

determining the charge for general market risk.

As in the maturity method, the base capital charge for general market risk is the sum of the estimated price changes across all time bands. If that sum is negative, the base charge would be its absolute value. Different time-bands are used for the two methods because an instrument's duration can be substantially different from its maturity.

In addition to the base capital charge for general market risk, as reflected by the institution's net risk-weighted position, an institution would be subject to a series of capital "add-ons" that are designed to take into account imperfect and uncertain correlations among instrument types and maturities. These add-ons recognize that long and short positions might not, in practice, offset each other by the full amount that their risk-weightings would suggest, and therefore, some portion of the hedged or offsetting position should be disallowed.

The first disallowance (referred to as the vertical disallowance) is intended to address the basis risk that exists between instruments with the same or similar maturities and also the possibly different price movements that may be experienced by different instruments within the same time-band due to the range of maturities (or repricing periods) that may exist within a time-band. To capture this risk, a vertical disallowance is applied to the smaller of the offsetting (long or short) positions within a time-band.¹⁶ This disallowance is 10 percent under the maturity method, and 5 percent under the duration method. For example, under the maturity method, if the sum of weighted long positions within a time-band equals \$100 million and the sum of weighted short positions equals \$90 million, the vertical disallowance for the time-band would be 10 percent of \$90 million, or \$9 million. This amount would be added to the institution's base capital charge. The use of two different vertical disallowances recognizes that because the duration method takes into account an instrument's specific characteristics (maturity and coupon), there is less opportunity for measurement error.¹⁷

¹⁶ If the offsetting amounts (long and short) are equal, the disallowance can be applied to either figure.

¹⁷ In the case of cash positions and transactions conducted on an exchange (e.g. futures) an institution has the opportunity to adjust its market risk either by acquiring a new position or selling an existing one. However, that is not typically the case with interest rate swaps, for which an institution almost always adjusts its position by entering into a new or offsetting swap, rather than by selling or unwinding one that it already holds. This procedure, required partly because of the lack of

The second disallowance (or horizontal disallowance) addresses the risk that interest rates along the yield curve are not perfectly correlated and that risk-weighted positions that might have been expected to offset will not fully offset, in practice. The horizontal disallowance applies to the smaller of the offsetting positions across different time-bands. The amount of this disallowance varies in size by zone (that is, a grouping of contiguous time bands), with greater netting allowed for positions in different time bands but within the same zone than is allowed for positions that are in different zones (Table 3—OCC, Table II—Board, Table 2—FDIC in the proposed regulatory language). The horizontal disallowances range from 30 percent to 100 percent of the smaller figure in a pair of offsetting transactions.¹⁸

In calculating these disallowances, an institution would first determine its offsetting positions within a zone and the associated "within zone" disallowance amounts. Once the institution has netted its positions within a zone, it would determine the amount of offsetting and associated disallowances across zones. An institution's general market risk requirement for debt instruments within a given currency would be the sum of (1) the value of its net risk-weighted position (base charge) and (2) all of its vertical and horizontal disallowances.

b. *Specific risk.* Under the proposal, generally every traded security, whether long or short, would be assessed a capital charge for specific market risk. In the debt portfolio this charge is based on the identity of the obligor and, in the case of corporate securities, on the credit rating and maturity of the instrument. Consistent with the original Accord, debt instruments of national governments of OECD countries are assigned zero specific risk. Other securities are assigned risk weights

standardization in the terms and credit risk characteristics of swaps, can produce large swap portfolios and potentially large disallowances under the standardized approach.

Consequently, the Agencies' proposal would allow institutions with large swap books to use alternative procedures for calculating the amounts that would be distributed into the maturity or duration time bands. One approach would be to convert the payments required by a swap into their present values using zero coupon yields and then to place those amounts into their appropriate time bands using the procedures that apply to zero (or low) coupon bonds. The net amounts for each time band would then be weighted and subject to the disallowances of the general market risk framework as if they were bonds. The Agencies would also consider other procedures.

¹⁸ Since the disallowance is applied to only one side of an offsetting transaction, a 100 percent disallowance effectively treats the hedge as being 50 percent effective.

ranging from 0.25 percent to 1.6 percent if they are issued by *qualifying* borrowers. Securities of nonqualifying issuers are charged a specific risk of 8.0 percent. To be considered as qualifying, the security must be rated as investment grade by at least two nationally recognized credit rating firms or, if the issuer has securities listed on a recognized stock exchange, it must be deemed to be of comparable investment quality by the reporting institution.

This latter condition is provided to accommodate the fact that in some countries credit ratings and the coverage of credit rating firms are not as extensive as in the United States. Consequently, the securities of many large and well-established foreign companies may not be rated. In such cases, a company's listing on an organized exchange may be an acceptable substitute for credit ratings if such listings are limited to financially strong and well-established firms. In these cases, and in the absence of independent credit ratings, the securities of a listed company may qualify for a lower capital charge if the trading institution and its appropriate supervisor believe the securities are equivalent to investment grade. However, the Agencies are proposing that, given the presence and wide coverage in the United States of credit rating firms, institutions would not be allowed to qualify the securities of a U.S. firm on the basis of a listing on an organized exchange.

During the examination process, the Agencies would also consider the extent to which an institution trades non-investment grade instruments (sometimes called high yield debt) that do not qualify for risk weights less than 8.0 percent because of the lack of investment grade ratings. If these holdings are not well diversified or if they otherwise represent material exposures to the institution, the Agencies may prevent an institution from netting the exposures arising from these instruments with otherwise offsetting exposures resulting from positions in qualifying instruments.

Equities Held in Trading Portfolios

The standardized measure of market risk in traded equities also consists of separate charges for specific and general market risk. These charges would apply not only to direct holdings of equity securities, but also to equity derivatives and off-balance-sheet positions whose market values are directly affected by equity prices.

a. *General market risk.* An institution's general market risk capital charge would be 8.0 percent of its net