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Thomson Reuters comments on the BCBS ‘Proposed Revisions to the Basel II market risk framework’

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Thomson Reuters welcomes the opportunity to offer comments to this consultation. Thomson Reuters is the largest provider of risk management software in the world, supplying trade and risk management solutions to over 750 financial institutions globally. With more than 950 risk professionals and more than two decades’ of experience in risk management, Thomson Reuters is pleased to be able to share its expertise with the Basel Committee on Banking Supervision (BCBS).

Overview

The recommended procedures and high-level descriptions of an improved framework for market risk management are very relevant. However, we believe the proposals may not go far enough in light of the recent systemic crisis.

In particular, the back testing and scenario-based stress testing of internal models are unlikely to provide the necessary insights that would cover extreme market conditions, such as the ones the industry recently experienced. Indeed tail risks of this magnitude are extremely rare, but it is generally expected that an efficient risk management framework would precisely shield the firm in such conditions.

The Chief Risk Officers (CROs) are empowered to validate a firm’s balance sheet by measuring its risk exposure and assessing its alignment with the corporate strategy. This requires an enterprise-wide approach to the company data and information flows specifically adapted to each firm’s actual exposure, including to risk factors buried under several layers of derivatives and securitised assets.

While value-at-risk remains a convenient statistical tool for back-testing on long term reporting for example, we believe a market risk framework should provide a firm with the agility necessary to take relevant and timely actions to ensure its own business continuity in full adhesion to the risk policies defined by and with its shareholders. This is more likely to be achieved through operational frameworks empowering the owners of the risk units to take pre-emptive action rather than with quantitative modelling or internal-model based stress testing.

Comments on the specific revisions

Paragraph 3 (a)

The proposal focuses on the consistency and alignment between the models in use for pricing, back-testing and value-at-risk calculations. Although we agree that this is a very relevant remark and that such integrity is truly necessary across the enterprise, we consider value-at-risk no longer to be a sufficiently reliable quantitative assessment of exposures to justify being a central element of a market risk framework. The recent turmoil has deeply exposed banks of all types, size and geographies to the point where recapitalization and emergency restructuring became necessary. This highlights the

failure of value-at-risk and internal model based capital allocations as a sound foundation for a risk management framework.

Paragraph 4 (c)

The proposal discusses procedures for independent supervisors to assess the reasonableness of value-at-risk calculations, the use of models and the relevance of stress tests. While we would fully agree with those very sensible recommendations, from an organizational perspective, however, they imply that risk management remains a supervisory function within the firm. Here again we would recommend a more radical departure from commonly implemented procedures, to make risk management a key part of the corporate strategy. The CRO should be empowered to highlight the root risk factors that a firm is truly exposed to, to distil the approved risk policy into achievable targets distributed to all levels of the hierarchy and to establish an appropriate methodology to track and report exposure to those factors.

Paragraph 4 (e)

The paper recommends that banks update their data set at least once every month. We believe modern markets and financial instruments demand a much higher frequency, of at least twice a week for static data, weekly for loan data, daily for collateral, corporate actions, and calculated OTC instruments and intra-day for all electronically traded instruments and portfolio movements. Credit events should be monitored continuously and reported in real-time through alerts.

Paragraph 5

Stress testing according to risk views, models and scenarios under the supervision and responsibility of the CROs are indeed, in our view, the proper way to assess the market risks a firm is exposed to. CROs need to be given enterprise-wide access to corporate data and to lay out the information flow necessary to make the firm agile enough to take action timely.

Paragraph 5 (ii) 718 (LXXXIII)

We fully agree that scenarios should be developed by the bank itself to reflect the specifics of their portfolios. We would add that even the methodologies, information flow and risk surveillance procedures must be tailored under the responsibility and accountability of the CRO. A regulatory approach here can actually create systemic risks as it may result in uniform tactics triggered in given market conditions.

III Treatment of illiquid positions

The paper recommends additional provisions of capital allocations for instruments and positions that would be considered illiquid by the supervisors. We are concerned that the very methodology relying on models to calculate the position to edge of provision capital upon would depend on assumptions rather than data.

We would recommend discerning two different kinds of illiquid positions:

- 1) Firstly, there are those positions which do not trade often, but do trade occasionally with reasonably available pricing information. In such cases, the notion of time should prevail in risk assessment and risk mitigation tactics.



2) Other positions are illiquid because they are difficult or impossible to evaluate. In this case, a qualitative approach should prevail. It would consist of assessing a liquidative value based on empirical observations of market trends and overall market conditions (volatility, correlations) as opposed to quantitative modelling.

We hope these comments are helpful to the work of the BCBS. We would be very pleased to offer further insights or to respond to any queries.

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