

Regulatory Capital: Market Risk

Q. If a banking organization reported in the first quarter of 2020 an increase in the number of backtesting exceptions, as part of its Pillar 3 disclosures for market risk, what are the capital implications under the market risk capital rule (12 CFR Part 3, subpart F; 12 CFR Part 217, subpart F; 12 CFR Part 324, subpart F)?

A. The market risk capital rule requires that a banking organization identify, once each quarter, the number of business days for which the actual daily net trading loss, if any, exceeds the corresponding daily VaR-based measure (“exceptions”) that have occurred over the preceding 250 business days (12 CFR 3.204(b)(1); 12 CFR 217.204(b)(1); 12 CFR 324.204(b)(1)). A banking organization must then apply a multiplication factor that corresponds to the number of exceptions to determine its VaR-based and stressed VaR-based capital requirements for market risk, unless the banking organization’s primary federal banking regulator notifies the banking organization in writing that a different adjustment or other action is appropriate. See 12 CFR 3.204(b)(2); 12 CFR 217.204(b)(2); 12 CFR 324.204(b)(2).

Concern about the impact of the COVID-19 has led to a sudden and significant repricing of global financial markets, amid an increase in market volatility and deterioration in market liquidity. Additional time may be required in order to evaluate the root cause of recent backtesting exceptions, which otherwise could result in a capital requirement for market risk that is not commensurate with the firm’s covered positions.

When determining whether a different adjustment to a banking organization’s VaR-based and stressed VaR-based capital requirements for market risk is appropriate, the primary federal banking regulator generally considers whether a regime shift, such as sudden abnormal changes in interest rates or exchange rates, major political events, or natural disasters, has occurred. During March and April of 2020, consistent with section 204(b)(2) of the market risk capital rule, affected banking organizations were notified that they may apply the multiplication factor that applied as of December 31, 2019, to determine VaR-based capital requirements for market risk and stressed VaR-based capital requirement for market risk through September 30, 2020, as a result of the impact of COVID-19 on financial markets.