

businesses in which the banking organization invests, geographical limitations, or limitations on the size of individual investments.

U.S. banking organizations also make investments in community development corporations (CDCs) or community and economic development entities (CEDEs) that promote the public welfare. These investments receive favorable tax treatment and investment subsidies that make their risk and return characteristics markedly different (and more favorable to investors) than equity investments in general. Recognizing this more favorable risk-return structure and the importance of these investments to promoting important public welfare goals, the Agencies are proposing the exclusion of all such investments from the A-IRB equity capital charge. Unlike the exclusion for SBIC exposures, the exclusion of CDC and CEDE investments would not be subject to a percentage of capital limit. All CDC and CEDE equity exposures would receive a 100 percent risk weight.

The Agencies seek comment on whether any conditions relating to the exclusion of CDC/CEDE investments from the A-IRB equity capital charge would be appropriate. These conditions could serve to limit the exclusion to investments in such entities that meet specific public welfare goals or to limit the amount of such investments that would qualify for the exclusion from the A-IRB equity capital charge. The Agencies also seek comment on whether any other classes of legislated program equity exposures should be excluded from the A-IRB equity capital charge.

Grandfathered Investments

Equity exposures held as of the date of adoption of the final A-IRB capital rule governing equity exposures would be exempt from the A-IRB equity capital charge for a period of ten years from that date. A banking organization would be required to risk weight these holdings during the ten-year period at 100 percent. The investments that would be considered grandfathered would be equal to the number of shares held as of the date of the final rule, plus any shares that the holder acquires directly as a result of owning those shares, provided that any additional shares do not increase the holder's proportional ownership share in the company.

For example, if a banking organization owned 100 shares of a company on the date of adoption of the final rule, and the issuer thereafter declared a pro rata stock dividend of 5 percent, the entire post-dividend holdings of 105 shares would be exempt from the A-IRB equity capital charge for a period of ten years from the date of the adoption of the final

rule. However, if additional shares are acquired such that the holder's proportional share of ownership increases, the additional shares would not be grandfathered. Thus, if a banking organization owned 100 shares of a company on the date of adoption of the final rule and subsequently acquired an additional 50 shares, the original 100 shares would be exempt from the A-IRB equity capital charge for the ten-year period from the date of adoption of the final rule, but the additional 50 shares would be immediately subject to the A-IRB equity capital charge.

Description of Quantitative Principles

The primary focus of the A-IRB approach to equity exposures is to assess capital based on an internal estimate of loss under extreme market conditions on an institution's portfolio of equity holdings or, in simpler forms, its individual equity investments. The methodology or methodologies used to compute the banking organization's estimated loss should be those used by the institution for internal risk management purposes. The model should be fully integrated into the banking organization's risk management infrastructure.

A banking organization's use of internal models would be subject to supervisory approval and ongoing review by the institution's primary Federal supervisor. Given the unique nature of equity portfolios and differences in modeling techniques, the supervisory model review process would be, in many respects, institution-specific. The sophistication and nature of the modeling technique used for a particular type of equity exposure should correspond to the banking organization's exposure, concentration in individual equity issues of that type, and the particular risk of the holding (including any optionality). Institutions would have to use an internal model that is appropriate for the risk characteristics and complexity of their equity portfolios. The model would have to be able to capture adequately all of the material risks embodied in equity returns, including both general market risk and idiosyncratic (that is, specific) risk of the institution's equity portfolio.

In their evaluations of institutions' internal models, the Agencies would consider, among other factors, (a) the nature of equity holdings, including the number and types of equities (for example, public, private, long, short); (b) the risk characteristics and makeup of institutions' equity portfolio holdings, including the extent to which publicly available price information is obtainable on the exposures; and (c) the

level and degree of concentration. Institutions with equity portfolios containing holdings with values that are highly nonlinear in nature (for example, equity derivatives or convertibles) would have to employ an internal model designed to appropriately capture the risks associated with these instruments.

The Agencies recognize that the type and sophistication of internal modeling systems will vary across institutions due to differences in the nature and complexity of business lines in general and equity exposures in particular. Although the Agencies intend to use a VaR methodology as a benchmark for the internal model approach, the Agencies recognize that some institutions employ models for internal risk management and capital allocation purposes that, given the nature of their equity holdings, can be more risk-sensitive than some VaR models. For example, some institutions employ rigorous historical scenario analysis and other techniques in assessing the risk of their equity portfolios. It is not the Agencies' intention to dictate the form or operational details of banking organizations' risk measurement and management practices for their equity exposures. Accordingly, the Agencies do not expect to prescribe any particular type of model for computing A-IRB capital charges for equity exposures.

For purposes of evaluating the A-IRB equity capital charges produced by a banking organization's selected methodology, the Agencies would expect to use as a benchmark a VaR methodology using a 99.0 percent (one-tailed) confidence level of estimated maximum loss over a quarterly time horizon using a long-term sample period. Moreover, A-IRB equity capital charges would have to produce risk weights for equity exposures that are at least equal to a 200 percent risk weight for publicly traded equity exposures, and a 300 percent risk weight for all other equity exposures.

VaR-based internal models must use a historical observation period that includes a sufficient amount of data points to ensure statistically reliable and robust loss estimates relevant to the long-term risk profile of the institution's specific holdings. The data used to represent return distributions should reflect the longest sample period for which data are available and should meaningfully represent the risk profile of the banking organization's specific equity holdings. The data sample should be long-term in nature and, at a minimum, should encompass at least one complete equity market cycle relevant to the institution's holdings,