ANNEX III

THE TREATMENT OF COUNTERPARTY CREDIT RISK OF DERIVATIVE INSTRUMENTS, REPURCHASE TRANSACTIONS, SECURITIES ORCOMMODITIES LENDING OR BORROWING TRANSACTIONS, LONG SETTLEMENT TRANSACTIONS AND MARGIN LENDING TRANSACTIONS

PART 6

Validation requirements for EPE models

42. A credit institution's EPE model shall meet the following validation requirements:

(a) the qualitative validation requirements set out in Annex V to Directive 2006/49/EC;

(b) interest rates, foreign exchange rates, equity prices, commodities, and other market risk factors shall be forecast over long time horizons for measuring CCR exposure. The performance of the forecasting model for market risk factors shall be validated over a long time horizon;

(c) the pricing models used to calculate CCR exposure for a given scenario of future shocks to market risk factors shall be tested as Part of the model validation process. Pricing models for options shall account for the nonlinearity of option value with respect to market risk factors;

(d) the EPE model shall capture transaction-specific information in order to aggregate exposures at the level of the netting set. A credit institution shall verify that transactions are assigned to the appropriate netting set within the model;

(e) the EPE model shall also include transaction-specific information to capture the effects of margining. It shall take into account both the current amount of margin and margin that would be passed between counterparties in the future. Such a model shall account for the nature of margin agreements (unilateral or bilateral), the frequency of margin calls, the margin period of risk, the minimum threshold of unmargined exposure the credit institution is willing to accept, and the minimum transfer amount. Such a model shall either model the mark-to-market change in the value of collateral posted or apply the rules set out in Annex VIII; and

(f) static, historical back-testing on representative counterparty portfolios shall be Part of the model validation process. At regular intervals, a credit institution shall conduct such back-testing on a number of representative counterparty portfolios (actual or hypothetical). These representative portfolios shall be chosen based on their sensitivity to the material risk factors and correlations to which the credit institution is exposed.

If back-testing indicates that the model is not sufficiently accurate, the competent authorities shall revoke the model approval or impose appropriate measures to ensure that the model is improved promptly. They may also require additional own funds to be held by credit institutions pursuant to Article 136.