EESTI PANK
GOVERNOR'S DECREE No 7

Tallinn, 4 November 2011

Amendments to Decree No 13 of the Governor of Eesti Pank from 29 December 2006 "Procedure for application and calculation of prudential ratios of credit institutions and consolidation groups of credit institutions"

The Decree is established under subsection 71 (7), subsections 79 (6)–(8) and subsection $86^1$ (3) of the Credit Institutions Act.

**§ 1.** The following amendments shall be made to Decree No 13 of the Governor of Eesti Pank from 29 December 2006 "Procedure for application and calculation of prudential ratios of credit institutions and consolidation groups of credit institutions" (RTL 2007, 3, 52; 93, 1548; RT I 2010, 51, 323; RT I, 29.12.2010, 17):

**1)** Clause 1 8) shall be worded as follows:

"8) the procedure for calculating capital requirements against a settlement/delivery risk, and against position risk and counterparty credit risk associated with the trade portfolio;";

**2)** Clause 9 (2) 4) shall be worded as follows:

"4) the capital requirements for trade portfolio position risk and counterparty credit risk calculated pursuant to the procedure established in Division 6 of this Chapter and multiplied by a coefficient of 1.25;";

**3)** Subsection 9 (2) shall be supplemented with clause 7 in the following wording:

"7) the capital requirement for settlement/delivery risk calculated pursuant to the procedure established in Division 8 of this Chapter and multiplied by a coefficient of 1.25.";

**4)** The words "and settlement/delivery" shall be omitted from subsection 9 (3);

**5)** Subsection 10 (5) shall be worded as follows:

"(5) In the case that a company belonging to the consolidation group has been released from the obligation to calculate capital requirements for trade portfolio counterparty credit risk under subsection 79 (3) of the Credit Institutions Act or the relevant legislation of a Member State, that credit institution's capital requirement for credit risk shall be calculated on trade portfolio credit risk positions pursuant to the procedure established in Division 2 of this Chapter.";

**6)** Section 12 shall be worded as follows:

"**§ 12. Calculation of consolidated capital requirements for credit risk, settlement/delivery risk, trade portfolio's counterparty credit risk, and operational risk**

For the purposes of calculating consolidated capital requirements for a credit risk, settlement/delivery risk, trade portfolio counterparty credit risk and operational risk, capital requirements shall be calculated on the pertinent positions of all companies within the consolidation group, excluding mutual positions of companies within the consolidation group, pursuant to the procedure established in Division 2, Subdivision 3 of Division 6, and Division 7 of this Chapter.";

**7)** In subsection 20 (6), the wording “the lowest risk weight shall be assigned“ shall be substituted with the wording “the lower rating shall be applied“;

**8)** Section 27 shall be supplemented with subsection (5) with the following wording:

“(5) Exposures of regional governments and local authorities of Member States, nominated and funded the official currency of the relevant Member State, shall be subject to risk weight of 20%.“;

**9)** In clause 29 (2) 6) of the original Decree in Estonian language, the wording “Euroopa Arengupanga Nõukogu” shall be substituted with the wording “Euroopa Nõukogu Arengupank”; clause 29 (2) 6) of the English translation of the Decree needs no correction;

**10)** Section 165 shall be supplemented with subsection (5) with the following wording:

“(5) The external credit assessment assigned to a securitised position must be independent from the credit institution. If the external assessment is under indirect influence of the credit institution, then the credit institution shall consider the position to have no external credit assessment upon calculating the risk-weighted assets of the position.”;

**11)** In subsection 166 (7) of the original Decree in Estonian language, the word “erisotstarbeline” shall be substituted with the word “eriotstarbeline”; subsection 166 (7) of the English translation of the Decree needs no correction;

**12)** Section 166 shall be supplemented with subsection (13) with the following wording:

“(13) Re-securitisation is a securitisation transaction where at least one of the exposures being securitised is a securitised risk position.”;

**13)** The Decree shall be supplemented with section $170^1$ with the following wording:

“**§ $170^1$. Value of overlapping securitised positions**

(1) If a credit institution has two or more securitised positions which are partially or fully based on the same risk position, then the calculation of risk-weighted assets for the overlapping part of the positions shall use position or part of position which results in a higher value of risk-weighted assets calculated from it.

(2) The procedure provided in subsection (1) may be used in case of overlapping capital requirements for specific risks of trading portfolio positions and overlapping capital requirements for banking portfolio positions, on the prerequisite that the credit institution is able to calculate and compare those capital requirements.

(3) Upon consent of the Financial Supervision Authority, a credit institution may use the risk weight of a liquidity facility for calculation of risk-weighted assets of a securitised position in an ABCP programme, if the ABCP programme and the liquidity facility have the same tranche and the security issued in the ABCP programme is fully covered by the liquidity facility.”;

**14)** Subsection 172 (1) shall be worded as follows:

“(1) Under the Standardised Approach, the risk-weighted exposure amount of a securitisation or re-securitised position shall be calculated by multiplying the exposure value calculated under section 170 by the risk weight calculated under this Sub-subdivision.”;

**15)** Section 172 shall be supplemented with subsections ($3^1$) and ($3^2$) with the following wording:

“($3^1$) Where a re-securitisation position has a short-term credit assessment, the risk weights corresponding to the credit quality steps determined by the Financial Supervision Authority pursuant to the procedure established in Sub-subdivision 2 of Subdivision 1 of this Division shall be as follows:

1) credit quality step 1 - 40%;
2) credit quality step 2 - 100%;
3) credit quality step 3 - 225%;
4) credit quality steps 4 and lower - 1,250%.

