Market-Risk Capital Standards

Cite

FDIC, FRB, OCC, Notice of Proposed Rulemaking, Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity

Recommended Distribution

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Website

https://www.fdic.gov/news/board-matters/2023/2023-07-27-notice-dis-a-fr.pdf

Impact Assessment

- The MRBC proposal increases capital in this arena by as much as seventy percent.
- The agencies believe higher MRBC will enhance market liquidity under stress because banks will be more resilient. However, banks could choose to abandon costly dealer or market-making activities, leaving the market under-served or served largely by nonbanks exempt from capital and liquidity regulation.
- To the extent this occurs, the Fed could find itself compelled to intervene or fear it could be compelled to do so, providing emergency safety nets for nonbanks that heighten moral hazard.
- It is unclear how the MRBC framework is to interact with SCB market-shock stresses.
- Risks could rise as certain hedges are not recognized for capital purposes, creating a disincentive for banks to obtain them as well as reducing the ability of banks to engage in derivatives activities. To the extent banks exit this arena, capital markets could be significantly riskier because it is unclear if nonbanks have sufficient capacity to substitute for banks in many key markets.

Overview

In this analysis, we turn to one of the costliest aspects of the proposed rewrite of U.S. regulatory-capital standards: the market-risk framework. This aspect of the proposal would significantly rewrite current U.S. market-risk rules[1] to reflect the "fundamental review of the trading book" (FRTB) regime the Basel Committee crafted in 2018.[2] However, unlike the global rules, the U.S. approach would largely dispense with reliance on internal models in a manner generally consistent with the overall decision to eschew models;[3] even where models are allowed for market risk, they are strictly constrained. These standards thus would raise current market risk-based capital (MRBC)

[1] See **CAPITAL181**, *Financial Services Management*, May 29, 2012.

[2] See **CAPITAL223,** *Financial Services Management*, March 18, 2018.

[3] See **CAPITAL230**, *Financial Services Management,* August 1, 2023.

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requirements by as much as seventy percent,[4] with much of this falling on category I and II banks no longer allowed to use their current, largely models-based methodologies. However, banks in category III and IV that do not have significant capital-markets activities would share at least some of this cost because the new approach proposed for equity holdings moves many positions now housed in the more generous banking book into the trading book covered by these market-risk standardized requirements.[5]

Impact

One rationale the preamble provides for applying market-risk standards to category I, II, III, and IV banks is that the Basel rules do so to like-kind banks in other nations. While some regions do apply Basel-like standards to all banks, the global standards expressly apply only to internationally active banks. As a result, domestic-focused U.S. banks would come under costly new rules that might ensure competitive parity with category I and II banks, but the international-equity rationale is unclear.

Another major objective of the new approach is to ensure consistency across all large banks. However, as noted below and detailed still more extensively in the NPR, primary supervisors have significant discretion on strategic areas such as which trading desks may use internal models. In practice, the banking agencies are likely to differ among themselves and even within themselves on initial and continuing eligibility as well as on the extent to which extensive internal-control standards are met. Some of this dissonance may be reduced by the decision of all but the largest banks to stick with only the standardized approach (SA), but numerous compliance requirements could still lead to significant practical variations and resulting capital arbitrage.

Unlike the Basel rules and current MRBC standards, the NPR includes a particularly long list of actions that require initial and ongoing supervisory approval as well as continuing compliance with complex model requirements and numerous controls. These appear intended to create strong incentives for banks to elect the SA unless their capital-markets operations are so extensive and profitable as to warrant significant initial investment and costly model validation, back-testing, governance, monitoring, and disclosure. Variability would be decreased by SA use, but the risks Basel and the U.S. initially feared from a standardized approach to highly-complex instruments and markets could result, adversely affecting safety, soundness, and liquidity.

In addition, Banks and especially large regional ones may reduce integrated banking and brokerage services if these involve bank actions with principal in the capital market and reduce debt and equity underwriting services for state and local corporate and municipal entities if these involve holding assets that are or could be subsequently traded. Smaller issuers could thus find it harder to access capital markets and/or do so at greater cost if regional banks find it uneconomic to serve local clients.

