3

Administrative practice and procedure, Capital, National banks, Reporting and recordkeeping requirements, Risk.

12 CFR Part 208

Accounting, Agriculture, Banks, banking, Confidential business information, Crime, Currency, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Securities.

12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

12 CFR Part 325

Bank deposit insurance, Banks, banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State non-member banks.

Authority and Issuance

Office of the Comptroller of the Currency

12 CFR Chapter I

For the reasons set out in the joint preamble, part 3 of chapter I of title 12 of the Code of Federal Regulations is amended as set forth below:

PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

1. The authority citation for part 3 continues to read as follows:

Authority: 12 U.S.C. 93a, 161, 1818, 1828(n), 1828 note, 1831n note, 1835, 3907, and 3909.

2. Section 2 of Appendix B to part 3 is amended by revising paragraph (b)(2) to read as follows:

Appendix B To Part 3—Risk-Based Capital Guidelines; Market Risk Adjustment

* * * * *

Section 2. Definitions

* * * * *

(b) * * *

(2) *Specific risk* means changes in the market value of specific positions due to factors other than broad market movements and includes default and event risk as well as idiosyncratic variations.

* * * * *

3. Section 5 of appendix B to part 3 is amended by revising paragraphs (a) and (b) to read as follows:

* * * * *

Section 5. Specific Risk

(a) *Specific risk surcharge.* For purposes of section 3(a)(2)(ii) of this appendix, a bank shall calculate its specific risk surcharge as follows:

(1) *Internal models that incorporate specific risk.* (i) *No specific risk surcharge required for qualifying internal models.* A bank that incorporates specific risk in its internal model has no specific risk surcharge for purposes of section 3(a)(2)(ii) of this appendix if the bank demonstrates to the OCC that its internal model adequately measures all aspects of specific risk, including default and event risk, of covered debt and equity positions. In evaluating a bank's internal model the OCC will take into account the extent to which the internal model:

(A) Explains the historical price variation in the trading portfolio; and

(B) Captures concentrations.

(ii) *Specific risk surcharge for modeled specific risk that fails to adequately measure default or event risk.* A bank that incorporates specific risk in its internal model but fails to demonstrate that its internal model adequately measures all aspects of specific risk, including default and event risk, as provided by this section 5(a)(1), must calculate its specific risk surcharge in accordance with one of the following methods:

(A) If the bank's internal model separates the VAR measure into a specific risk portion and a general market risk portion, then the specific risk surcharge equals the previous day's specific risk portion.

(B) If the bank's internal model does not separate the VAR measure into a specific risk portion and a general market risk portion, then the specific risk surcharge equals the sum of the previous day's VAR measure for subportfolios of covered debt and equity positions.

(2) *Specific risk surcharge for specific risk not modeled.* If a bank does not model specific risk in accordance with section 5(a)(1) of this appendix, then the bank shall calculate its specific risk surcharge using the standard specific risk capital charge in accordance with section 5(c) of this appendix.

(b) *Covered debt and equity positions.* If a model includes the specific risk of covered debt positions but not covered equity positions (or vice versa), then the bank may reduce its specific risk charge for the included positions under section 5(a)(1)(ii) of this appendix. The specific risk charge for the positions not included equals the standard specific risk capital charge under paragraph (c) of this section.

* * * * *

Dated: December 19, 1997.

Eugene A. Ludwig,

Comptroller of the Currency.

Federal Reserve System

12 CFR Chapter II

For the reasons set forth in the joint preamble, parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations are amended as follows:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

1. The authority citation for part 208 continues to read as follows:

Authority: 12 U.S.C. 24, 36, 92(a), 93(a) 248(a), 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1816, 1818, 1820(d)(9), 1823(j), 1828(o), 1831, 1831o, 1831p–1, 1831r–1, 1835(a), 1882, 2901–2907, 3105, 3310, 3331–3351, and 3906–3909; 15 U.S.C. 78b, 781(b), 781(g), 781(i), 78o–4(c)(5), 78q, 78q–1, and 78w; 31 U.S.C. 5318; 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128.