($3^2$) Where the external credit assessment assigned to a re-securitisation position is not a short-term credit assessment, the risk weights corresponding to the credit quality steps determined by the Financial Supervision Authority pursuant to the procedure established in Sub-subdivision 2 of Subdivision 1 of this Division shall be as follows:
1) credit quality step 1 - 40%;
2) credit quality step 2 - 100%;
3) credit quality step 3 - 225%;
4) credit quality step 4 - 650%;
5) credit quality steps 5 and lower - 1,250%.";

**16)** Subsections 183 (1) and (2) shall be worded as follows:

"(1) The Ratings Based Method shall be used if a securitised or re-securitised position has an external assessment.
(2) Under the Ratings Based Method, the risk-weighted exposure amount of a rated securitised or re-securitised position shall be calculated by applying to the exposure value, calculated pursuant to the procedure established in this Subdivision, the risk weight set out in subsections (3) to ($4^2$) of this section. The risk-weighted exposure amount shall be adjusted by multiplying it by a coefficient of 1.06.";

**17)** Section 183 shall be supplemented with subsections ($4^1$) and ($4^2$) with the following wording:

"($4^1$) To re-securitised positions with a short-term credit assessment the risk weights set out in the following table shall be applied on the basis of the credit quality steps determined by the Financial Supervision Authority pursuant to the procedure established in Sub-subdivision 2 of Subdivision 1 of this Division:

| Credit quality step | Risk weight | |
|---|---|---|
| | A | B |
| 1 | 20% | 30% |
| 2 | 40% | 65% |
| 3 | 150% | 225% |
| 4 and lower | 1,250% | 1,250% |

($4^2$) Where the external assessment assigned to a re-securitised position is not a short-term credit assessment, the risk weights set out in the following table shall be applied to them on the basis of the credit quality steps determined by the Financial Supervision Authority pursuant to the procedure established in Sub-subdivision 2 of Subdivision 1 of this Division:

| Credit quality step | Risk weight | |
|---|---|---|
| | A | B |
| 1 | 20% | 30% |

| | | |
|---|---|---|
| 2 | 25% | 40% |
| 3 | 35% | 50% |
| 4 | 40% | 65% |
| 5 | 60% | 100% |
| 6 | 100% | 150% |
| 7 | 150% | 225% |
| 8 | 200% | 350% |
| 9 | 300% | 500% |
| 10 | 500% | 650% |
| 11 | 750% | 850% |
| 12 and lower | 1,250% | 1,250%”; |

**18)** Subsections 183 (5), (10) and (11) shall be worded as follows:

“(5) The risk weights in column A of the tables set out in subsections (3) to ($4^2$) of this section shall be applied to securitised or re-securitised positions that are the most senior tranche of the securitisation or re-securitisation. No securitised exposure of a re-securitised position can be a re-securitised position. When determining whether a tranche is the most senior, a credit institution shall not take into consideration amounts due under interest rate or currency derivative contracts, fees due, or other similar payments.

(10) In the case of re-securitisation, the credit institution must determine the number of securitised exposures in the re-securitisation portfolio and not the number of underlying exposures in the original pools from which the underlying securitisation exposures stem.

(11) In the cases not regulated by subsections (5) and (7), the risk weights in column B of the tables set out in subsections (3) to ($4^2$) of this section shall be applied to securitised or re-securitised positions.”;

**19)** Subsection 184 (2) shall be supplemented with clause $2^1$) with the following wording:

“$2^1$) $K_{IRB}$ is the sum of the position’s expected loss and the position’s capital requirement calculated in accordance with Subdivision 2 of Division 2 that would have been calculated if the position would not be securitised;”;

**20)** Clause 184 (2) 5) and subsection 184 (6) shall be worded as follows:

“5) $N$ is the effective number of exposures calculated in accordance with the formula set out in subsections 182 (8) and (9);

(6) Where the risk weight of a securitised position determined by a credit institution under subsection (1) of this section is lower than 7%, the risk weight of 7% shall be applied.”;

**21)** Section 184 shall be supplemented with subsection (7) with the following wording:

“(7) Where the risk weight of a re-securitised position determined by a credit institution under subsection (1) of this section is lower than 20%, the risk weight of 20% shall be applied.”;

**22)** The last sentence of subsection 266 (1) shall be worded as follows:

“Where marking to market is not possible, credit institutions must mark their trade portfolio positions conservatively to model.”;

**23)** Clause 266 (2) 1) shall be worded as follows:

“1) documented policies for the process of valuation, incl. guidelines for use of inputs which are not market-based but reflect the assumptions of the credit institution about what market participants would use upon valuation of the position;”;