The impact on markets could be still more significantly marked if large banks exit key businesses such as prime brokerages in which market share is already highly concentrated. Although foreign banks would generally fall under U.S. MRBC standards for their operations here, the cost could be significantly reduced in total impact when consolidated with that for like-kind activities outside the U.S. U.S.-domiciled trading activities could also move offshore to the extent that time zones and dollar-clearing needs allow.

The largest banks are also now subject to a "global market shock" in concert with Fed-dictated stress tests. Much in the proposed methodology appears designed to ensure resilience under like-kind stress with the possible exception of those stresses still

[4] See forthcoming *FedFin report*.

[5] See **CAPITAL232**, *Financial Services Management*, August 8, 2023.

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allowed to be determined by internal models. However, the SA would still be binding if tougher than internal models and it is unclear how its results may differ from the Fed's scenarios (likely based on SA or similar approaches under stresses comparable to those mandated in the MRBC). Even if they do not precisely align, it is most unclear if two exercises that identify severely adverse scenarios and then mandate differing capital requirements against them are additive as the agencies intend or duplicative in ways costly enough to adversely affect the ability of banks to remain major market participants. Should some large U.S. banks curtail their activities, nonbanks with none of the resilience demanded by these rules would join foreign banks in picking up those aspects of big-bank business they wish. However, how the system would fare in an actual global-market shock would thus seem to be an even greater concern.

The NPR generally sets market-risk measurements on an average quarterly or annual basis. This is intended to eliminate the "window-dressing" possible under the current quarter-end measure. This approach will likely require systems revamp as well as often lead to more binding MRBC.

Perhaps understanding the new burden even for banks that elect the SA, the preamble's initial discussion asks if these market-risk rules should apply only to banking organizations with only immaterial exposure in equities or the capital markets. Should they decide to provide this materiality exemption, then category III and IV banks will duck what for them would otherwise be a very costly compliance exercise for asset-price vulnerabilities unlikely to have meaningful safety-and-soundness impact.

What's Next

The capital standards were approved on a 4-2 vote by the Federal Reserve Board, a 3-2 vote by the FDIC board, and the Acting Comptroller of the Currency on July 27. Comment is due November 30. The new rules will be phased in beginning on July 1, 2025 until June 30, 2028. A similar three-year phase-in is detailed for category III and IV banks with regard to AOCI recognition.

In addition to these standards, the agencies will issue new disclosure requirements. They will also modify rules affected by the new approach to regulatory capital, including via the GSIB modification proposed in concert with this proposal.[6] Other affected rules revised by this proposal govern TLAC[7] and single-counterparty exposures, eliminating reliance on internal models.[8] The Board in 2019 also issued a long-delayed proposal governing the capital of depository institution holding companies with significant insurance operations.[9] Any final rule will reflect the new capital regime, with no time indicated for how long it may take the Board to do so once these rules are finalized. Thus, as has long been the case, these insurance-focused companies remain subject to significant uncertainty about parent-company capital standards but avert the top-down, bank-focused approach the Board once favored.

Analysis

The MRBC proposal is the longest and most complex aspect of the agencies' proposal. This analysis focuses on its framework, key provisions, and likely outcomes. It does not

[6] See forthcoming *FedFin report.*

[7] See **TLAC6**, *Financial Services Management,* December 21, 2016.

[8] See **CONCENTRATION11**, *Financial Services Management*, June 25, 2018.

[9] See **INSURANCE60**, *Financial Services Management,* September 17, 2019.

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address the complex formulas taken for many different forms of equity holdings, trading assets, and related positions.

A. Scope

1. Covered Banks

In addition to covering category I, II, III, and IV banks, the new approach would cover banking organizations with average aggregate trading assets and trading liabilities, excluding customer and proprietary broker-dealer reserve bank accounts, over the previous four calendar quarters equal to $5 billion or more (up from the current $1 billion threshold to adjust for inflation) or ten percent or more of total consolidated assets. Subsidiaries of covered banks also come under this rule if they have any trading activity over the past four quarters unless the primary supervisor prefers another measure by which to decide if a bank should be in or out of the market-risk rules.

2. Covered Assets

Trading assets, unencumbered hedges, trading liabilities and other "covered positions" generally come under the rule, albeit with various technical definitions and occasional exemptions and areas of supervisory discretion. Because certain assets that are not trading assets are placed within the MRBC framework, reflecting the new approach to relatively liquid equity investments (e.g., those in investment funds) the proposed definition is broader than the current one to ensure that market risk is fully within the MRBC framework. This is one of the proposal's costliest provisions, especially with regard to internal risk transfers and net-short risk positions. As in the current rule, some tradeable assets (e.g., MSAs) that are deducted from capital are not considered MRBC covered positions; comment is sought on other assets that are deducted from capital but still considered covered.

