Chapter 1

Commission Delegated Regulation (EU) 2016/101

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Article 11 Calculation of model risk AVA

(1) Institutions shall estimate a model risk AVA for each valuation model ("individual model risk AVA") by considering valuation model risk which arises due to the potential existence of a range of different models or model calibrations, which are used by market participants, and the lack of a firm exit price for the specific product being valued. Institutions shall not consider valuation model risk which arises due to calibrations from market derived parameters, which shall be captured according to Article 9.

(2) The model risk AVA shall be calculated using one of the approaches defined in paragraphs 3 and 4.

(3) Where possible, institutions shall calculate the model risk AVA by determining a range of plausible valuations produced from alternative appropriate modelling and calibration approaches. In this case, institutions shall estimate a point within the resulting range of valuations where they are 90 % confident they could exit the valuation exposure at that price or better.

(4) Where institutions are unable to use the approach defined in paragraph 3, they shall apply an expert-based approach to estimate the model risk AVA.

(5) The expert-based approach shall consider all of the following:

(a) complexity of products relevant to the model;

(b) diversity of possible mathematical approaches and model parameters, where those model parameters are not related to market variables;

(c) the degree to which the market for relevant products is "one way";

(d) the existence of unhedgeable risks in relevant products;

(e) the adequacy of the model in capturing the behaviour of the pay-off of the products in the portfolio.

Institutions shall notify competent authorities of the models for which this approach is applied, and the methodology used to determine the AVA.

(6) Where institutions use the method described in paragraph 4, the prudence of the method shall be confirmed annually by comparing the following:

(a) the AVAs calculated using the method described in paragraph 4, if it were applied to a material sample of the valuation models for which the institution applies the method in paragraph 3; and

(b) the AVAs produced by the method in paragraph 3 for the same sample of valuation models.

(7) Institutions shall calculate the total category level AVA for model risk by applying to individual model risk AVAs the formulae for either Method 1 or Method 2 laid down in the Annex.