**24)** Clause 266 (6) 1) shall be worded as follows:

“1) The senior management of the credit institution shall be aware of the positions of the trade portfolio and other positions valuated in fair value which are subject to marking to model and shall understand the materiality of the uncertainty this creates in the reporting of the risk/performance of the business;”;

**25)** In the first sentence of subsection 266 (7) of the original Decree in Estonian language, the wording “mudelite baasil” shall be substituted with the wording “mudelite põhjal”; subsection 266 (7) of the English translation of the Decree needs no correction;

**26)** Sections 267 and 268 shall be worded as follows:

“**§ 267. Valuation adjustments**

(1) Credit institutions shall establish and maintain procedures for adjusting the valuations of trade portfolio positions.

(2) Credit institutions shall adjust the valuations of unearned credit spreads, close-out costs, operational risks, early termination, investing and funding costs, future administrative costs and, where relevant, model risk.

**§ 268. Adjustment of valuations of less liquid positions**

(1) Less liquid positions can arise from both market events and credit institution-related situations, e.g. concentrated positions and/or stale positions.

($1^1$) Credit institutions shall establish and maintain procedures for adjusting the valuations of less liquid positions. Corrections must compensate for the low liquidity of such positions and they shall be added to the changes of valuation of positions presented in financial reporting if necessary.

(2) The procedure for adjusting the valuations of less liquid positions must consider the amount of time it would take to hedge out the position/risks within the position, the volatility and average of bid/offer spreads, the availability of market quotes, the number of market makers, the volatility and average of trading volumes (incl. trading volumes in stress periods), market concentrations, the aging of positions, the extent to which valuation relies on marking-to-model, and the impact of other model risks.

(3) When using third party valuations of trading book positions or marking to model, credit institutions shall consider the need for valuation adjustments on an ongoing basis.

(4) A credit institution shall valuate separately the need for valuation adjustments of complex products (incl. securitised positions and n-th-to-default credit derivatives), in order to reflect the model risk associated with possible use of incorrect valuation method and the model risk associated with use of calibration parameters which are not market-based and thus have a higher risk of error.”;

**27)** Subsection 270 (1) shall be worded as follows:

“(1) A credit institution shall calculate the capital requirement for the interest rate risk and equity position risk, unless it has been released from the obligation to calculate capital requirements for the interest rate risk and equity position risk and the counterparty credit risk associated with the trade portfolio under subsection 79 (3) of the Credit Institutions Act.";

**28)** The following text shall be added to the end of subsection 276 (1):

"A credit institution may replace the notional amount of the credit derivative with a notional amount minus any changes of the credit derivative's market value which occurred after the start of trading.";

**29)** Subsection 277 (8) shall be worded as follows:

"(8) If an n-th-to-default credit derivative has been externally rated and it meets the requirements for eligible debt instruments specified in section 285, the capital requirement for specific risk shall be calculated on the long position of the derivative and the relevant securitisation risk weights shall be applied if applicable.";

**30)** Section 282 shall be worded as follows:

"**§ 282. Calculation of capital requirements for interest rate risk**

A credit institution shall calculate capital requirements for the specific interest rate risk pursuant to the procedure established in sections 283 and 284 and for the general interest rate risk pursuant to the procedure established in sections 286 to 289 separately for each currency.";

**31)** Subsection 283 (2) shall be worded as follows:

"(2) To calculate the capital requirement for the specific interest rate risk, long and short positions shall be multiplied by the capital requirement rates specified in section 284 and the absolute values of these products shall be totalled, except in the case provided in subsection ($2^1$).";

**32)** Section 283 shall be supplemented with subsection ($2^1$) with the following wording:

"($2^1$) The capital requirement for a specific risk of trade portfolio based on correlation as provided for in section $285^1$ may be calculated, using the higher of the following values:

1) the sum total of capital requirements for specific interest rate risk calculated on long positions,
2) the sum total of capital requirements for specific interest rate risk calculated on short positions.";

**33)** Clause 284 (3) 1) shall be worded as follows:

"1) if these debt instruments would qualify for credit quality step 1, 2 or 3 under section 32 and their residual term to final maturity is less than 6 months, the capital charge shall be 0.25%; if the residual term to final maturity is at least 6 months and up to 2 years, the capital charge shall be 1%; and if the residual term to final maturity is more than 2 years, the capital charge shall be 1.6%;";

**34)** Section 284 shall be supplemented with subsections ($4^1$) and ($5^1$) to ($5^4$) with the following wording:

"($4^1$) The capital requirements for specific risk of debt instruments which are not listed in Subsections (1) to (4) and are conforming to the conditions stated in section 285 of this Decree are as follows:
1) if their residual term to final maturity is less than 6 months, the capital charge shall be 0.25%;
2) if their residual term to final maturity is at least 6 months and up to 2 years, the capital charge shall be 1%;
3) if their residual term to final maturity is more than 2 years, the capital charge shall be 1.6%.

