Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (Text with EEA relevance)

PART THREE

CAPITAL REQUIREMENTS

TITLE II

CAPITAL REQUIREMENTS FOR CREDIT RISK

CHAPTER 4

Credit risk mitigation

Section 4

Calculating the effects of credit risk mitigation

Sub-Section 1

Funded credit protection

Article 225

Own estimates of volatility adjustments under the Financial Collateral Comprehensive Method

1 The competent authorities shall permit institutions to use their own volatility estimates for calculating the volatility adjustments to be applied to collateral and exposures where those institutions comply with the requirements set out in paragraphs 2 and 3. Institutions which have obtained permission to use their own volatility estimates shall not revert to the use of other methods except for demonstrated good cause and subject to the permission of the competent authorities.

For debt securities that have a credit assessment from an ECAI equivalent to investment grade or better, institutions may calculate a volatility estimate for each category of security.

For debt securities that have a credit assessment from an ECAI equivalent to below investment grade, and for other eligible collateral, institutions shall calculate the volatility adjustments for each individual item.

Institutions using the Own Estimates Approach shall estimate volatility of the collateral or foreign exchange mismatch without taking into account any correlations between the unsecured exposure, collateral or exchange rates.

In determining relevant categories, institutions shall take into account the type of issuer of the security, the external credit assessment of the securities, their residual maturity, and their modified duration. Volatility estimates shall be representative of the securities included in the category by the institution.

2 The calculation of the volatility adjustments shall be subject to all the following criteria:

a institutions shall base the calculation on a 99th percentile, one-tailed confidence interval;

b institutions shall base the calculation on the following liquidation periods:

(i) 20 business days for secured lending transactions;

(ii) 5 business days for repurchase transaction, except insofar as such transactions involve the transfer of commodities or guaranteed rights relating to title to commodities and securities lending or borrowing transactions;

(iii) 10 business days for other capital market driven transactions;

c institutions may use volatility adjustment numbers calculated according to shorter or longer liquidation periods, scaled up or down to the liquidation period set out in point (b) for the type of transaction in question, using the square root of time formula:

$$H_M = H_N \cdot \sqrt{\frac{T_M}{T_N}}$$

where:

T_M	=	the relevant liquidation period;
H_M	=	the volatility adjustment based on the liquidation period T_M;
H_N	=	the volatility adjustment based on the liquidation period T_N.

d institutions shall take into account the illiquidity of lower-quality assets. They shall adjust the liquidation period upwards in cases where there is doubt concerning the liquidity of the collateral. They shall also identify where historical data may understate potential volatility. Such cases shall be dealt with by means of a stress scenario;

e the length of the historical observation period institutions use for calculating volatility adjustments shall be at least one year. For institutions that use a weighting scheme or other methods for the historical observation period, the length of the effective observation period shall be at least one year. The competent authorities may also require an institution to calculate its volatility adjustments using a shorter observation period where, in the competent authorities' judgement, this is justified by a significant upsurge in price volatility;

f institutions shall update their data sets and calculate volatility adjustments at least once every three months. They shall also reassess their data sets whenever market prices are subject to material changes.

3 The estimation of volatility adjustments shall meet all the following qualitative criteria:

a an institutions shall use the volatility estimates in the day-to-day risk management process including in relation to its internal exposure limits;

b where the liquidation period used by an institution in its day-to-day risk management process is longer than that set out in this Section for the type of transaction in question, that institution shall scale up its volatility adjustments in accordance with the square root of time formula set out in point (c) of paragraph 2;

c an institution shall have in place established procedures for monitoring and ensuring compliance with a documented set of policies and controls for the operation of its system for the estimation of volatility adjustments and for the integration of such estimations into its risk management process;

d an independent review of the institution's system for the estimation of volatility adjustments shall be carried out regularly within the institution's own internal auditing process. A review of the overall system for the estimation of volatility adjustments and for the integration of those adjustments into the institution's risk management process shall take place at least once a year. The subject of that review shall include at least the following:

(i) the integration of estimated volatility adjustments into daily risk management;

(ii) the validation of any significant change in the process for the estimation of volatility adjustments;

(iii) the verification of the consistency, timeliness and reliability of data sources used to run the system for the estimation of volatility adjustments, including the independence of such data sources;

(iv) the accuracy and appropriateness of the volatility assumptions.