

Basel Committee on Banking Supervision

Consultative document

Revisions to market risk disclosure requirements

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Dr. Axel Sauer does permit to publish these comments on the Bank for International Settlements' website.

Revisions to market risk disclosure requirements

Annex 1: Proposed revisions to chapter DIS50 – Market risk

50.2 The disclosure requirements under this section are:

General information about market risk

(1) Table MRA – General qualitative disclosure requirements related to market risk

Purpose: Provide a description of the risk management objectives and policies for market risk as defined in minimum capital requirements for market risk MAR11.1.

("Market risk is defined as the risk of losses arising from movements in market prices. The risks subject to market risk capital requirements include but are not limited to: (1) default risk, interest rate risk, credit spread risk, equity risk, foreign exchange (FX) risk and commodities risk for trading book instruments; and (2) FX risk and commodities risk for banking book instruments". see, Basel Committee on Banking Supervision (BCBS), Minimum capital requirements for market risk, January 2019 (rev. February 2019), MAR11.1)

Scope of application: The table is mandatory for all banks that are subject to the market risk framework.

Content: Qualitative information.

Frequency: Annual.

Format: Flexible.

Banks must describe their risk management objectives and policies for market risk according to the framework as follows:

(a) **Strategies and processes of the bank, which must include an explanation and/or a description of:**

- The bank's strategic objectives in undertaking trading activities, as well as the processes implemented to identify, measure, monitor and control the bank's market risks, including policies for hedging risk and the strategies/processes for monitoring the continuing effectiveness of hedges.
- A general description of the trading desk structure (as defined in MAR12). (see, Basel Committee on Banking Supervision (BCBS), Minimum capital requirements for market risk, January 2019 (rev. February 2019), MAR 12.4 The key attributes of a trading desk are as follows: (1) A trading desk **for the purposes of the regulatory capital charge** is an unambiguously defined group of traders or trading accounts.)
- Types of instruments included in the trading desks or desk categories that are not covered by Template MRC - refers to the structure of trading desks for banks using the internal model approach (IMA).
- Policies for determining whether a position is designated as trading, including the definition of stale positions and the risk management policies for monitoring those positions. In addition, banks should describe cases where instruments are assigned to the trading or banking book contrary to the general presumptions of their instrument category and the market and gross fair value of such cases, as well as cases where instruments have been moved from one book to the other since the last reporting period, including the gross fair value of such cases and the reason for the move.

- (b) The structure and organisation of the market risk management function, including a description of the market risk governance structure established to implement the strategies and processes of the bank discussed in row (a) above.
- (c) **The scope and nature of risk reporting and/or measurement systems.**

I. **Comments to the nature of risk, “natural” laws of market risk, and/or reporting and measurement systems**

Trader at a trading desk might have “intrinsic” intentions but a model, concept or a theory cannot have “intrinsic” intentions. **There is no nature of market risk (interest rate change) to observe, and there is no “natural” law of market risk (interest rate change) in place.**

In case of market risk, the **simplified standardized approach (SSA) does document and prepare for disclosure**, by referring to (i) one calendar day trading time horizon, including an one calendar day (delivery versus payment (DVP)) transaction settlement, **end of trading day profit and loss (P&L)**, by referring to (ii) all traded instruments profit (margin) out of one calendar day trading time horizon with more than one calendar days (delivery versus payment (DVP)) transaction settlement, and by referring to (iii) under SAA calculated fair value of all trading instruments being end of trading day at the bank trading book and to be kept (until next trading day) as trading instruments.

Trader should believe under SSA - in at the end of the trading day, (daily) calculated “fair value” of kept trading instruments, and should acknowledge that under SSA for any trading instrument calculated fair value change, will be documented as end of trading day profit and loss (P&L) and daily booked, at unambiguously defined group of traders at their trading (P&L) account.

In all cases where “the risk-weighted assets for market risk under the simplified standardized approach are determined”, **uncertainties about future developments – apart from** the remaining, next day to be traded instruments, and transactions calculated fair value with more than one calendar day settlement, **are replaced by end of trading day “certain” P&L, at traders trading account.** (see, Basel Committee on Banking Supervision (BCBS), Minimum capital requirements for market risk, January 2019 (rev. February 2019), paragraph 40.1.)