($5^1$) The capital charge applied to the securitised positions shall be 8 percent of the risk weight applied to those positions in accordance with Subdivision 4 of Division 2 which would be used if those positions would be included in the banking portfolio of the credit institution, considering the specifics provided in subsections ($5^2$) to (6) of this section.

($5^2$) A credit institution which is not the originator of the securitised position may use the Supervisory Formula Method provided in section 184 only with prior approval of the Financial Supervision Authority.

($5^3$) A credit institution which uses the method of calculating capital requirements for additional risks provided in section $310^1$ for covering the specific risk of trade portfolio under approval of the Financial Supervision Authority, may use this method as a basis for valuations of probability of default and loss given default for calculations of risk weights by the Supervisory Formula Method.

($5^4$) Until 31 December 2013, the long and the short weighted net positions shall be summed separately when calculating the specific risk capital requirements of securitised positions. The sum that has the highest absolute value shall be considered the capital requirement of the specific risk.";

**35)** The decree shall be supplemented with Section $285^1$ with the following wording:

### "§ $285^1$. Correlation-based trade portfolio

(1) A correlation-based trade portfolio consists of securitised positions and n-th-to-default credit derivatives conforming to the following criteria:
1) the securitised positions are not re-securitised positions, securitisation series options or other derivative instruments not yielding a proportional share of the revenue of the underlying securitised series;
2) all underlying instruments are instruments with a single underlying asset, incl. credit derivatives with a single underlying asset, for which there is a liquid two-way market, or common-trade indexes based on their underlying instruments. A two-way market shall be considered to exist if there are independent bids and offers made in good faith so that the price which is reasonably related to the latest sales price or to a valid trustworthy competing bid/offer, and the bid/offer prices can be determined within one day and can be settled within a relatively short time and in accordance with the usual trading practices.

(2) Positions shall not be included in a correlation-based trade portfolio if they are based on the following:
1) Underlying assets which can be categorised in the banking portfolio of the credit institution as belonging to risk position classes provided in clauses $86^3$ (1) 8) and 9) of the Credit Institutions Act;
2) SSPE exposures.

(3) A credit institution may include positions in its correlation-based trade portfolio if these positions are not securitised positions or n-th-to-default credit derivatives but they mitigate the risk of other positions of that portfolio on the prerequisite that the relevant instrument or its underlying asset has a liquid two-way market as provided in clause (1) 2) of this section.";

**36)** The first sentence of section 290 shall be worded as follows:

"Besides the interest rate risk, a debt instrument may be associated with a foreign-exchange risk, settlement/delivery risk and trade portfolio counterparty credit risk.";

**37)** In subsection 293 (1), the wording "4 percent" shall be substituted with the wording "8 percent" and subsection 293 (2) shall be repealed;

**38)** The first sentence of section 295 shall be worded as follows:

“In addition to position risk, equities may be associated with a foreign-exchange risk, settlement/delivery risk and trade portfolio counterparty credit risk.”;

**39)** The title of Subdivision 3 of Division 6 of Chapter 3 of this Decree shall be worded as follows:

“**Subdivision 3**
**Capital requirements for trade portfolio counterparty credit risk**”;

**40)** Sections 301, 303 and 305 shall be repealed;

**41)** The first sentence of subsection 302 (2) shall be worded as follows:

“The capital requirement for a counterparty credit risk shall be calculated on risk positions resulting from the following transactions:”;

**42)** Subsection 304 (4) shall be worded as follows:

“(4) In the case of a credit default swap, a credit institution the exposure of which arising from the swap represents a long position in the underlying may use a figure of 0% for potential future credit exposure when applying the Mark-to-Market Method, unless the credit default swap is terminated due to default of the counterparty whose risk position in the credit default swap is a short position in the underlying assets, even if the obligations related to the underlying assets are performed. In the latter case, the credit institution’s possible future large exposure shall be the amount unpaid by the counterparty to the credit institution.”;

**43)** In section 306, the wording “risk-management models” shall be substituted with the wording “risk-measurement models”;

**44)** The second sentence of subsection 309 (4) shall be worded as follows:

“The Financial Supervision Authority shall examine at least the credit institution's capability to perform back-testing on the results produced with the model as regards hypothetical trading (using hypothetical changes in the portfolio's value by the end of the subsequent banking day, assuming unchanged positions.”;

**45)** Section 309 shall be supplemented with subsection (5) with the following wording:

“(5) If the Financial Supervision Authority estimates that the back-testing capability prescribed in subsection (4) is insufficient, then the Financial Supervision Authority shall be entitled to request that the credit institution take relevant measures to improve its back-testing programme.”;

**46)** Section 310 shall be worded as follows:

“**§ 310. Using internal models to calculate capital requirements for specific interest rate and equity position risks**

(1) For the purpose of calculating capital requirements for specific risk associated with traded debt and equity positions, the Financial Supervision Authority may recognise the use of a credit institution's internal model if, in addition to compliance with the conditions in the remainder of this Division, the internal model meets the following conditions:
1) it explains the historical price volatility in the portfolio;
2) it adequately captures the concentration risk both in terms of limited liquidity of positions and changes of composition of the portfolio;
3) it is robust to an adverse environment;
4) it is validated through back-testing aimed at assessing whether specific risk is being accurately captured. If back-testing is performed on the basis of relevant sub-portfolios, these must be chosen in a consistent manner;
5) it captures name-related basis risk, i.e. it is sensitive to material differences between similar but not identical positions;
6) it adequately captures event risk.

