



Discussion Paper

Implementation of the Basel II Capital Framework

8. Market risk

2 August 2007

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Introduction

The new Basel II capital adequacy regime, known as the Basel II Framework (the Framework), defines market risk as 'the risk of losses in on- and off-balance sheet positions arising from movements in market prices. The risks subject to this requirement are: the risks pertaining to interest rate-related instruments and equities in the trading book; and foreign exchange risk and commodities risk throughout the bank'.

The market risk arising from interest rate risk in the banking book is covered by a separate standard, *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book (Advanced ADIs)*.

The Framework describes two main methods of determining market risk capital – a standardised approach and an internal model approach – and sets out additional requirements for use of an internal model approach.

This discussion paper focuses on the proposed application of the market risk principles in the Framework to authorised deposit-taking institutions (ADIs) in Australia.

Prudential standard

This discussion paper introduces a draft *Prudential Standard APS 116 Capital Adequacy: Market Risk* (APS 116) setting out minimum requirements for locally incorporated ADIs to hold capital against market risk, and the risk management practices that must be in place. APS 116 will replace *Prudential Standard APS 113 Capital Adequacy: Market Risk*.

The key requirements of APS 116, reflecting the Framework, are:

- an ADI must allocate positions in financial instruments to its trading book if they are held with trading intent or in order to hedge other elements of the trading book;
- an ADI must maintain a framework for prudential valuation practices for trading book positions;

- an ADI operating in the foreign exchange, commodities, interest rate or equities markets must ensure that appropriately robust risk measurement and management systems are in place;
- an ADI must hold capital against market risks arising from positions allocated to the trading book and all foreign exchange and commodity risks; and
- an ADI must either use the standard method or seek approval from APRA to use its own risk measurement model for determining the regulatory capital requirement for market risk. ADIs using their own risk measurement model to determine regulatory capital are subject to a more robust set of requirements.

The draft APS 116 and a draft *Prudential Practice Guide APG 116 Market Risk* are available on the APRA web site www.apra.gov.au. Written submissions on the draft standard should be forwarded by 5 September 2007 to:

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Important

Submissions will be treated as public unless clearly marked as confidential and the confidential information contained in the submission is identified.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982 (FOIA)*. APRA will determine such requests, if any, in accordance with the provisions of the FOIA.

Prudential issues surrounding APS 116

Key changes resulting from the implementation of the Basel II Framework

The draft APS 116 clarifies that positions are to be allocated to the trading book if they are held for trading intent or to hedge other elements of the trading book. APS 116 also reflects the Framework's minimum requirements for a trading book policy statement.

The draft standard also reflects the requirements for prudent valuation practices for positions allocated to the trading book, as set out in the Framework. Where possible, an ADI is to mark-to-market such positions and consider valuation reserves for less liquid positions. Where marking to market is not possible, additional requirements ensure that mark-to-model valuations are prudent.

The draft APS 116 updates specific risk calculations under the standard method consistent with the rules set out in the Framework, which are consistent with the standardised method for credit risk. Key aspects of these changes are that lower-rated government securities will now attract a non-zero risk-weighting, and the maximum charge for lower-rated securities has been increased from eight per cent to 12 per cent.

Under the draft APS 116, ADIs modelling specific risk (i.e. the risk of changes in the value of a security due to issuer-specific factors) for the purpose of calculating regulatory capital will be required to adequately capture event and default risks, thereby removing the need for a surcharge where the model does not adequately capture event and default risks. The Framework also requires that an ADI calculating regulatory capital for specific risk using an internal model must be able to capture in its regulatory capital the default risk that is incremental to the risk captured by the internal model. APRA notes that the Basel Committee is still to publish its guidelines for computing capital for incremental default risk in the trading book. However, an ADI

which had been granted approval by APRA prior to 1 January 2008 to use an internal model to calculate its specific risk charge will be permitted to continue to calculate specific risk in accordance with the approved methodology in place on that date until 1 January 2010.

Other changes introduced by the Framework and reflected in the draft APS 116 include:

- additional clarification on the minimum requirements for review of the internal model; and
- greater clarity on the minimum requirements for stress testing, and a requirement that results of stress tests be taken into account in an ADI's internal assessment of capital adequacy.

Exercise of supervisory discretion

The Framework allows national supervisors the discretion to require banks to perform back-testing on either hypothetical outcomes (i.e. using changes in portfolio value that would occur were end-of-day positions to remain unchanged) or actual trading outcomes (i.e. excluding fees, commissions, and net interest income), or both. APRA has chosen to exercise this discretion and it is proposing that an ADI must perform back-tests using both actual trading outcomes and hypothetical trading outcomes.

Other policy issues

The following provisions of the previous market risk standard are not consistent with the Framework and have been removed: use of internal limits to measure market risk capital; and a limitation of five on the multiplication factor.



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