



Annex 2: Supervisory Benchmarks for the Setting of Pillar 2 Own Funds Requirements for Market Risk

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1. Introduction

This document is an Annex to *Common criteria and methodologies for SREP (Almenn viðmið og aðferðafræði vegna könnunar- og matsferlis hjá fjármálafyrirtækjum)* which describes the criteria, procedures and methodology applied in the Financial Supervisory Authority of the Central Bank of Iceland's (FSA) assessment of institutions' overall risk level and need for capital, i.e. SREP. The methodology of the FSA is based on the European Banking Authority's [Guidelines on common procedures and methodologies for SREP](#).

Building on Chapter 2.4.3 in the main text, this Annex further elaborates on specific supervisory benchmark calculations used by the FSA to inform the setting of Pillar 2 capital for market risk. Additional own funds requirements are determined on a risk-by-risk basis, using supervisory judgement, supported by the ICAAP calculations of institutions, the outcome of supervisory benchmarks and other relevant inputs, including those arising from dialogue with the institutions.

Supervisory benchmarks and *benchmark calculations* refer to risk-specific quantitative tools developed by the FSA to provide an estimation of additional own funds needed to cover risks or elements of risk not covered by [Regulation \(EU\) No 575/2013](#), cf. [Regulation No 233/2017](#), or to further support the determination of risk-by-risk additional own funds requirements where ICAAP calculations for those material risks, or elements of such risk, are considered insufficient or are unavailable. Given the variety of different business models, the outcome of the supervisory benchmarks may not be appropriate in every instance for every institution. The benchmarks calculations have been constructed adequately to avoid double counting.

2. Market risk not covered by Pillar 1

The EBA's Guidelines on common procedure and methodologies for SREP require supervisory authorities to evaluate market risk in the trading book, as well as interest rate risk and equity risk in the banking book. Under Pillar 1, capital charges are set for equity and interest rate risk in the trading book and for exchange rate risk, commodity risk and CVA risk in the overall portfolio, see Table 1.

Table 1: Risk factors under Pillar 1 and Pillar 2

Books	Pillar 1	Pillar 2
Trading	<ul style="list-style-type: none"> • General interest rate risk • Specific interest rate risk • General equity risk • Specific equity risk 	<ul style="list-style-type: none"> • General interest rate risk • General equity risk
Banking		<ul style="list-style-type: none"> • General equity risk • General interest rate risk (IRRBB)
Overall	<ul style="list-style-type: none"> • Exchange rate risk • Commodity risk • CVA risk 	<ul style="list-style-type: none"> • Exchange rate risk • Indexation risk • Risk management and controls

In the case of equities and bonds in the banking book, no capital charges are set under Pillar 1 for market risk, but these portfolios are included in the Pillar 1 calculation of capital for credit risk. Under Pillar 1,

equities are included in the calculation with a risk weight of a minimum of 100%, whereas bonds are included in the calculation with a risk weight of 0 to 100%, depending on the issuer's rating score.

The FSA assesses the suitability of the Pillar 1 capital requirements for general equity risk in the banking book and if required, calculates additional charges under Pillar 2. As no capital requirements are set for interest rate risk in the banking book (IRRBB) under Pillar 1, the FSA assesses the capital requirements under Pillar 2. Table 1 shows which risks are covered under Pillar 1 and which risks the FSA includes in its Pillar 2 assessment.

Where Pillar 1 fails to capture risk in the trading book adequately (e.g. due to complex products, illiquid positions etc.), the FSA seeks to address this issue in Pillar 2. This also entails making a qualitative assessment of concentration and market liquidity in both the trading book and the banking book, and the bank's management and control of market risk.

For most risk categories there is more than one viable method for assessing the own funds requirement. Each method has different sensitivities to the various underlying risk factors and will, therefore, result in different estimates of risk and own funds required to mitigate the risk under consideration. The FSA will therefore in most cases use more than one method to evaluate the appropriate own fund requirement. In addition, qualitative assessments are made of risk management and control.