(2) The credit institution's internal model shall conservatively assess the risk arising from less liquid positions and positions with limited price transparency under realistic market scenarios. Proxies shall be appropriately conservative and may be used only where available data is insufficient or is not reflective of the true volatility of a position or portfolio.

(3) Upon use of its internal model for calculating capital requirements for specific risk, a credit institution may exclude such securitised positions or n-th-to-default credit derivative positions for which it calculates capital requirements for equity position risks and interest position risks in accordance with Subdivision 2 of this Division, except positions subject to use of internal method provided in section $310^{8}$ of this Decree.

(4) As techniques and best practices evolve, credit institutions shall avail themselves of these advances.

(5) A credit institution’s model shall not be required to include the risk of changing ratings and the default risk of the traded debt instruments, if those risks are subject to the provisions of sections $310^{1}$ to $310^{7}$.

(6) Credit institutions using internal models which are not recognised in accordance with this Division shall be subject to a separate capital charge for specific risk as calculated according to Subdivision 2 of Division 6 of this Chapter.”;

**47)** The Decree shall be supplemented with sections $310^{1}$ to $310^{8}$ with the following wording:

### “§ $310^{1}$. Calculation of capital requirements for additional risks

(1) A credit institution using internal models for covering the specific risk resulting from traded debt instrument positions upon calculating capital requirements shall establish a method allowing the calculations of capital requirements to include also the risk of changing ratings and the default risk related to trade portfolio positions, added to the considered value-at-risk in accordance with section 310.

(2) A credit institution shall prove that its approach conforms to the requirements provided in Subdivision 3 of Division 2 of this Chapter on the prerequisite that the risk level is uniform and adjusted as needed so that it reflects the effects of liquidity, exposures and risk mitigation.

(3) The method used for taking account of additional default risk and risk of changing ratings (hereinafter the method) must include all positions subject to capital requirements for specific interest rate risk, except securitised positions or n-th-to-default credit derivative positions.

(4) With approval of the Financial Supervision Authority, a credit institution may include as its additional risks all positions of equities listed on an exchange and all positions of derivative instruments based on those, if such an approach is in conformity with the credit institution’s internal policies of measuring and managing risks. The approach must be used consistently. The correlation of defaults and rating changes shall be taken into account upon calculating capital requirements for additional risks.

(5) The effect of diversification of defaults and rating changes and other factors related to market risk shall not be taken into account.

### § $310^{2}$. Parameters for calculating capital requirements for additional risks

(1) The method provided in section $310^{1}$ shall include losses from defaults and changes of internal and external ratings for a one-year period with a confidence interval of 99.9‰.

(2) The correlation forecasts must be based on analysis of objective data in a reliable framework.

(3) The method must consider in a relevant manner the concentration of issuers and the possible intra-class and inter-class concentrations occurring in adverse environment.

(4) The method must be based on the assumption that the risk level will remain uniform for the duration of one year, i.e. the trade portfolio positions or position sets in relation with which there have been occurrences of defaults or rating changes in that period are balanced at the end of the liquidity period in order to achieve the initial risk level. A credit institution may also base its

method consistently on the assumption that a position remains constant for the duration of one year.
(5) The method must consider the non-linear effect of options, structured credit derivatives and other non-linear positions regarding price changes. A credit institution shall also properly take into account the model risk which accompanies the valuation and forecasting of the price risk related to such products.
(6) The method must be based on objective and timely data.

## § $310^{3}$. Parameters for determining liquidity terms

(1) Liquidity terms shall be determined according to the time necessary for selling the position or for mitigating all relevant significant price risks in adverse market conditions, taking into account the amount of the position. Liquidity terms must conform to the actual practice and experience with both systematic and unique market tensions.
(2) A liquidity term shall be determined on the basis of conservative assumptions and it must be long enough that the sale or risk mitigation itself has no significant influence on the price of the sale or risk mitigation.
(3) A liquidity term for a position or a set of positions must be at least 3 months.
(4) Upon determining a liquidity term for a position or a set of positions, a credit institution shall take into account the provisions of its internal regulations regarding adjustments of valuations and management of expired positions.
(5) If a credit institution determines liquidity terms for position sets instead of individual positions, then the criteria for determining the position sets must consider the substantial differences in liquidity.
(6) Liquidity terms of concentrated positions must be longer, reflecting the longer times necessary for liquidating such positions. Liquidity terms of positions kept for securitisation must reflect the time necessary for acquisition, sale and securitisation of assets or mitigation of significant risk factors in adverse market conditions.

