

31st January 2014

Secretariat of the Basel Committee on Banking Supervision,
Bank for International Settlements,
CH-4002 Basel,
Switzerland

via email to: baselcommittee@bis.org

To: The Basel Committee,

We welcome this opportunity to comment on the consultative document issued by the Basel Committee on Banking Supervision (Committee) in October 2013 entitled 'Fundamental Review of the Trading Book: A Revised Market Risk Framework' (Paper).¹

Our interest in this subject matter is the consequence of our ongoing research, in collaboration with the Leeds University Business School, into improved mechanisms and techniques for risk quantification and risk data aggregation.² Our specific research has explored these areas from the following perspectives:

- 'Risk Accounting'... the convergence of accounting and risk management systems within a common enterprise exposure measurement framework
- 'Global identification Standards'... for example, the Legal Entity identifier (LEI) used to aggregate counterparty exposures across the industry
- 'Big Data' ... intelligent semantic networks for systemic risk analysis

We collectively refer to these research initiatives, all of which have been translated into implementation modules, as 'risk adjusting the financial system'.

¹ Basel Committee on Banking Supervision, 'Fundamental Review of the Trading Book: A Revised market Risk Framework', (October 2013), <https://www.bis.org/publ/bcbs265.pdf> accessed on 24th January 2014

² Grody AD, Hughes PJ, Fernandes KJ, Phillips O, and Toms JS, 'Risk Accounting: An Accounting Based Approach to Measuring Enterprise Risk and Risk Appetite' (October 20, 2012). Available at SSRN: <http://ssrn.com/abstract=2165034>, and Hughes P, Grody AD, Toms JS, 2010, 'Risk Accounting - a Next Generation Risk Management System for Financial Institutions', The Capco Institute Journal of Financial Transformation, 29 (1): 43-56

Given the Paper is primarily concerned with capital adequacy we have focused our comments in the pages that follow on Risk Accounting. For discussion of the other perspectives ‘Global Identification Standards’ and ‘Big Data’ we refer to our comments submitted with respect to the Committee’s March 2013 consultative paper ‘Supervisory Framework for Measuring and Controlling Large Exposures’³

In this letter it is not our intention to provide a detailed commentary on the Paper but rather to offer our comments within the context of the Committee’s recently issued discussion paper on balancing risk sensitivity, simplicity and comparability in the regulatory framework.⁴ We believe this is appropriate as we assume the Paper has been written with these same aims in mind. This is evident from the modified stance presented on the revised standardized approach which is to be applied, and its outputs reported, by all regulated firms irrespective of whether they have adopted internal model methods.

Our principal observation from reading the Paper is that the revised standardized approach presents a potential dilemma in that it may be too complex to be ‘simple’ and too simple to be considered ‘risk sensitive’. We acknowledge that comments submitted by other parties during this consultation period and subsequent quantitative impact studies may provide a broader and more reliable base on which to conclude whether such a dilemma is of genuine concern. There are, however, indications that this may be the case. For example, Rowe (2014)⁵ concludes that, “Most disturbingly, it is now proposed that the revised, and now highly complex, standardized approach must be implemented by all banks, including those with approved internal models. It appears those behind the proposal have little or no appreciation of how complex, costly and error-prone such an effort would be.” In the more general case Tarullo (2008)⁶ concludes, “Narrowly framed, the conclusion of this book is that Basel II’s detailed rules for capital regulation are not an appropriate basis for international arrangements among banking supervisors.”

Notwithstanding the foregoing, we believe that the revised standardized approach fails to address the need for ‘comparability’ in the regulatory framework. Our conclusion presupposes that comparability should not only relate to market risk exposures within and between firms, but relative to all risk types (market, credit, operational, liquidity, IRRBB etc). Stakeholders in the global financial system need a regulatory framework that provides simple and comparable information on the amount and types of risks taken-on by financial

³ Grody AD, Hughes PJ, Fernandes KJ, and Toms JS, ‘Comments on the Consultative Paper – Supervisory Framework for Measuring and Controlling Large Exposures’ (June 2013), <http://www.bis.org/publ/bcbs246/financialinterg.pdf> accessed on 11th August 2013

⁴ Basel Committee on Banking Supervision, ‘The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability’, (July 2013), <https://www.bis.org/publ/bcbs258.pdf> accessed on 9th August 2013

⁵ Rowe DM, ‘An Impractical White Elephant’, Risk.Net/Risk Magazine (January 2014), <http://davidmrowe.com/publications/Risk%20Magazine/201401%20An%20Impractical%20White%20Elephant.pdf> accessed on 24th January 2014

⁶ Tarullo, D.K, “Banking on Basel, The Future of international Financial Regulation”, Peterson Institute for International Economics (August 2008)

firms absolutely and in comparison with others. Such risk information can only be of value if it is the output of a standardized and universally accepted method of calculating exposure to risk. The revised standardized approach for market risk proposed in the Paper fails to satisfy this particular need due to its non-transferability to other risk types. This is a critical failure as it is the risk profile of the overall enterprise that stakeholders consider when making judgments around soundness and stability.

