(v) The FDIC generally expects any bank that is subject to this appendix C, especially those with large trading accounts, to compute the measure for market risk by using internal risk-measurement models. A bank may not change its measurement approach for the purpose of minimizing capital requirements. In limited instances, on a case-by-case basis, the FDIC may permit a bank that has internal models to incorporate alternative measures for market risk of negligible exposures (for example, *de minimis* positions, activities in remote locations, minor exposures in a currency, or activities that present negligible risk to the bank), so long as it adequately captures the risk.

(vi) The FDIC will monitor the implementation and effect of these guidelines in relation to domestic and international developments in the banking industry. When necessary and appropriate, the FDIC will consider the need to modify this appendix C in light of any significant changes in the economy, financial markets, banking practices, or other relevant factors.

I. Scope of the Market Risk Capital Requirement

A. Banks Subject to This Appendix C

1. Effective December 31, 1997, this appendix C will be applied to any FDIC-insured state-chartered bank that is not a member of the Federal Reserve System (excluding insured branches of foreign banks) and that, on a consolidated basis, either:

a. Has total assets in excess of $5 billion, and:

i. Has a total volume of trading activities (measured as the sum of the bank's trading assets and liabilities [4] on a daily average basis for the quarter) that is 3.0 percent or more of the total assets of the bank; or

ii. Has interest rate, foreign exchange, equity, and commodity off-balance-sheet derivative contracts relating to trading activities whose total notional amounts exceed $5 billion; or

b. Has total assets of $5 billion or less and has a total volume of trading activities exceeding 10.0 percent of the total assets of the bank.

2. Such banks identified in paragraph 1 (hereinafter referred to as ''banks''), when calculating their risk-based capital ratio under appendix A of this part, are required to refer to this appendix C for supplemental rules to determine their qualifying and eligible capital, calculate risk-weighted assets, calculate market-risk equivalent assets and add them to risk-weighted assets, and calculate risk-based capital ratios adjusted for market risk.[5]

B. Market Risks Subject to a Capital Requirement

1. *General Market Risk and Specific Risk*. A bank must hold capital against exposure to general market risk and specific risk arising from its trading and other foreign exchange and commodity activities. For this purpose, general market risk refers to changes in the market value of covered transactions resulting from market movements, such as changing levels of market interest rates, broad equity indices, or currency exchange rates. Specific risk refers to credit risk, that is, the risk that the issuer of a debt or equity instrument might default, as well as to other factors that affect the market value of specific instruments but that do not materially alter market conditions.[6]

2. *Trading Activities*. a. The measure for market risk in trading activities is based on on- and off-balance-sheet positions in a bank's trading account. For this purpose, the trading account consists of positions in financial instruments acquired with the intent to resell in order to profit from short-term price movements (or other price or interest-rate variations), including, but not limited to:

i. Assets acquired with the intent to resell to customers;

ii. Positions in financial instruments arising from matched principal brokering and market making; or

iii. Positions taken in order to hedge other elements of the trading account (that is, reduce risk by offsetting other positions that have exposure to changes in market rates or prices).[7]

b. Trading account activities may include positions in debt instruments, equities, foreign currencies, and commodity instruments, or related derivative [8] or other off-balance-sheet contracts.

c. The debt instruments in the trading account category consists of all fixed-rate and floating-rate debt securities and instruments that behave like debt, including non-convertible preferred stock. Convertible bonds, i.e., preferred stock or debt issues that are convertible, at a stated price, into common shares of the issuer, should be treated as debt instruments if they trade like debt instruments and as equities if they trade like equities. Also included are derivative contracts of debt instruments and other off-balance-sheet instruments in the trading account that react to changes in interest rates (for example, forward rate agreements (FRAs), bond futures, interest rate and cross-currency swaps and forward foreign exchange positions). A security that has been sold subject to a repurchase agreement or lent subject to a securities lending agreement is treated as if it were still owned by the lender of the security, but the off-balance-sheet portion of the transaction remains an element of risk-weighted assets as set forth in section II. of appendix A of this part.

d. The equities in the trading account category consist of equity instruments that behave like equities. The instruments covered include common stocks (whether voting or non-voting), convertible securities that behave like equities, and commitments to buy or sell equity securities. Also included are derivative contracts of equity instruments and other off-balance-sheet instruments in the trading account that are affected by changes in equity prices. However, non-convertible preferred stock is included in debt instruments.

3. *Foreign Exchange and Commodities Risk*. Foreign exchange or commodities positions, whether or not included in a bank's trading account, are subject to a measure for market risk of those positions.

a. The measure for market risk of foreign exchange applies to a bank's total currency and gold positions. This includes spot positions (that is, asset items and liability items, including accrued interest and expenses, denominated in each currency); forward positions (that is, forward foreign exchange transactions, including currency futures and the principal on currency swaps not included in the spot position); and certain guarantees. It also includes future income and expenses from foreign currency transactions not yet accrued but already fully hedged (at the discretion of the reporting bank), foreign exchange derivative and other off-balance-sheet positions that are affected by changes in exchange rates, and any other item representing a profit or loss in foreign currencies.

b. A bank doing negligible business in foreign currency and that does not take foreign exchange positions for its own account may be exempted from the market risk measure for foreign exchange risk provided that:

i. Its foreign currency business, defined as the greater of the sum of its gross long positions and the sum of its gross short positions in all foreign currencies as determined under section IV.C.2 of this appendix C, does not exceed 100 percent of eligible capital as defined in section II. of this appendix C; and

ii. Its overall net open foreign exchange position as determined under section IV.C.3. of this appendix C does not exceed 2.0 percent of eligible capital.

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simplified and scenario methods, the underlying position of an option is ''carved-out,'' and is not included in the prescribed risk measure for the underlying debt, equity, foreign exchange or commodity. Instead it is evaluated together with the related option according to the procedures described for options to determine the capital requirement. Under the third alternative, the ''delta-plus'' approach, the delta-equivalent value of each position is included in the measurement framework for the prescribed risk measure for the underlying.

[4] As reflected in the bank's quarterly Consolidated Reports of Condition and Income (call report.)

[5] The FDIC may apply all or portions of this appendix C to other state non-members banks when deemed necessary for safety and soundness purposes.

[6] This appendix C does not impose specific risk capital requirements for foreign exchange risk and commodities positions because they do no have the type of issuer-specific risk associated with debt and equity instruments in the trading account.

[7] Subject to FDIC review, when on- or off-balance-sheet non-trading account instruments are deliberately used to hedge trading account instruments, the non-trading account instruments may be included in the measure for general market risk, but if so included, are not included in the measure for specific risk and instead remain an element of risk-weighted assets under section II of appendix A of this part. Instruments such as swaps used to hedge non-trading account activities should be excluded from the measure for market risk if they are not part of the trading account.

[8] In general terms, a derivative is a financial contract whose value is derived from the values of one or more underlying assets or reference rates or indexes of asset values (referred to as ''the underlying''). Derivatives include standardized contracts that are traded on exchanges and customized, privately negotiated contracts known as over-the-counter (OTC) derivatives.