(i) **Example for transactions end of trading day and same trading day settlement**

A positive margin out of two transactions (bets) does become a (certain event) **profit or loss – at settlement date**, and after the involved bettors (trader) did fulfil their duties. **SSA is mitigating to same trading day settlement** - a part of for the

remaining instruments calculated fair value and calculated end of trading day P&L out of transactions in instruments with more than same trading day settlement, **any** default **risk**, interest rate risk, credit spread risk, equity risk, foreign exchange (FX) risk and commodities risk for the traded and settled instruments; and (2) FX risk and commodities risk for banking book traded and settled instruments.

Uncertainties about future developments are replaced by SSA through settled, “realized” P&L, also to be called “**certain**” results, apart from above mentioned exceptions. **SSA is recommended by** Basel Committee on Banking Supervision (BCBS) “**as an alternative** to calculate capital requirements for market risk. **For banks that have relatively small or non-complex trading portfolios**, the **SSA** – a recalibrated version of the Basel 2.5 market risk standardised approach – may be used by banks in lieu of use of the “full” standardised approach, subject to supervisory approval.” (see, Basel Committee on Banking Supervision (BCBS), Revisions to market risk disclosure requirements, Issued for comment by 14 February 2020, November 2019, page 5.)

SSA is using, apart from end of trading day remaining instruments, **and** same day or if needed more than one calendar days settlement time horizon, for “all” traded instruments the “mechanic” of one calendar day trading and settlement - “**snap shot**” analysis.

Traders, accountants and supervisors may believe into the daily, by “snap shot” analysis, calculated “fair value” change of each traded instrument and the calculated fair value of the remaining end of trading day trading instruments, as **an up-to the best of traders and accountants knowledge** calculated, **accumulated and for each trading book** end of trading day **to disclose profit and loss (P&L) amount**. Supervisor and accountants should be aware about the fact to **measure by SSA “mainly” and** in a backward view, **end of trading day given** (realized) value (price) **changes** of traded instruments.

(ii) Example for transactions end of trading day and not same trading day settlement – fair value calculation of pending (not settled) transactions

Supervisor monitoring “fair value” changes of each trading book instrument might conjecture: - **one day** “fair value” changes **at trading book** instruments (defined at MAR 11.1) which are **not** settled (DVP) **at the same trading day**, and the calculated fair value at remaining end of trading day instruments **are interrelated**. **But at the end of each trading day** measured **correlations**, between instruments, and instruments traded but not settled at the end of the trading day, **are not equal to** future oriented price or value change **explanations**. A **future event** is **not predictable or replicable**. And it is also **not possible to explain change (risk) for future time periods** (means traded instruments with more than same calendar day settlement), **from in the past** during a certain time period **observed changes** (or past events).

At the end of each trading day, under SSA calculated fair value of traded instruments at the portfolio settled at same value day, and by SSA calculated fair value of traded instruments settled by more than one trading day, and the calculated “fair” value of end of trading day remaining instruments, will be documented – at (end of trading

day) **trading book profit and loss (P&L) account**. The risk-weighted assets for market risk under the SSA **are determined**, and have for calculating regulatory capital requirement to be multiplied by 12.5. (see, Basel Committee on Banking Supervision (BCBS), Minimum capital requirements for market risk, January 2019 (rev. February 2019), paragraph 40.1)

These definitions at MAR 40 are used at snap-shot calculations, and **have limited “market risk” prognostic power**. But, this snap-shot accounting approach, on “the position and more than one day transaction” settlement, does provide a “fair value” change estimation or approximation for quantifying “market risk”, and a base for calculating required regulatory capital.

The SSA process to estimate and quantify “market risk” out of instruments traded under not same day settlement, and end of trading day remaining instruments fair value **for calculating capital requirements, does contradict “the second lie”** of Mr. Mark Carney’s – three truth for finance, outlined as: **“The belief that markets (supervisor, accountants using SSA for (market risk) disclosure at the end of each trading day) always clear, and does mitigate two dangerous consequences.**

First, if markets always clear, **they can be assumed to be in equilibrium**; or said differently “to be **always right**”.

Second, if markets always clear (at the end of each trading day), **they should possess a natural stability.**

Evidence to the contrary (as shown by SSA on not same day settlement and end of trading day remaining transaction) **must be** the product of market distortions or a result of incomplete markets.” (see, Mr. M. Carney, “Three truths for finance”, London, 21 September 2015, Lie II: Markets always clear, page 3, 4; and Mark Carney, True Finance – Ten years after the financial crisis, at the Economic Club of New York, 19 October 2018.)