## § $310^{4}$. Risk mitigation parameters

(1) A credit institution may take into account risk mitigations if using the method provided in section $310^{1}$.
(2) Positions maybe netted if long and short positions are related to the same financial instrument. The effect of risk mitigation or diversification related to long and short positions in different securities or different instruments of the same debtor and related to long and short positions of different issuers may be taken into account only if the long and short gross positions of different instruments are modelled separately.
(3) A credit institution's risk mitigation strategy must take into account the effect of possible significant risks occurring between the final term of risk mitigation and the end of the liquidity term, and strategies for mitigation of possible significant underlying risks by products, capital structure tranche priorities, internal or external ratings, final terms, issue dates and other differences between instruments. Risk mitigation shall be taken into account only in the scope that is valid also in case of a credit event or other event occurring that affects the debtor.
(4) In case of trade portfolio positions which are mitigated with dynamic risk mitigation strategies, a credit institution may take into account the balancing of the mitigation during the liquidity term of the mitigated position on the prerequisite that the credit institution:
1) models the balancing of the mitigation consistently by the relevant set of trade portfolio positions;
2) proves that taking account of the balancing ensures a more trustworthy measuring of risks;
3) proves that the markets of the instruments used as mitigations are sufficiently liquid for taking account of such balancing even in adverse market conditions. The remaining risks after applying of dynamic risk mitigation strategies must be reflected in the capital requirements.

### § $310^{5}$. Validating the method used for calculating capital requirements for additional risks

(1) Upon independent verification of the risk measurement system provided in this Division and upon validation of internal models, a credit institution shall act as follows regarding the method provided in section $310^{1}$:
1) shall prove that the method of modelling price changes and correlations is suitable for its portfolio, considering also the type and weight of systematic risk factors;

2) shall conduct various stress tests, incl. sensitivity analysis and scenario analysis, in order to assess the qualitative and quantitative correctness of the method, particularly regarding the managing of concentrations, whereas such tests must not be limited to only past events;
3) shall conduct a relevant quantitative validation which includes the relevant internal modelling benchmarks.
(2) The method must conform to the credit institution's internal risk management methods intended for identifying, measuring and managing of trading risks.

### §$310^{6}$. Internal methods based on various parameters

(1) If a credit institution's method of calculating additional default risk and risk of rating changes does not conform to all requirements prescribed in subsections $310^{1}$ to $310^{8}$, but conforms to the credit institution's internal methods for identifying, measuring and managing of risks, then the credit institution must be able to prove that the method results in a capital requirement that is at least equal to the capital requirement resulting from a method that fully conforms to all requirements prescribed in the aforementioned sections.
(2) The Financial Supervision Authority shall verify the conformity of the method to the provisions of subsection (1) of this section at least once a year.

### § $310^{7}$. Frequency and documentation of calculating capital requirements for additional risks

(1) A credit institution shall perform the calculations for inclusion of additional risks as prescribed by its chosen method, at least once per week.
(2) The method used for accounting of additional default risk and risk of rating changes must be documented in a way that ensures that the correlation forecasts and other assumptions used in modelling would be transparent for the Financial Supervision Authority.

### § $310^{8}$. Using the method of calculating capital requirements for additional risks upon calculation of capital requirements for correlation-based trade portfolio positions

(1) With approval of the Financial Supervision Authority, a credit institution may use its internal method for calculation of capital requirements for its correlation-based trade portfolio positions and positions managed similarly in its internal risk management procedures, if all prerequisites prescribed in subsections (2) to (8) of this section are fulfilled.
(2) The internal method shall take into account all relevant price risks for one year with a confidence interval of 99.9‰, on the prerequisite that the risk level is uniform and adjusted as needed so that it reflects the effects of liquidity, exposures and risk mitigation.
(3) The capital requirement calculated according to the internal method must not be lower than 8 percent of the capital requirement that would be calculated in accordance with subsection 283 ($2^{1}$).
(4) The internal method stated in subsection (1) of this section shall take into account the following risks, among others:
1) the cumulative risk resulting from many defaults, incl. consecutive defaults of products divided into series;
2) the risk of changes of credit risk margin, incl. gamma and cross-gamma effects;
3) the volatility of estimated correlations, incl. interaction between margins and correlations;
4) the underlying risk, incl. both the underlying risk between the index margin and the margins of individual components of the index, and the underlying risk between the estimated correlation of the index and the individual portfolios;
5) the volatility of the restoration rate, related to the effect of the restoration rate on prices of series;
6) the risk of failure of risk mitigation and the potential expenses of balancing such risk mitigations, in the scope that the profits resulting from the dynamic risk mitigation are included in the overall risk parameter.
(5) A credit institution must have sufficient market data to ensure full consideration of significant risks of risk positions in its internal calculation method in accordance with the norms prescribed in this section, and the credit institution must prove by back-testing or other relevant means that its risk parameters are able to properly explain the earlier price changes of such products, and that the credit institution is able to differentiate between positions regarding which it has received a permission in accordance with this section to add them into the capital

requirement calculation, and the positions regarding which the credit institution lacks such permission.
(6) In case of portfolios included in the scope of application of this section, a credit institution shall regularly use a specific predetermined set of stress scenarios. Such stress scenarios must be used for analysing the effect of stresses on default rates and restoration rates and on correlations of revenues and expenses of a trading unit. The credit institution shall prepare such stress scenarios at least once per week and shall submit to the Financial Supervision Authority at least quarterly reports on the results, incl. on comparisons with the credit institution's capital requirement calculated in accordance with the provisions of this section.
(7) A credit institution shall inform the Financial Supervision Authority in due time about all cases where stress tests indicate a significant shortage of capital requirements. On the basis of the results of those stress tests, the Financial Supervision Authority shall consider the establishing of an additional capital requirement for the correlation-based trade portfolio in accordance with subsection 104 (2) of the Credit Institutions Act.
(8) A credit institution shall calculate a capital requirement including all price risks at least once per week.";