The SREP is primarily based on data already reported under the EBA reporting framework (COREP and FINREP), the Icelandic FSA reporting framework (IRRBB report) and the institution's own reports (ICAAP, Internal-Risk, Pillar 3 and financial statements). Further information is acquired during the SREP, as needed. Additionally, the commercial banks are required to report specific information on risk limits, daily profit and loss (P&L) and the various portfolios' positions and exposures over the past year, at year-end.

For discussions on risk management and control and intra-risk diversification refer to Chapters 2.4.2 and 3.2.1, respectively, in *Common criteria and methodologies for SREP*.

3. The basis for calculation: actual exposure vs limits and historical P&L

Pillar 1 requirements are based on actual positions. As the positions, particularly those in the trading book, are likely to be subject to frequent fluctuation, the FSA also considers the daily positions over the last 12 months to determine whether the reporting date positions reflect the risk inherent in each institution's business activities. In order to increase the risk sensitivity of the Pillar 2 assessment, some methods ignore the actual positions and focus solely on the volatility of each portfolio's historical P&L.

Additionally, institutions are required to have established risk limits for the majority of risk factors. The limits reflect the level of risk acceptable to the board of directors, and for those institutions that adjust their limits infrequently, give insight into how the positions and the risk levels might change in the short term. However, the FSA does not use risk limits directly as a basis for calculation of Pillar 2 requirement.

In the banking book, institutions make less use of risk limits, except as regards interest rate risk in the banking book (IRRBB). Moreover, adjusting exposures in the banking book will generally take longer than in the trading book, where substantial changes are likely to happen on an intraday basis. As a result, there is less reason for the FSA to monitor the risk limits of the banking book for risk evaluation purposes, except in the case of interest rate risk.

4. VaR and Stressed VaR

Many of the methods used by the FSA utilize VaR and Stressed VaR calculations. The methods are based on the VaR standards presented in Regulation (EU) No 575/2013, cf. Regulation No 233/2017, as well as the EBA Guidelines on [Stressed Value at Risk](#). These methods are intended as a minimum standard for

institutions using the Internal Model Approach (IMA) for calculating the capital requirement for market risk in the trading book. However, the FSA uses them as a supervisory benchmark for risk assessment. The VaR calculations are based either on historical daily P&L figures or on historical changes to the underlying risk factors.

The former approach assumes that the volatility of the historical daily profit and loss is a good indicator of potential future losses for the institution. This approach is often used when good historical information or even decent risk proxies are unavailable. The second approach assumes that the volatility of the underlying risk factors is a good indication of their future behaviour and therefore the risk of holding the current positions. In some cases, it is prudent to put more weight on the more recent data, especially if volatility is on the rise.

The observation period for the VaR calculation is the previous 250 business days. For the Stressed VaR, even though the observation period is 250 days, the period used must include a significant stress event relevant to the portfolio under assessment. There are a number of ways to identify a suitable period, for example, the period with the highest risk factor volatility or the 12-month period with the highest VaR result. For many portfolios, a 12-month period relating to significant losses in the 2007/2008 period would adequately reflect a period of such stress. In addition, other periods relevant to the current portfolio should also be considered by institutions to determine a historical period that would provide a conservative capital outcome.

5. Assessment of the trading book

The supervisory benchmarks for the setting of Pillar 2 capital for market risk are based on a calculation of the estimated potential for loss due to adverse changes in critical market risk factors. The interest rate and equity risk in the trading book is estimated by using VaR models. Commodity risk has thus far not been considered a part of the institutions' overall market risk.

Compared to equity and bond markets in larger countries, the Icelandic markets are small, illiquid and relatively volatile. It is, therefore, the view of the FSA that relying only on risk weights and nominal amounts in the trading portfolios is neither prudent nor risk-sensitive and does not reward institutions that manage their portfolios in a risk-sensitive manner. This also means that during times of extreme volatility, the resulting capital requirement can become greater than the nominal value of the bond or equity exposures at the reporting date. This is appropriate, as the purpose of the capital requirement is to meet potential losses from day to day business activities of the trading portfolio, not only the position at the reporting date.

