PRA consults on Market Risk

Calculation of risks not in VaR, and stressed VaR

On 6 October, the PRA published [Consultation Paper CP15/20] (PDF 760 KB) which sets outs proposals to update its expectations around measurement of risks not in VaR (RNIV) and the meaning of "period of significant financial stress relevant to the institution's portfolio" for stressed VaR (sVaR) calculation.

Market volatility related to the COVID-19 outbreak has highlighted elements of the market risk framework that may lead to an excessively pro-cyclical increase in own funds requirements during periods of stress. The PRA's proposals are intended to reduce this effect.

Measurement of risks not in VaR (RNIVs)

Due to significant COVID-19 related market volatility, the PRA has identified that RNIV own funds requirements calculated at a single point in time (for example, at quarter-end) can suddenly and unexpectedly increase, where a sudden increase in market volatility occurs close to quarter-end. The existing [Supervisory Statement] (PDF 638 KB) (SS 13/13) does not specify whether own funds requirements should reflect the portfolio across the preceding quarter or at a single point in time. The PRA therefore proposes that:

- RNIV own funds requirements should be calculated at quarter-end as the average across the preceding twelve-week period of an RNIV measure calculated at least weekly.
- For those risk factors where a firm calculates an RNIV measure less frequently than weekly, the firm should notify the PRA and be able to justify, on an ongoing basis, their reasons for not performing that calculation at least weekly.

Meaning of `period of significant financial stress relevant to the institution's portfolio' for stressed VaR (sVaR) calculation

CRR article 365(2) requires firms to use a "relevant" period of financial stress for the sVaR calculation. SS 13/13 specifies only that the sVaR period should be equivalent to the period that would maximise VaR given the firm's portfolio. The PRA therefore proposes that:

- Firms should consider an sVaR observation period that starts at least from 1 January 2007.
- Firms may include the most recent 12 months where it leads to a more appropriately prudent outcome.
- Where a firm believes that the observation period for determining sVaR should exclude more than the most recent 12 months, it should contact the PRA setting out and providing justification for this rationale.

Implications for firms

The RNIV measures are expected to improve consistency in calculation across firms and reduce the potential for significant market volatility near quarter-ends due to spikes in own funds requirements. They will also increase transparency over the RNIV framework.

The PRA recognises that expecting weekly calculation of the RNIV measure may impose additional costs to firms, and therefore proposes that the measure may be calculated less frequently than weekly for certain risks where a firm notifies the PRA and is able to justify why a weekly calculation is not appropriate for those risks.

The observation period measures are expected to improve consistency of identification of the "period of significant financial stress" across firms, ensure that firms consider a sufficiently broad observation period and minimise overlaps between VaR and sVaR measures. The PRA does not anticipate any significant additional costs to firms as a result of this proposal.

Scope and Timeline

The CP is relevant to all firms to which Capital Requirements Directive IV applies.

The consultation will close on 6 November 2020, with draft amendments to SS13/13 (see Appendix to the CP) taking effect from publication of the final policy.