**48)** Subsection 311 (1) shall be worded as follows:

"(1) For the purposes of clauses 313 (5) 1) and 2) of this Decree, the results of the credit institution's own calculation shall be scaled up by multiplication factors $m_c$ and $m_s$ which shall be at least 3.";

**49)** In subsection 311 (2), the text preceding the table shall be worded as follows:

"(2) The multiplication factor shall be increased by a plus-factor of between 0 and 1 in accordance with Table 1, depending on the number of overshootings for the most recent 250 banking days as evidenced by the credit institution's back-testing. Overshootings shall be calculated consistently on the basis of back-testing either on actual or on hypothetical changes in the portfolio's value. An overshooting is a one-day change in the portfolio's value that exceeds the related one-day value-at-risk measure generated by the credit institution's model. For the purpose of determining the plus-factor the number of overshootings shall be assessed at least quarterly and it shall be equal to the highest number of overshootings considering the hypothetical and actual changes in the portfolio's value.";

**50)** Section 312 shall be repealed;

**51)** Sections 313 and 314 shall be worded as follows:

### "§ 313. Minimum requirements on calculating risk measures (value-at-risk)

(1) The calculation of the value-at-risk measure shall be subject to the following minimum requirements:
1) at least daily calculation of the value-at-risk measure;
2) a $99^{th}$ percentile, one-tailed confidence interval;
3) a 10-day equivalent holding period;
4) an effective historical observation period of at least one year except where a shorter observation period is justified by a significant upsurge in price volatility;
5) monthly data set updates.

(2) In addition to the provisions of subsection (1) of this section, a credit institution shall calculate a value-at-risk for adverse market conditions on the basis of the value-at-risk of the existing portfolio calculated with a 10-day equivalent holding period and a 99th percentile, one-tailed confidence interval and using input data which originate from a 12-month period of continual financial difficulties significant for the credit institution's portfolio.

(3) Approval from the Financial Supervision Authority must be obtained for the set of data stated in subsection (2). A credit institution shall review the set of data at least once per year.

(4) A credit institution shall calculate the value-at-risk for adverse market conditions at least once per week.

(5) A credit institution shall daily fulfil a capital requirement which equals the sum total of the following:

1) the credit institution's value-at-risk of the previous day calculated in accordance with subsection (1) of this section ($VaR_{t-1}$) or the credit institution's average value-at-risk of the previous 60 days calculated in accordance with subsection (1) of this section ($VaR_{avg}$), multiplied by the multiplication factor ($m_c$), whichever is higher;

2) the credit institution's latest value-at-risk for adverse market conditions calculated in accordance with subsection (2) of this section ($sVaR_{t-1}$), or the credit institution's average value-at-risk for adverse market conditions calculated in accordance with subsection (2) of this section at the frequency prescribed in subsection (4) of this section ($sVaR_{avg}$), multiplied by the multiplication factor ($m_s$), whichever is higher.

(6) If a credit institution uses an internal model for calculating the capital requirement for specific risk, then its capital requirement shall be equal to the sum total of the following:

1) the capital requirement for the interest rate risk and equity position risk of the securitised positions and n-th-to-default credit derivatives in the credit institution's trade portfolio, except the capital requirement calculated in accordance with subsections 310[8] (2) to (8);

2) the latest amount of the credit institution's additional default risk and risk of ratings change measured in accordance with subsections 310[1] (1) and (2) of this Decree or the average of such amounts for the past 12 weeks, whichever is higher; and, if relevant, the latest amount of the credit institution's all price risks measured in accordance with subsections 310[8] (2) to (8) of this Decree or the average of such amounts for the past 12 weeks, whichever is higher.

(7) A credit institution shall also conduct reverse stress tests.