2. In appendix E to part 208, section 1., paragraph (a), footnote 1 is revised to read as follows:

Appendix E to Part 208—Capital Adequacy Guidelines for State Member Banks; Market Risk Measure

Section 1. Purpose, Applicability, Scope, and Effective Date

(a) * * * * *

3. In appendix E to part 208, section 2., paragraph (b)(2) is revised to read as follows:

* * * * *

Section 2. Definitions

* * * * *

(b) * * *

(2) *Specific risk* means changes in the market value of specific positions due to factors other than broad market movements. Specific risk includes such risk as idiosyncratic variation, as well as event and default risk.

* * * * *

4. In appendix E to part 208, section 5., paragraphs (a), (b), and (c) introductory text are revised to read as follows:

* * * * *

¹ This appendix is based on a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Supervision and endorsed by the Group of Ten Central Bank Governors. The framework is described in a Basle Committee paper entitled "Amendment to the Capital Accord to Incorporate Market Risks," January 1996. Also see modifications issued in September 1997.

Section 5. Specific Risk

(a) *Modeled specific risk* A bank may use its internal model to measure specific risk. If the bank has demonstrated to the Federal Reserve that its internal model measures the specific risk, including event and default risk as well as idiosyncratic variation, of covered debt and equity positions and includes the specific risk measures in the VAR-based capital charge in section 3(a)(2)(i) of this appendix, then the bank has no specific risk add-on for purposes of section 3(a)(2)(ii) of this appendix. The model should explain the historical price variation in the trading portfolio and capture concentration, both magnitude and changes in composition. The model should also be robust to an adverse environment and have been validated through backtesting which assesses whether specific risk is being accurately captured.

(b) *Add-on charge for modeled specific risk.* If a bank's model measures specific risk, but the bank has not been able to demonstrate to the Federal Reserve that the model adequately measures event and default risk for covered debt and equity positions, then the bank's specific risk add-on is determined as follows:

(1) If the model is susceptible to valid separation of the VAR measure into a specific risk portion and a general market risk portion, then the specific risk add-on is equal to the previous day's specific risk portion.

(2) If the model does not separate the VAR measure into a specific risk portion and a general market risk portion, then the specific risk add-on is the sum of the previous day's VAR measures for subportfolios of covered debt and covered equity positions.

(c) *Add-on charge if specific risk is not modeled.* If a bank does not model specific risk in accordance with paragraph (a) or (b) of this section, then the bank's specific risk add-on charge equals the components for covered debt and equity positions as appropriate:

* * * * *

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p-1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331-3351, 3907, and 3909.

2. In appendix E to part 225, the appendix heading is revised and in section 1., paragraph (a), footnote 1 is revised to read as follows:

Appendix E To Part 225—Capital Adequacy Guidelines For Bank Holding Companies: Market Risk Measure

Section 1. Purpose, Applicability, Scope, and Effective Date

(a) * * * 1 * * *

¹ This appendix is based on a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee

* * * * *

3. In appendix E to part 225, section 2., paragraph (b)(2) is revised to read as follows:

* * * * *

Section 2. Definitions

* * * * *

(b) * * *

(2) *Specific risk.* means changes in the market value of specific positions due to factors other than broad market movements. Specific risk includes such risk as idiosyncratic variation, as well as event and default risk.

* * * * *

4. In appendix E to part 225, section 5., paragraphs (a), (b), and (c) introductory text are revised to read as follows:

* * * * *

Section 5. Specific Risk

(a) *Modeled specific risk.* A bank holding company may use its internal model to measure specific risk. If the institution has demonstrated to the Federal Reserve that its internal model measures the specific risk, including event and default risk as well as idiosyncratic variation, of covered debt and equity positions and includes the specific risk measures in the VAR-based capital charge in section 3(a)(2)(i) of this appendix, then the institution has no specific risk add-on for purposes of section 3(a)(2)(ii) of this appendix. The model should explain the historical price variation in the trading portfolio and capture concentration, both magnitude and changes in composition. The model should also be robust to an adverse environment and have been validated through backtesting which assesses whether specific risk is being accurately captured.

(b) *Add-on charge for modeled specific risk.* If a bank holding company's model measures specific risk, but the institution has not been able to demonstrate to the Federal Reserve that the model adequately measures event and default risk for covered debt and equity positions, then the institution's specific risk add-on is determined as follows:

(1) If the model is susceptible to valid separation of the VAR measure into a specific risk portion and a general market risk portion, then the specific risk add-on is equal to the previous day's specific risk portion.

