Federal Deposit Insurance Corporation
550 17th Street NW, Washington, DC 20429

Division of Supervision

Market Risk

FIL-12-96
March 15, 1996

TO: CHIEF EXECUTIVE OFFICER

SUBJECT: *Proposed Requirements for Banks to "Backtest" Internal Models for Predicting Market Risk*

The FDIC, the Office of the Comptroller of the Currency and the Federal Reserve Board have jointly proposed for public comment a rule to require banks with large trading portfolios to monitor the performance of the internal models used to estimate the market risk of their portfolios. Under this proposal, affected banks would compare past estimates of market risk with actual results -- a process known as "backtesting." Banks using models that produce poor backtesting results may be required to increase their capital for market risk. A copy of the *Federal Register* notice describing the proposal is attached.

The proposed rule expands on a July 1995 proposal (see FIL-50-95, dated July 31, 1995) to establish a capital requirement for market risk in foreign exchange and commodity activities and in the trading of debt and equity instruments. Under the July proposal, institutions with large trading activities would calculate their risk-based capital requirements using their own internal model estimates of "value-at-risk" -- essentially a probability-weighted measure of the amount a trading portfolio might decline during a given holding period.

The FDIC will accept public comments on the new proposal until April 5, 1996. For more information about the proposal, please contact one of the FDIC officials listed on Page 9114 of the attached *Federal Register* notice.

Nicholas J. Ketcha Jr.
Director

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