## § 314. General requirements for calculation of value-at-risk

(1) The risk-measurement model shall capture a sufficient number of risk factors, depending on the level of activity of the credit institution in the respective markets.
(2) If a risk factor is included in a credit institution's assessment model but not in its risk measurement model, then such omission from the risk measurement model must be explained to the Financial Supervision Authority.
(3) The risk measurement model must take into account the non-linearity of options and other instruments and also the correlation risk and basis risk.
(4) If proxies are used as risk factors, then such proxies must conform to the behaviour of the actual positions.
(5) In addition to the provisions of subsections (1) to (4), the following conditions must be met for various risk types:
1) the risk-measurement model shall accurately capture all the material price risks of options or option-like positions and that any other risks not captured by the model are covered adequately by own funds;
2) the risk-measurement system shall incorporate a set of risk factors corresponding to the interest rates in each currency in which the credit institution has interest rate sensitive on or off-balance sheet positions. The credit institution shall model the yield curves using one of the generally accepted approaches. For material exposures to interest-rate risk in the major currencies and markets, the yield curve shall be divided into a minimum of six maturity

segments, to capture the variations of volatility of rates along the yield curve. The risk-measurement system shall also capture the risk of less than perfectly correlated movements between different yield curves;
3) the risk-measurement system shall incorporate risk factors corresponding to gold and to the individual foreign currencies in which the credit institution's positions are denominated. For CIUs the actual foreign-exchange positions of the CIU shall be taken into account in calculating the net open positions of currencies. Credit institutions may rely on third party reporting of the foreign-exchange positions of the CIU, where the correctness of such reports is adequately ensured. If a credit institution is not aware of the foreign-exchange positions of a CIU, such positions shall be treated in accordance with section 257;
4) the risk-measurement system shall use a separate risk factor at least for each of the equity markets in which the credit institution holds significant positions;
5) the risk-measurement system shall use a separate risk factor at least for each commodity in which the credit institution holds significant positions. The risk-measurement system shall also capture the risk of less than perfectly correlated movements between similar, but not identical, commodities and the exposure to changes in forward prices arising from maturity mismatches. The risk-measurement system shall also take account of market characteristics, notably delivery dates and the scope provided to traders to close out positions.”;

**52)** Chapter 3 of this Decree shall be supplemented with Division 8 with the following wording:

“**Division 8**

**Capital requirements for settlement/delivery risk and counterparty credit risk on free deliveries**

**§ 329[1]. Capital requirement for settlement/delivery risk**

(1) In the case of transactions where debt instruments, equities, foreign currencies or commodities are not settled by the prescribed due delivery dates and where this results in a price change that could involve a loss for the credit institution, the credit institution shall calculate the capital requirement for a settlement/delivery risk.

(2) Repurchase and reverse repurchase transactions, and securities or commodities lending and borrowing transactions shall not be taken into account in the calculation of the capital requirement.

(3) To calculate the capital requirement, the difference between the agreed settlement price for the debt instrument, equity, foreign currency or commodity in question and its current market value, if the difference could involve a loss for the credit institution, shall be multiplied by the following capital charge rates:

| Number of banking days after due settlement date | Capital charge rate (%) |
|---|---|
| 5 to 15 | 8 |
| 16 to 30 | 50 |
| 31 to 45 | 75 |
| 46 or more | 100 |

**§ 329[2]. Capital requirement for counterparty credit risk on free deliveries**

(1) A credit institution shall treat the following transactions as free deliveries:
1) it has paid for securities or commodities before receiving them or it has delivered securities or commodities before receiving payment for them;
2) in the case of cross-border transactions, one day or more has elapsed since it made that payment or delivered the securities or commodities.

(2) Where securities have not been delivered or payment has not been received when due, the positions arising from the transaction shall be treated as exposures for which capital requirements shall be calculated pursuant to the procedure established in Subdivision 1 or Subdivision 2 of Division 2 of this Chapter, depending on the method the credit institution employs for calculating the capital requirement for credit risk, taking into account the provisions of subsection (4) and (5) of this section. The calculation of the capital requirement shall be commenced on the first day following the due date of the first contractual payment or delivery leg and shall be applied until the fourth day following the due date of the second payment or delivery leg.

(3) Starting from the fifth day following the due date of the second payment or delivery leg, the value of the transaction (plus any increase in the value of non-delivered securities) shall be deducted from the credit institution's own funds.

(4) Credit institutions that apply the Internal Ratings Based Approach to calculate capital requirements for credit risk may assign PDs to counterparties, for which they have no other non-trade portfolio exposure, on the basis of the counterparty's external assessment and apply the expected loss rates referred to in section 74.

(5) Irrespective of the provisions of subsection (4) of this section, credit institutions using the Internal Ratings Based Approach for calculating capital requirements against credit risk may apply the Standardised Approach set out in Subdivision 1 of Division 2 of this Chapter or a risk weight of 100% to free delivery exposures. A selected treatment shall be applied to all free delivery exposures.

**§ 329$^3$. Waiver of capital requirements for settlement/delivery risk and counterparty credit risk for free deliveries**

In cases of a system-wide failure of a settlement or clearing system, compliance with the capital requirements established in sections 329$^1$ and 329$^2$ shall be waived until the situation is rectified. In this case, the failure of a counterparty to settle a trade shall not be deemed a default for the purposes of credit risk.”;
**53)** Subsection 331 (2) shall be worded as follows:

“(2) claims and contingent claims that would be assigned a 0% risk weight under the Standardised Approach set out in Sub-subdivision 3 of Subdivision 1 of Division 2 of Chapter 3 (except cash and cash equivalents and gold bullions).”.

**§ 2.** The Decree shall be effective from 31 December 2011.

Andres Lipstok
Governor