(2) If the model does not separate the VAR measure into a specific risk portion and a general market risk portion, then the specific risk add-on is the sum of the previous day's VAR measures for subportfolios of covered debt and covered equity positions.

(c) *Add-on charge if specific risk is not modeled.* If a bank holding company does not model specific risk in accordance with paragraph (a) or (b) of this section, then the institution's specific risk add-on charge

on Banking Supervision and endorsed by the Group of Ten Central Bank Governors. The framework is described in a Basle Committee paper entitled "Amendment to the Capital Accord to Incorporate Market Risks," January 1996. Also see modifications issued in September 1997.

equals the components for covered debt and equity positions as appropriate:

* * * * *

By order of the Board of Governors of the Federal Reserve System, December 19, 1997.
William W. Wiles,
Secretary of the Board.

**Federal Deposit Insurance Corporation
12 CFR Chapter III**

For the reasons set forth in the joint preamble, part 325 of chapter III of title 12 of the Code of Federal Regulations is amended as follows:

PART 325—CAPITAL MAINTENANCE

1. The authority citation for part 325 continues to read as follows:

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(m), 1828(o), 1831o, 1835, 3907, 3909, 4808; Pub. L. 102-233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102-242, 105 Stat. 2236, 2355, 2386 (12 U.S.C. 1828 note).

2. In appendix C to part 325, section 1(a), footnote 1 is revised to read as follows:

Appendix C to Part 325—Risk-Based Capital For State Non-Member Banks; Market Risk

Section 1. Purpose, Applicability, Scope, and Effective Date

(a) * * * 1 * * *

* * * * *

3. In appendix C to part 325, section 2., paragraph (b)(2) is revised to read as follows:

* * * * *

Section 2. Definitions

* * * * *

(b) * * *

(2) *Specific risk* means changes in the market value of specific positions due to factors other than broad market movements. Specific risk includes such risk as idiosyncratic variation, as well as event and default risk.

* * * * *

4. In appendix C to part 325, section 5., paragraphs (a), (b), and (c) introductory text are revised to read as follows:

* * * * *

Section 5. Specific Risk

(a) *Modeled specific risk.* A bank may use its internal model to measure specific risk. If

¹ This appendix is based on a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Supervision and endorsed by the Group of Ten Central Bank Governors. The framework is described in a Basle Committee paper entitled "Amendment to the Capital Accord to Incorporate Market Risks," January 1996. Also see modifications issued in September 1997.

the bank has demonstrated to the FDIC that its internal model measures the specific risk, including event and default risk as well as idiosyncratic variation, of covered debt and equity positions and includes the specific risk measure in the VAR-based capital charge in section 3(a)(2)(i) of this appendix, then the bank has no specific risk add-on for purposes of section 3(a)(2)(ii) of this appendix. The model should explain the historical price variation in the trading portfolio and capture concentration, both magnitude and changes in composition. The model should also be robust to an adverse environment and have been validated through backtesting which assesses whether specific risk is being accurately captured.

(b) Add-on charge for modeled specific risk. If a bank's model measures specific risk,

but the bank has not been able to demonstrate to the FDIC that the model adequately measures event and default risk for covered debt and equity positions, then the bank's specific risk add-on for purposes of section 3(a)(2)(ii) of this appendix is as follows:

(1) If the model is susceptible to valid separation of the VAR measure into a specific risk portion and a general market risk portion, then the specific risk add-on is equal to the previous day's specific risk portion.

(2) If the model does not separate the VAR measure into a specific risk portion and a general market risk portion, then the specific risk add-on is the sum of the previous day's VAR measures for subportfolios of covered debt and covered equity positions.

(c) *Add-on charge if specific risk is not modeled.* If a bank does not model specific risk in accordance with paragraph (a) or (b) of this section, the bank's specific risk add-on charge for purposes of section 3(a)(2)(ii) of this appendix equals the components for covered debt and equity positions as appropriate:

* * * * *

Dated at Washington, D.C. this 9th day of December, 1997.

By order of the Board of Directors.
Federal Deposit Insurance Corporation.
Robert E. Feldman,
Executive Secretary.

[FR Doc. 97-33653 Filed 12-29-97; 8:45 am]

BILLING CODE 4810-33-P, 6210-01-P, 6714-01-P