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PRA publishes feedback to responses to Consultation Paper (CP) 15/20 'Market risk: Calculation of risks not in value at risk, and stressed value at risk'

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Background and Introduction

Calculation of RNIVs and sVaR

Two major components of the PRA's market risk capital requirements for internal models are the “Risks not in VaR” (RNIVs) and “Stressed VaR” (sVaR). The previous guidance, set out in the Supervisory Statement SS 13/13 'Market Risk', remained ambiguous on key aspects of the calculations for these components. As such, the PRA issued the Consultation Paper CP 15/20 followed by the Policy Statement PS 23/20, which provides additional rules and guidance on both RNIV calculation frequency and sVaR window selection.

Risks not in VaR

The concept of RNIVs was introduced to ensure that own funds are held to meet all risks which are not captured, or not captured adequately, by the firm's VaR and sVaR models.

Under SS 13/13, the RNIV framework requires firms to calculate their RNIV own fund requirement every quarter. Prior to PS 23/20, the PRA allowed the calculation of the capital to be performed at a single point of time. As was acknowledged in CP 15/20, a risk measure calculated at a single point-of-time may not adequately reflect the actual range of risks for an RNIV over the past quarter, especially during periods of market volatility.

Stressed VaR

The sVaR is a VaR calculation that is calibrated to a period of financial stress, hence simulating the potential loss of a firm under adverse conditions. The output is used as component of own funds capital requirements for market risk.

SS 13/13 requires a sVaR calculation to be performed weekly, where the measure is equal to the average of the second and third worst loss in a twelve-month window. The window should be calibrated to maximise the value at risk by selecting a 'period of significant financial stress relevant to the institution’s portfolio’. Before PS 23/20, no guidance was given as to the date period required for finding the sVaR window.

PS 23/20 has been incorporated into the updated SS 13/13 and has been effective since Thursday 26th November 2020.

Implementation Timeline

- The PRA appreciates that, particularly for the measurement of RNIVs, firms may not be able to immediately comply with the new expectations. Firms are asked to contact their supervisor to agree plans and a timeline for complying with these new expectations.
- PS23/20 has been designed to consider the UK’s withdrawal from the European Union (EU) and entry into the transition period, during which time the UK remains subject to European law. The PRA will review the policy statement to assess whether any changes would be required because of changes in the UK regulatory framework at the end of the transition period, including those arising once any new arrangements with the EU take effect.
- The PRA has assessed that the policy would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA).

Risk Not In VaR

Initial statements, responses and final policy

After consultation, the PRA have updated SS 13/13 to provide additional requirements on the frequency of RNIV calculations.

CP 15/20 Initial Statements

- RNIV measures (a risk measure calculated at a single point-of-time) should be calculated at least weekly, as opposed to quarterly.
- The RNIV own funds requirements should be calculated at quarter-end, as the average of the RNIV measures over the last twelve-week period.
- Where a firm chooses to calculate RNIVs for specific risk factors less frequently, the firm should notify the PRA, and be able to justify, on an ongoing basis, the reasons for not performing the calculation at least weekly.

PS 23/20 Responses and PRA Feedback

Calculation using an average of RNIV measures

- In general, the respondents agreed with the PRA's proposal of RNIV own funds being calculated as an average RNIV measure. Consequently, the PRA maintained their position that RNIV own funds requirements should be calculated as an average of RNIV measures.

Operational burden and frequency of RNIV calculation

- All respondents argued that weekly calculations would significantly increase operational, governance and technological burdens, and proposed decreasing the calculation frequency of RNIVs.
- Three respondents proposed that only material RNIVs should be calculated weekly, while less material RNIVs could be calculated less frequently. The remaining three respondents proposed that monthly calculation would generally be sufficient for all RNIVs.
- The PRA acknowledged the burden produced by weekly RNIV measure calculations and changed their expectation of calculation frequency to monthly.

Final Policy Changes

- RNIV measures are to be calculated monthly, with the RNIV own fund requirements equal to the average of the preceding three-month's RNIV measures.
- The PRA expects firms to consider whether the RNIV measure should be calculated more frequently for more material or more volatile RNIV positions. However, the PRA agrees that for such RNIVs, only position and sensitivity inputs need to be updated more frequently than monthly.
- The PRA will allow firms to calculate a maximum of 10% of RNIV own funds requirements using RNIV measures that were calculated less-than-monthly (e.g. once per quarter). However, the PRA expects firms to provide a risk-based justification for why less-than-monthly calculation of an individual RNIV is warranted and to document the materiality and calculation frequency of individual RNIVs.

sVaR Window

Initial statements, responses and final policy

Following PS 23/20, the PRA have updated SS 13/13 with additional guidance on the selection rules for the sVaR window.

CP 15/20 Initial Statements

- In order to identify a ‘period of significant financial stress relevant to the institution’s portfolio’ for sVaR, firms should consider an observation period which begins, as a minimum, from Monday 1 January 2007. In general, the observation period does not need to include the most recent twelve months of historical data immediately preceding the point of calculation.
- If it leads to a more appropriately prudent outcome, firms may include the most recent twelve months in their observation period.
- Where a firm believes that the observation period for determining the sVaR stress period should exclude more than the most recent twelve months, the firm should contact the PRA and justify their reasoning.

PS 23/20 Responses and PRA Feedback

Determining the sVaR stress period period

- The majority of respondents agreed with the PRA’s proposed expectations on the observation period used for determining the sVaR stress period.
- The PRA decided not to change its expectation that firms should consider an observation period that starts from Monday 1 January 2007.

Excluding the most recent twelve months of historical data immediately preceding the point of calculation

- Two respondents stated that they intend to continue including the most recent twelve months of historical data in the observation period that they use for determining their sVaR stress period.
- One respondent suggested that firms that use a longer VaR window than the most recent twelve months should be allowed to exclude their full VaR window from their sVaR observation period.

Backtesting multiplier adjustments

- One respondent proposed that the PRA could consider adjusting firms' back-testing multiplier independently for VaR and sVaR. However, it is not possible to adjust a firms' back-testing multiplier independently for VaR and sVaR as Article 366(2) of CRR prescribes a minimum of three for back-testing multipliers.

Final Policy Changes

- Firms should consider an observation period which begins, as a minimum, from Monday 1 January 2007. In general, the observation period does not need to include the most recent twelve months of historical data immediately preceding the point of calculation.
- Firms may exclude the most recent twelve months of data but must contact the PRA where they propose to exclude more than the most recent twelve months.

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