

Chapter 7

Market risk

7.1 Application, purpose, general provisions and non-standard transactions

Application

7.1.1 **R** This chapter applies to a *BIPRU firm*.

Purpose

7.1.2 **G** Pursuant to the third paragraph of article 95(2) of the *UK CRR*, the purpose of this chapter is to apply requirements that correspond to Annexes I, III, IV and V of the *Capital Adequacy Directive*.

General provisions: Obligation to calculate PRR

7.1.3 **R** A *firm* must calculate a *PRR* in respect of:

- (1) all its *trading book positions*;
- (2) all *positions* falling within **■ BIPRU 7.5.3 R** (Scope of the foreign exchange *PRR* calculation), whether or not in the *trading book*; and
- (3) all *positions* in *commodities* (including *physical commodities*) whether or not in the *trading book*;

even if no treatment is provided for that *position* in the other sections of this chapter.

7.1.4 **R** A *firm* must calculate a *PRR* for any *position* falling into **■ BIPRU 7.1.3 R** using:

- (1) the *PRR* calculations contained in **■ BIPRU 7**; or
- (2) another method provided the *firm* is able to demonstrate that in all circumstances the calculation being employed results in a higher *PRR* for the *position* than would be required under (1).

General provisions: Non-trading book items

7.1.5 **G** *Positions* in instruments which are *non-trading book* items should be treated under **■ BIPRU 3** (Standardised credit risk), **■ BIPRU 4** (The *IRB* approach) or **■ BIPRU 13** (Financial derivatives, *SFTs* and long settlement transactions) unless deducted as an *illiquid asset*. If they fall into **■ BIPRU 7.1.3R(2)** or **■ (3)** they also give rise to a *PRR charge*.

General provisions: Frequency of calculation

7.1.6 **R** A *firm* must be able to monitor its total *PRR* on an intra-day basis, and, before executing any trade, must be able to re-calculate *PRR* to the level of detail necessary to establish whether or not the *firm's capital resources* exceed its *capital resources requirement*.

7.1.7 **G** A *firm* may rely on intra-day limits for the purposes of ■ BIPRU 7.1.6R.

Purpose of rules for non-standard transactions and instruments for which no PRR treatment has been specified

7.1.8 **G** The methodologies which have been developed for calculating *PRR charges* have been based on existing instruments and assume instruments with standard characteristics. However, as a result of innovation and because there are instruments which, although based on a standard contract, contain structural features which would make the *rules* in the rest of this chapter inappropriate, flexible *rules* are required. The *rules* in this section about transactions for which no *PRR* treatment has been specified and non-standard transactions are designed to address this.

Instruments for which no PRR treatment has been specified

7.1.9 **R** Where a *firm* has a *position* for which no *PRR* treatment has been specified, it must calculate the *PRR* for that *position* in accordance with ■ BIPRU 7.1.12R-■ BIPRU 7.1.13R.

7.1.10 **R** If ■ BIPRU 7.1.9 R applies, a *firm* must document its policies and procedures for calculating the *PRR* for that *position* of that type in its *trading book policy statement*.

7.1.11 **G** Under ■ BIPRU 1.2.30 R (2) a *firm* should notify the *appropriate regulator* as soon as is reasonably practicable if its *trading book policy statement* is subject to significant changes. Therefore if a *firm* makes a change in accordance with ■ BIPRU 7.1.10R it should consider whether it is necessary to report it to the *appropriate regulator*.

7.1.12 **R** A *firm* may calculate the *PRR* for a *position* falling into ■ BIPRU 7.1.9R by applying by analogy the *rules* relating to the calculation of the *interest rate PRR*, the *equity PRR*, the *commodity PRR*, the *foreign currency PRR*, the *option PRR* or the *collective investment undertaking PRR* if doing so is appropriate and if the *position* and *PRR item* are sufficiently similar to those that are covered by those *rules*.

7.1.13 **R** Where a *firm* has a *position* for which no *PRR* treatment has been specified and it is not applying ■ BIPRU 7.1.12R, it must calculate a *PRR* of an appropriate percentage of the current value of the *position* calculated under ■ GENPRU 1.3 (Valuation).