The SSA process to estimate and quantify “market risk” out of instruments trading not same day settlement, and end of trading day remaining instruments fair value for calculating capital requirements, is showing traders and accountants end of trading day **fair valued instruments which are not cleared (remaining instruments, not same trading day settlement)**, and should be not assumed to be in equilibrium. It might be worth to mention that in case – e g securities markets not always clear at the end of each trading day, **they cannot possess a natural stability, and this fact will be enclosed by SSA as estimated and quantified “market risk”.**

The finding how SSA does estimate and quantify “market risk”, might bring trader and other decision maker back to “the challenge” - humans are not capable to make “reliable” fair value calculations or prognosis. **But humans applying SSA are putting** all efforts up to the best of their knowledge, **on the SSA process to derive** (e g inductively or deductively) **their decisions, by using the “logical” rule**

– increasing, decreasing **informational content** (e g not equivalent to probability statements),

or by using SSA to make up to the best of their knowledge decisions **by accumulating fair values (probabilities).**

Comment to (c) “The scope and nature of risk reporting and/or measurement systems.”

There is **no nature of risk** as there are no “natural” laws of market risk, there should be **no and/or** on reporting and measurement systems.

Recommendation: “The scope of risk reporting”.

II. Market risk explanations are not equal to a market risk description, trader and other decision maker at banks are not capable to explain and/or describe their trading book strategies and processes

The SSA with one day delivery versus payment (DVP) settlement for all traded items (instruments) **should not claim for “substantial” prognostic market risk power**. According to minimum capital requirements for market risk defined boundary between the banking book and the trading book it is outlined at paragraph 25.4; **“Banks must fair value daily any trading book instrument and recognise any valuation change in the profit and loss (P&L) account”**. (see, Basel Committee on Banking Supervision (BCBS) - Minimum capital requirements for market risk, January 2019 (rev. February 2019), RBC 25, paragraph 25.4)

The (fair value estimation) requirement has to be applied, at end of each trading day, on remaining instruments, and at all transactions by instruments with more than one day delivery versus payment (DVP) settlement.

Central Banks took over, during the great financial crisis (GFC) starting in 2007, rolls - to act (against collateral) **as one day settlement local currency liquidity provider**, and (without collateral) to act for banks as domestic currency liquidity absorber.

At the GFC did market participants, – e g on FX – forward contracts (bets) related to **informational asymmetries**, act by shortening FX – forward contracts maturities (e g from 3 months to 1 month and over-night) **to mitigate** (e g settlement) **risk to one day time horizon**.

SSA does not focus on informational asymmetries and market failure. But Central Banks did after the GFC focus more - on trader and other market participants **reasons for distrust** on potential trading partners, **and** market participants **in-ability to approximate** (e g settlement) **risk** (on FX – bets with longer than same value date maturities), as **market failure argument**.

The simplified standardized approach (**SSA**) applied by banks and supervising authorities as “snap – shot” analysis, **is of limited prognostic power**. But the SSA reviewed and disclosed daily by banks’ - e.g. to traders, treasurer, accountants and risk manager, responsible according to recommendations outlined at BCBS revisions to market risk disclosure requirements, and Basel II (pillar 2, “Capital Adequacy Assessment Process” (ICAAP), **does daily quantify and aggregate market risk**, and does by calculating daily capital requirements **improve banks’ market risk management**.

Comments to (a) Strategies and processes of the bank, which must include **an explanation and/or a description** of:

A market risk **explanation** is **not equal** to a market risk **description**, therefore trader and other decision maker at banks are not capable **to explain and/or describe** their trading book strategies and processes.

Recommendation to (a): “Strategies and processes of the bank, must include **a description**” of:

References:

- Basel Committee on Banking Supervision (BCBS), Revisions to market risk disclosure requirements, Issued for comment by 14 February 2020, November 2019.
- Basel Committee on Banking Supervision (BCBS), Minimum capital requirements for market risk, January 2019 (rev. February 2019).
- Mark Carney, Three truths for finance, remarks by Mr. Mark Carney, Governor of the Bank of England and Chairman of the Financial Stability Board, at the Harvard Club UK Southwark Cathedral dinner, London, 21 September 2015.
- Mark Carney, True Finance – Ten years after the financial crisis, Governor of the Bank of England and Chairman of the Financial Stability Board, at the Economic Club of New York, 19 October 2018.