5.1 General interest rate risk

To assess the suitability of Pillar 1 capital requirement for general interest rate risk in accordance with Articles 339-340 of Regulation (EU) No 575/2013, cf. Articles 56 and 92 of Regulation No 233/2017, the FSA uses historical VaR and Stressed VaR models in accordance with Articles 362-369 of Regulation (EU) No 575/2013, cf. Articles 56 and 92 of Regulation No 233/2017 and EBA Guidelines on Stressed Value-At-Risk, which applies to institutions using the Internal Model Approach (IMA) when calculating regulatory capital requirements. The supervisory assessment is based on clean (no cost of carry) historical P&L values for the portfolio. No weighting of historical data is applied. For the stressed VaR calculation, the historical P&L values are scaled for those that are older than the most recent 250 data points, to reflect changes in the size of the portfolio over the observation period. The scaling is done by comparing the portfolio size at each data point to the average portfolio size over the most recent 250 data points. The supervisory benchmark for general interest rate risk in the trading book is calculated as the sum of:

- 99% VaR on P&L scaled to 10-day holding period, using the last 250 days as a historical observation period. The higher of (a) the most recent VaR result and (b) an average of the VaR results calculated over the last 60 business days multiplied by a back-testing multiplication factor of 3.
- 99% Stressed VaR on P&L scaled to 10-day holding period using the most adverse 250-day period observed during the last five years. The higher of (a) the most recent SVaR result and (b) an average of the SVaR results calculated over the last 60 business days multiplied by a back-testing multiplication factor of 3.

The general interest rate risk capital requirement under Pillar 1 is deducted from the result.

5.2 General equity risk

The Pillar 1 capital requirement for equity risk in the trading book is a 100% risk weight for general risk and 100% risk weight for specific risk in accordance with Articles 342-343 of Regulation (EU) No 575/2013, cf. Articles 56 and 92 of Regulation No 233/2017. To assess the suitability of Pillar 1 capital requirement for equity risk, the FSA uses three different methods.

First, the *Risk Weight Method*, which is in accordance with Article 155 of Regulation (EU) No 575/2013 (Simple risk weight approach), cf. Article 92 of Regulation No 233/2017. This is an IRB method for calculating capital requirements for equity exposures in the banking book. In general, the exposures in the trading book should be more liquid and therefore not as risky as the exposures in the banking book. However, because of the permeability of the boundary between trading and banking books and the illiquidity of the Icelandic equity market, the FSA considers the 'Simple risk weight approach' appropriate. This supervisory benchmark for equity risk in the trading book is calculated as the sum of the following:

- 370% risk weight for unlisted equities in the trading book.
- 290% risk weight for listed equities in the trading book.
- 190% risk weight for private equity exposures in sufficiently diversified portfolios.
- Look through approach for fund exposures in the trading book (290% or 370% risk weights) and 370% risk weight if such an approach is not possible.

The general and specific equity risk capital requirement under Pillar 1 is deducted. The second method uses historical VaR and Stressed VaR models in accordance with Articles 362-369 of Regulation (EU) No 575/2013, cf. Articles 56 and 92 of Regulation No 233/2017 and EBA Guidelines on Stressed Value-At-Risk, which applies to institutions using the Internal Model Approach (IMA) when calculating regulatory capital requirements. The supervisory assessment uses clean (excluding cost of carry) historical P&L values for the portfolio. No weighting of historical data is applied. For the stressed VaR calculation, the historical P&L values are scaled for those that are older than the most recent 250 data points, to reflect changes in the size of the portfolio over the observation period. The scaling is done by comparing the portfolio size at each data point to the average portfolio size over the most recent 250 data points. This supervisory benchmark for general equity risk in the trading book is the sum of:

- 99% VaR on P&L scaled to 10-day holding period, using the last 250 days as a historical observation period. The higher of (a) the most recent VaR result and (b) an average of the VaR results calculated over the last 60 business days multiplied by a back-testing multiplication factor of 3.
- 99% Stressed VaR on P&L scaled to 10-day holding period using the most adverse 250-day period observed during the last five years. The higher of (a) the most recent SVaR result and (b) an average of the SVaR results calculated over the last 60 business days multiplied by a back-testing multiplication factor of 3.