Instruments in non-standard form

7.1.14

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- (1) If a *firm* has a *position*:
- (a) in a *PRR item* in non-standard form; or
 - (b) that is part of a non-standard arrangement; or
 - (c) that, taken together with other *positions* (whether or not they are subject to *PRR charges* under ■ BIPRU 7), gives rise to a non-standard *market risk*;
- the *firm* must notify the *appropriate regulator* of that fact and of details about the *position*, *PRR item*, arrangements and type of risk concerned.
- (2) Except as (1) provides to the contrary, (1) applies to a *position* that is subject to a *PRR* under ■ BIPRU 7.1.3R.
- (3) The question of what is non-standard for the purposes of (1) must be judged by reference to the standards:
- (a) prevailing at the time the *rule* is being applied; and
 - (b) of *firms* generally who carry on business which gives rise to *PRRs* under ■ BIPRU 7 rather than merely by reference to the *firm's* own business.

7.1.15

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If a *firm* has a *position* or combination of *positions* falling into ■ BIPRU 7.1.14R and the *PRR* relating to that *position* or *positions* materially underestimates the *market risk* incurred by the *firm* to which they give rise, the *firm* must calculate the *PRR* for that *position* or *positions* under ■ BIPRU 7.1.13R.

Meaning of appropriate percentage for non-standard transactions

7.1.16

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- (1) In ■ BIPRU 7.1.13R and, to the extent that that *rule* applies ■ BIPRU 7.1.13R, ■ BIPRU 7.1.15R, an "appropriate percentage" is:
- (a) 100%; or
 - (b) a percentage which takes account of the characteristics of the *position* concerned and of discussions with the *appropriate regulator* or a predecessor regulator under the Banking Act 1987 or the Financial Services Act 1986.
- (2) Compliance with (1) may be relied on as tending to establish compliance with ■ BIPRU 7.1.13R or, insofar as it incorporates the requirements relating to an appropriate percentage, ■ BIPRU 7.1.15R.
- (3) Contravention of (1) may be relied on as tending to establish contravention with ■ BIPRU 7.1.13 R or, insofar as it incorporates the requirements relating to an appropriate percentage, ■ BIPRU 7.1.15 R.

Stress testing and scenario analyses of trading book positions

7.1.17

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A *firm* must conduct a regular programme of stress testing and scenario analysis of its *trading book positions*, both at the trading desk level and on a *firm-wide* basis. The results of these tests must be reviewed by senior management and reflected in the policies and limits the *firm* sets.

- 7.1.17A **G** The *firm's* stress testing programme should be comprehensive in terms of both risk and *firm* coverage, and appropriate to the size and complexity of *trading book positions* held.
- 7.1.18 **R** In carrying out the stress tests and scenario analyses required by ■ BIPRU 7.1.17 R, a *firm* must incorporate and take into account any other relevant stress tests and scenario analyses that it is required to carry out under any other provision of the *Handbook*, and in particular under ■ BIPRU 7.10.72 R where the *firm* has a *VaR model permission*.
- 7.1.19 **G** This paragraph gives *guidance* in relation to the stress testing programme that a *firm* must carry out in relation to its *trading book positions*.
- (1) The frequency of the stress testing of *trading book positions* should be determined by the nature of the *positions*.
 - (2) The stress testing should include shocks which reflect the nature of the portfolio and the time it could take to hedge out or manage risks under severe market conditions.
 - (3) The *firm* should have procedures in place to assess and respond to the results of the stress testing programme. In particular, stress testing should be used to evaluate the *firm's* capacity to absorb losses or to identify steps to be taken by the *firm* to reduce risk.
 - (4) As part of its stress testing programme, the *firm* should consider how prudent valuation principles (see ■ GENPRU 1.3) will be met in a stressed scenario.
- 7.1.20 **G** The stress testing and scenario analysis under ■ BIPRU 7.1.17 R should be taken into account under the *overall Pillar 2 rule*.