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Bank for International Settlements

Basel Committee on Banking Supervision

№B-001/1

Re: Consultative Document "Revisions to the minimum capital requirements for market risk" (*d*436)

Dear Sir or Madam,

Consulting company BSC (Business Systems Consult LLC) investigated the proposals for improvement the Standards for the minimum capital requirements for market risk (*d*352) (referred further as Standard) and would like to express its views on the changes proposed.

1. Revisions to trading desk structure

We propose to directly introduce the concept of business models into the Basel regulations.

In our opinion, the requirements to trading desk structure represent a good illustration of business model specification as it should be developed by a bank in accordance with IFRS 9. We propose directly introduce this concept into the Basel regulations.

Business model is a well established concept widely approved in a banking sector. It has the following features:

- it defines the purpose of a set of financial instruments, procedures for management in the going concern scenario (see Section 4 of IFRS 9);
- it should be a matter of fact not an assertion (see p. B4.1.2B of IFRS 9);
- it should correspond to the characteristics of financial instruments (see pp. 4.1.2(*b*), 4.1.2A(*b*) of IFRS 9);

IFRS 9 implicitly requires to prepare reports on adherence to business model specifications. Analysis of business activity of a bank and its correspondence to the specified business model is a routine procedure in auditing financial reporting.

Introduction of the concept of business model does not contradict to the principles of market risk management set out by the Standard, but it will definitely clarify the application of the risk management models to trading desks. Unification with financial reporting will definitely prevent separate accounting for financial reporting and risk management (such accounting is directly prohibited by IFRS 7 but may become inevitable without explicit specification of business models in the Standard). Moreover, given the experience of the audits of financial reporting, practical implementation of the business model concept does not carry any regulatory risks.

2. Revisions to the treatment of liquid FX pairs

We propose to expand the list of liquid currency pairs with pairs containing gold and silver (XAU and XAG).

At present, USD plays a role of international currency. However, monetary gold and silver remain important for the international finance system. Many local regulators consider monetary gold and silver as financial instruments.

3. Revisions to the treatment of liquid FX pairs (continued)

We propose to generalise the principle of definition of liquid currency pairs via triangle to polygon.

The role of USD leads to liquidity of many currency pairs containing USD. Conversion operations between many currencies are cheaper when conducting through the USD than direct conversion in currency pair. This deal structure is referred as triangle and is taken into account in the proposed Consultation document.

However, there can be a more difficult currency structure, if international trade and international financial markets become more diversified. There can be situations when a currency pair CCY_1/CCY_2 is liquid as well as CCY_2/USD and CCY_3/USD while neither of the currency pairs CCY_1/CCY_3, CCY_1/USD, CCY_2/CCY_3 are directly liquid. This means that conversion of CCY_1 to CCY_3 can be conducted through the liquid currency pairs and should be considered as liquid pair as well.

This example may appear of only theoretical value. However, there were some examples in the near past showing that this option may be demanded. For example, a wide list of African nations used colonial francs (XAF, XOF) and continue to use them. When starting national currencies they continued to peg them to colonial francs. This currency regime by default assumes high liquidity for the currency pair *CCY*/XAF or *CCY*/XOF while both *CCY*/USD and XAF/USD (XOF/USD) are illiquid. However, these special currencies have historical links to French Franc (FRF), and therefore the pairs XAF/FRF (XOF/FRF) would likely be liquid as well as FRF/USD would definitely treated as liquid.

The mutual sanctions and spreading of protective tariffs stimulate the development of the situation when this example turns to be realistic in a world.

4. Revisions to the treatment of liquid FX pairs (continued)

We propose to consider the unification of the approaches to FX and equity risk.

Many equity instruments may be formally nominated in the different currencies but represent the same bundle of rights and cash flows. Examples include the relationships between equity instruments and their GDRs. Moreover, for a global company, its value represented as its equity price is a product of various currency exposures. REPO deals are in reality a variation of currency swap.

The unification of methodologies for foreign exchange rate risk and equity risk is possible in some business models. It may help to solve the tricky and ambiguous problems in calculation of currency exposures and taking into account provision reserves

Please, consider our proposals. We strongly believe that they may significantly improve the market risk methodologies and regulation. If you need further clarifications on our positions, please, do not hesitate address me.

Sincerely yours,

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