Many questions are posed about which assets would be covered and how.

B. Framework

1. Binding Ratios

SA calculations would be the default MRBC requirement, with prior approval necessary to use models-based options. Model use where allowed is further restricted to the trading desks (tightly defined and governed) that is then able to capture market risk validated by back-testing and comparison to front-office calculations of the same risks. Current VaR models would be replaced with a new shortfall methodology based on the average of all potential losses exceeding the VaR at a given confidence level over a specified horizon.

Liquidity horizons would vary by underlying risks, ending the current, fixed ten-day liquidity horizon. Capital would be determined by a four-quarter average, not at year-end.

2. SA

The proposed standardized measure for market risk would consist of be the sum of three initial and three optional components. The initial ones would be:

- a sensitivities-based requirement capturing non-default market risk based on estimated losses produced by risk sensitivity under regulator-determined stress conditions;

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- a standardized default-risk requirement capturing losses on credit and equity positions in the event of issuer default; and
- a residual risk add-on addressing any other known risks not already captured by the first two components (e.g., gap, correlation, behavioral risks). These factors limit the capital benefit of hedging and diversification on grounds that these factors often do not absorb risk under stress.

Further, three additional components that could apply in limited instances to specific positions include:

- a fallback requirement when a bank is unable to calculate MRBC under the sensitivities-based method or the standardized default risk requirement;
- an add-on when a bank reclassifies an instrument under different capital standards; and
- any additional capital required by the primary supervisor.

3. Model-Based Charges

The core components of the models-based measure for market risk would be:

- the internal models approach requirements for model-eligible trading desks (specified in the proposal);
- the SA for model-ineligible trading desks; and
- the additional capital requirement applied to model-eligible trading desks with shortcomings in the internal models used for determining risk-based capital requirements in the form of a PLA (profit/loss adjustment) add-ons.

Possible additional charges in the model's approach include:

- add-ons when the capital requirements for model-eligible desks exceed those under the standardized approach;
- a fallback capital requirement when a bank cannot apply the SA to positions on model-ineligible trading desks or the internal model's approach to market risk covered positions on model-eligible trading desks and all securitization and correlation trading positions excluded from the capital add-on for ineligible positions on model-eligible trading desks;
- the capital add-on for capital reclassifications; and
- any PLA.

The models-based measure for market risk would cap the sum of these components at the capital required for all trading desks under the standardized approach. However, a primary supervisor could still require more capital and use of many definitions, modelling practices, and formulas requires supervisory approval, with supervisors again given considerable discretion to allow variations.

C. Risk Management

The proposal also includes extensive requirements for internal and independent controls, with these particularly stringent for trading desks allowed to use internal models. While current rules have similar requirements, the proposal demands considerably more (e.g., a broader set of monitoring risk metrics, more reporting to senior management, additional documentation). Trading desks also allowed to use the expected-shortfall and other models described above would also need to incorporate results into daily risk monitoring and management, back-testing and

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validating models on their own and with independent entities. The NPR states that the agencies recognize that the new framework is formidable and commit to give companies time to bring their trading desks into compliance not only as the rule comes into effect, but also as banks change their business model or otherwise later capital-markets activities. However, banks could not even seek regulatory approval for internal-model use for six months after trading desks have implemented all the requisite models and risk controls unless another bank trading desk has implemented all the requirements and received supervisory approval; trading desks in the process of building out the new internal-models standards would need to hold more capital (although the proposal does not make it clear if the SA suffices). Banks would also need to obtain written supervisory approval before changing key aspects of trading desks that use internal models. Prompt notice is required even for non-material changes, but supervisors have discretion to mandate only limited remedies in these cases. Model approval would also depend on continual compliance.

D. Reporting and Disclosure Requirements

The proposal includes numerous public and confidential supervisory reports the agencies believe strike the proper balance between transparency and sensitive business information. In general, current standards related to public disclosure and attestation are unchanged, with the proposal confining most of its new standards to confidential supervisory reporting. These would be extensive, especially for banks using internal models.

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