In our comments submitted to the Committee⁷ in connection with its discussion paper on balancing risk sensitivity, simplicity and comparability we described 'Risk Accounting'⁸ which is underpinned by two key principles:

- i. the disclosure of an enterprise's financial condition and the concomitant determination of its capital adequacy should be a function of accounting rather than financial modeling; and
- ii. outcomes should be based on a standard unit of risk measurement that blends quantitative and qualitative risk elements into a single additive metric that can be validly applied to all risk types.

We have not reproduced in this letter a detailed description of risk accounting but, in summary, it introduces a simple, comparable and auditable method of measuring and reporting enterprise risks as an extension of management accounting. It comprises three categories of tables and templates that assign standardized risk-weights to individual transactions according to:

1. The risk characteristics of the relevant products
2. The amounts accepted for processing in accordance with accounting records
3. The risk mitigation effectiveness of the operating environment that handles them

The risk weights are heuristically determined through a structured process that allows for the expert knowledge of business and operating management and supervisors to be embedded into the very fabric of risk accounting's risk measurement system. This is a critical part of managing risk, the ability of management to 'feel' the risk embedded in the metrics. Risk accounting allows management to make intuitive judgments at times of market stress when many of the existing model-based metrics are invalidated due to their reliance on past correlations and volatility measures that do not obtain.

⁷ University of Leeds and Financial InterGroup, <http://www.bis.org/publ/bcbs258/unileeds.pdf> accessed on 24th January 2014

⁸ Grody AD, Hughes PJ, Fernandes KJ, Phillips O, and Toms JS, '*Risk Accounting: An Accounting Based Approach to Measuring Enterprise Risk and Risk Appetite*' (2012), accessible at <http://ssrn.com/abstract=2165034>, and Hughes P, Grody AD, Toms JS, 2010, '*Risk Accounting - A Next Generation Risk Management System for Financial Institutions*', The Capco Institute Journal of Financial Transformation, 29 (1): 43-56

Another critical part of risk management is risk mitigation. Risk accounting, at its base level, is tied to the people, process and systems of an enterprise in interactions with products and transactions, both internally and externally. This tie-in to internal operational activities and external financial dynamics allows for the drilldown to the very causes of risk exposures thereby enabling proactive risk mitigation as the natural outcome.

The risk-weights tagged to each transaction are used in a calculation of its exposure to risk using a new unitised metric, the Risk Unit (RU). In this way, risk accounting accounts for the risk exposures inherent in individual transactions enabling the production of risk reports that can be aggregated by risk type (market, credit, operational, liquidity, IRRBB etc.) and by organisation, geography, product and customer. It should be noted that the technique of tagging transactions with coding that enables the production of cross-enterprise management reports is not new; it is used in transfer pricing, unit costing, large exposure reporting, business line profitability reporting and much more.

It should also be noted that using an abstract unit of measure, such as the Risk Unit (RU), is not new in finance. We understand intuitively an AAA credit rating or an 850 FICO⁹ score each metric being a distillation of very complex interactions of other factors, refined over many years and data points. The RU can become such a measure for risk management, especially as its unitized metric can be applied across all products, transactions and processes; both for operational risk as well as financial risk.

We argue that internal models are a tool of granular risk management and not enterprise risk measurement. Internal models can be validly applied in: the day-to-day management and control of trading portfolios' risk exposures; the calculation and allocation of risk (economic) capital to products; and pricing the risks inherent in products. Their development, maintenance and deployment should be at the discretion of business and operating management.

However, the calculation of enterprise level exposures to risk that need to be comparable within and between firms and provide a basis for capital determination requires an accounting solution that operates at the individual transaction level and whose application is universally replicable. In this regard we observe that a risk measurement system based on heuristics, such as that contained in risk accounting, can be validated over time and a monetary value assigned to the Risk Unit (RU) through its statistical correlation with actual loss experience.


In conclusion, we are concerned that the implementation of the revised standardized approach as a means to provide a more meaningful balance between risk sensitivity, simplicity and comparability in the regulatory framework may not be successful. We suggest

⁹ Fair Isaac Corporation, 'FICO' is the retail credit scoring system widely used in North America

that the Committee should consider accounting solutions where we anticipate a potentially more valuable outcome for the global financial system's stakeholders.

We stand ready to provide any assistance the Committee may require in this regard.

Yours sincerely,



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