



Temporary approach to VAR back-testing exceptions to mitigate the possibility of excessively pro-cyclical market risk capital requirements

Overview

We are aware that the exceptional levels of market volatility over the past few weeks have led to an elevated level of VAR back-testing exceptions across the industry. In order to mitigate the possibility of excessively pro-cyclical market risk capital requirements through the automatic application of a higher VAR multiplier (ie m_c and m_s , as defined in CRR Article 366), we will allow firms – on a temporary basis – to offset increases due to new exceptions through a commensurate reduction in risks-not-in-VAR (RNIV) capital requirements. This approach will be reviewed by the PRA after 6 months.

Scope

The PRA's temporary approach is relevant to firms experiencing an elevated level of VAR back-testing exceptions.

Implementation

The baseline number of back-testing exceptions to be used, which will determine the point at which the RNIV reduction starts, should be agreed with the PRA at the outset. The intention is that this should represent the situation immediately before the onset of the Covid-19 outbreak; please confirm this with your supervisor before applying this temporary approach. Firms are expected to continue to monitor and analyse exceptions during this temporary period and, when the situation returns to normal (i.e. after the end of the temporary period), we will consider which (if any) of the exceptions can reasonably be discounted (per section 6 of the PRA Supervisory Statement 13/13 on Market Risk). Existing exceptions that drop out of the 250-day back-testing period should be treated in the normal way.

The length of the temporary period is, naturally, somewhat uncertain at this stage. However, we will review after 6 months, i.e. in September 2020. Our intention is that it should terminate for all firms at the same time, and we will provide advance notice of this.

Worked example

Period	No. of exceptions		M factor		VAR-based capital requirements			RNIV	
	Baseline	Total	Baseline	Total	Baseline	Total	Diff	Total	Adjusted
Q4 2019	4	4	3	3	1000.0	1000.0	0.0	400.0	400.0
Q1 2020	4	7	3	3.65	1000.0	1216.7	216.7	400.0	183.3
Q2 2020	4	9	3	3.85	1000.0	1283.3	283.3	400.0	116.7
Q3 2020	4	10	3	4	1000.0	1333.3	333.3	400.0	66.7



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The adjustment can be expressed via the following formula:

$$RNIV\ capital = \max\left(0, \sum_i RNIV_i - \Delta VaR\right)$$

where ΔVaR is the difference between:

- a. VAR-based requirements with the multiplier including all exceptions, and
- b. VAR-based requirements with the multiplier excluding exceptions which occur during the temporary crisis period

The floor at 0 is to explicitly ensure that RNIV capital requirements cannot become negative. For the avoidance of doubt, VAR-based requirements includes VAR, SVAR and VAR-based RNIVs (i.e. all components of IMA capital requirements subject to the multiplier).

If you have any questions, please contact the PRA via your normal supervisory contacts.

30 March 2020