

The market risk amendment and internal models

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The Accord of 1988 addressed credit risk alone. As the trading activities of large banks expanded rapidly during the early 1990s, the losses that could arise from movements in interest rates, exchange rates, equity prices and commodity prices became more significant than credit risk for some institutions. The Committee worked on a framework for market risk in parallel with the European Community, which adopted its Capital Adequacy Directive in 1993. Its first proposal of April 1993 relied on standardised methods that many banks considered crude.¹

The large banks had meanwhile developed their own value-at-risk models, which estimated the maximum loss of a trading portfolio at a given confidence level over a given period. J.P. Morgan published its RiskMetrics methodology in 1994 and thereby made such techniques widely available. The Committee accepted the argument that these models measured risk more accurately than any standardised formula. In January 1996, it published the "Amendment to the Capital Accord to Incorporate Market Risks". Banks could choose between a standardised approach and their own internal models, subject to supervisory approval and to quantitative and qualitative conditions.²

The conditions were demanding by the standards of the time. The model had to calculate value at risk daily at a 99 per cent one-tailed confidence level for a holding period of ten trading days, with the resulting figure multiplied by a factor of at least three. The factor could be increased if back-testing showed that actual losses exceeded the model's predictions more often than expected. A new category of capital, Tier 3, consisting of short-term subordinated debt, could be used to meet market risk requirements.³

The market risk amendment marked a turning point in the philosophy of banking regulation. For the first time, supervisors allowed banks to calculate their own capital requirements with their own models, which reflected a belief that sophisticated banks understood their risks better than

any rule written by supervisors. The idea of risk sensitivity, which would dominate Basel II, was born here. It also introduced the reliance on historical data and on the assumption of normal market conditions, which the crisis of 2007 and 2008 would expose as dangerous.⁴

1 Notes

1. Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions; Basel Committee, consultative proposal on the supervisory treatment of market risks (April 1993). To be verified. ↩
2. Basel Committee, Amendment to the Capital Accord to Incorporate Market Risks (January 1996), to be implemented by the end of 1997. To be verified. ↩
3. Basel Committee (1996), Part B (use of internal models), including the multiplication factor and the back-testing framework published alongside. To be verified. ↩
4. For a critical assessment of the reliance on internal models introduced in 1996, see Tarullo, *Banking on Basel: The Future of International Financial Regulation* (Peterson Institute for International Economics, 2008), chapters 3 and 5. To be verified. ↩

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