objectives. However, this tendency toward conservatism would be tempered by fears that an excessive capital commitment would cause the public (including stock analysts and rating agencies) to overestimate the riskiness of the bank's trading activities. Thus, market forces could be harnessed to induce banks to make appropriate capital commitments.

II. Issues and Questions for Public Comment

The basic issue is whether the pre-commitment approach is feasible and, if so, whether it might form the basis for future enhancements to supervisory approaches to assessing capital adequacy.

Q1. Should the Board explore use of the pre-commitment approach during the time that will elapse before the scheduled implementation of the proposed market risk capital requirements?

Q2. What are the advantages of the pre-commitment approach compared to other approaches under consideration by supervisors? Would it, in fact, produce capital allocations that more accurately reflect banks' assessments of trading risks? Would it be more compatible with banks' risk measurement systems? Would it provide stronger incentives for the improvement of risk management systems?

Q3. What are the potential drawbacks to the pre-commitment approach? Could penalties be destabilizing to banks? To the financial system? What other unintended consequences might result from implementation of the approach?

Before the pre-commitment approach could be implemented,the penalties associated with failure to limit trading losses to an amount less than the capital commitment would need to be specified more precisely.

Q4. What form should the penalties take? Fines? Higher future capital requirements? Other restrictions on future trading opportunities?

Q5. Should regulators reserve the right to waive the penalties under certain circumstances? If so, under what circumstances? To avoid adverse effects on market liquidity? To avoid impairing a bank's capital so significantly that its viability is threatened? Is there a danger that the prospect of a waiver could undermine the incentive effects of the penalties? How could such adverse incentive effects of waivers be minimized?

Q6. Should capital commitments, trading results, and penalties be publicly disclosed? What effects would public disclosure have on capital allocations? On trading behavior? How would stockholders and creditors react to news that a capital commitment had been violated? Could the reactions be destabilizing? On the other hand, if commitments and results are not publicly disclosed, would the approach lack credibility?

Another set of issues that would need to be addressed is the restrictions and limitations that would be placed on use of a pre-commitment approach.

Q7. Are qualitative standards for market risk management necessary to implement the pre-commitment approach? What qualitative standards for market risk management should be met by banks seeking to use the pre-commitment approach? Are the qualitative standards set out by the Basle Supervisors for use of the internal models approach sufficient? Or should more stringent standards be imposed? If so, in what ways should the standards be more stringent?

Q8. Should a bank's choice of a capital commitment be subject to review by supervisory authorities? Or would such a review be unnecessary or undesirable?

Q9. The incentive effects of the pre-commitment approach can be relied upon to induce banks to make realistic capital commitments only if the bank is being managed as a going concern. (A bank would not necessarily be concerned about penalties that would be imposed only in the event of its insolvency.) Could this potential problem be addressed adequately by limiting use of the pre-commitment approach to adequately capitalized banks (or even to well-capitalized banks)?

Q10. Even for well-capitalized banks, is the approach viable if market risk is the predominant element in the institution's overall risk profile? Or must its use be restricted to banks for which market risk associated with the trading account is a relatively small element in their overall risk profile? As practical matter, do banks typically allocate more than a small fraction of their total capital to cover market risk?

A final issue that would benefit from public comment relates to how trading gains and losses should be measured for purposes of determining whether the capital commitment has been violated.

Q11. Should spreads on customer or market-making businesses be included in trading gains and losses or should they be excluded? Why or why not? Can revenues from customer accommodation and market making be separated reliably from revenues from position taking?

Q12. Should gains or losses from changes in the credit quality of assets held in trading accounts be included or excluded? If included, would there be any need for separate capital requirements for specific risk (as opposed to general market risk)?

Q13. In general, are profits and losses on trading accounts sufficiently transparent that supervisors could reliably determine whether a capital commitment has been violated? Could concerns on this score be addressed through qualitative standards for valuation (e.g., standards for documentation of policies regarding valuation adjustments and adherence to those policies)?

By order of the Board of Governors of the Federal Reserve System, July 12, 1995.

William W. Wiles,

Secretary of the Board.

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