

Chapter 4

Credit risk

4.14 Counterparty credit risk

Hedging sets

- 4.14.1 **R** For the purpose of article 282(6) of the *EU CRR* (Hedging sets), a *firm* must apply the CCR Mark-to-market method as set out in Part Three, Title II, Chapter 6, Section 3 (Mark-to-market method) of the *EU CRR* to:
- (1) transactions with non-linear risk profile; or
 - (2) *payment legs* and transactions with debt instruments as underlying; for which it cannot determine the delta or the modified duration, as the case may be, using an internal model approved by the *FCA* under Part Three Title IV of the *EU CRR* for the purposes of determining *own funds requirements* for market risk.

Recognition of netting: interest rate derivatives

- 4.14.2 **R** For the purpose of article 298(4) of the *EU CRR* (Effects of recognition of netting as risk-reducing), a *firm* must use the original maturity of the *interest-rate contract*.
- 4.14.3 **G** A *firm* may apply to the *FCA* under section 138A of the *Act* to *waive* ■ IFPRU 4.14.2 R if it wishes to use the residual maturity of the *interest-rate contract*.

Use of internal CVA model for calculation of the maturity factor 'M'

- 4.14.4 **G**
- (1) This *guidance* sets out the *FCA*'s expectations for granting permission to a *firm* to use its own one-sided credit valuation adjustment internal models (an "internal CVA model") for the purpose of estimating the maturity factor "M", as proposed under article 162(2)(h) of the *EU CRR* (Maturity).
 - (2) In the context of counterparty credit risk, the maturity factor "M" is intended to increase the *own funds requirements* to reflect potential higher risks associated with medium and long-term OTC derivative portfolios, more specifically when the exposure profile of these contracts is significant beyond one year. This adjustment is only applicable to a *firm* using the Internal Model Method for the calculation of *exposure* values.
 - (3) A *firm* is permitted to replace the formula for the maturity factor "M", as set out in article 162(2)(g) of the *EU CRR* with the 'effective

credit duration' derived by a *firm's* internal CVA model, subject to permission being granted by the *FCA*, as the *competent authority*.

- (4) Internal CVA models are complex by nature and modelling practises vary significantly across the industry. The *FCA* considers the creation of an acceptable model resulting in an appropriate credit duration to be challenging, and so would require extensive review. Accordingly, the *FCA* expects a *firm* to demonstrate a strong case for the granting of such permission.
- (5) A *firm* that wishes to make an application under article 162(2)(h) should provide a satisfactory justification for the use of an internal CVA model for estimating the maturity factor "M". The purpose of reducing the *own funds requirements* for counterparty credit risk will not, on its own, be considered as a reasonable justification. The *FCA* will also expect highly conservative modelling assumptions within a *firm's* internal CVA model for the purpose of article 162(2)(h).

Permission to set the maturity factor 'M' to 1 for the counterparty credit risk default charge

4.14.5

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- (1) This *guidance* sets out the *FCA's* expectations for permitting a *firm* with the permission to use the Internal Model Method set out in Part Three, Title II, Chapter 6, Section 6 (Internal model method) and the permission to use an internal VaR model for specific risk set out in Part Three, Title IV, Chapter 5 (Use of internal models) associated with traded debt instruments to set to 1 the maturity factor "M" defined in article 162 of the *EU CRR*.
- (2) In the context of counterparty credit risk, the maturity factor "M" is intended to increase the *own funds requirements* to reflect the potential higher risks associated with medium and long-term *OTC derivative* portfolios, more specifically when the exposure profile of these contracts is significant beyond one year. This adjustment is only applicable to *firms* using the Internal Model Method for the calculation of *exposure* values.
- (3) Article 162(2)(i) of the *EU CRR* allows a *firm* to set the maturity factor "M" to 1 for a *firm* using the Internal Model Method provided that the *firm's* internal value-at-risk (VaR) model for specific risk associated with traded debt instruments reflects the effect of rating migration and subject to the permission of the *FCA*, as the *competent authority*.
- (4) Internal VaR models for specific risk associated with traded debt instruments are not specifically designed to capture the effects of rating migrations. The risk captured by these models is based on a 10-day time horizon which cannot appropriately reflect the dynamics of rating migrations, which occur on an irregular, infrequent basis. This deficiency was one of the main reasons underlying the introduction of a separate risk measure for the capture of both credit default and rating migration risks, based on a one-year time horizon (the IRC models in article 372 of the *EU CRR* (Internal IRC model)).
- (5) Since the challenges of appropriately capturing credit-rating migrations in an internal VaR model are high, the *FCA* expects a *firm* to demonstrate a strong case for the granting of the permission set out in article 162(2)(i) of the *EU CRR*.

- (6) A *firm* that wishes to make an application under article 162(2)(i) of the *EU CRR* should provide a satisfactory justification for use of its internal VaR model to capture the risks associated with ratings migration. The purpose of reducing the *own funds requirements* for counterparty credit risk will not be considered as a reasonable justification.
- (7) The *FCA* expects highly conservative modelling assumptions for the capture of rating migrations within a *firm's* internal VaR models for specific risk associated with traded debt instruments under article 162(2)(i) of the *EU CRR* (Maturity).