The general equity risk capital requirement under Pillar 1 is deducted from the result. The third method uses historical VaR and Stressed VaR models in accordance with Articles 362-369 of Regulation (EU) No 575/2013, cf. Articles 56 and 92 of Regulation No 233/2017 and EBA Guidelines on Stressed Value-At-Risk, which applies to institutions using the Internal Model Approach (IMA) when calculating regulatory capital requirements. The supervisory assessment uses historical log returns of the instruments in the portfolio to calculate VaR using a variance-covariance matrix. No weighting of historical data is applied. Due to lack of historical data, the FSA prescribes the use of the following proxies: REGINN for HEIMA, VIS for ARION and VIS for KVIKA.

To account for the SVaR component, the FSA has decided to scale up the VaR with a SVaR multiplier. The minimum value of the multiplier is 2.0, which would indicate that the current VaR period is suitable for SVaR assessment. As the VaR period becomes less stressful, FSA will increase the SVaR multiplier. The goal is for an identical portfolio to have a constant SVaR component over time and a VaR component that reflects the current level of market volatility. The multiplier, along with the prescribed proxies, is subject to an annual review. As a reference, in the 2018 EBA benchmark exercise, the average ratio between VaR and SVaR was 3.0 (multiplier = 4) and 2.4 (multiplier = 3.4) last year. The current SVaR multiplier of 2.5 reflects the current level of market volatility. The calculation for this supervisory benchmark for general equity risk in the trading book is as follows:

- 99% VaR on the logarithmic change in historical prices, scaled to 10-day holding period, using the last 250 days as a historical observation period. The higher of a) the most recent VaR result and b) an average of the VaR results calculated over the last 60 business days. Both (a) and (b) are multiplied by a back-testing multiplication factor of 3 and a stressed VaR multiplier of 2.5.

The general equity risk capital requirement under Pillar 1 is deducted from the result.

5.3 Market making discount

Banks play a key role in maintaining market liquidity for equities, in which they are market makers. To reflect the importance of this role, the FSA gives a specific discount to the capital requirements for benchmarks in 5.2.

The formula for the discount percentage is as follows:

$$Discount\% = \left(\frac{\sum_{i=1}^n (\min(p_i, t_i))}{P} \right) * 50\%$$

Where:

- P = The average value of the bank's portfolio over the last 60 business days.
- i = Each equity that has been in Portfolio P at one point or another over the last 60 business days and for which the bank has an active market-making contract.
- p_i = Average daily position (market value) for equity i in portfolio P over the last 60 business days.
- t_i = average daily market turnover of equity i over the last 60 business days.

As the formula states, the discount is only applied to positions, for which the bank has an active market-making contract. Furthermore, only the part of the position that is at or under the average daily market turnover gets a discount.

The Pillar 1 capital requirement acts a floor, i.e. the discount can never lead to a negative Pillar 2 requirement. The formula for the Pillar 2 requirement after discount is as follows:

$$Pillar\ 2\ after\ discount = Max(0, (Pillar\ 1 + Pillar\ 2) * (1 - Discount\%) - Pillar\ 1)$$

6. Assessment of the Banking book

The supervisory benchmarks for the setting of Pillar 2 capital for market risk are based on a calculation of the estimated potential for loss due to negative changes in the most important market risk factors. In the SREP, the loss potential related to equity, interest rate and property risk in the banking book is measured by stressing the institutions' portfolio holdings.

6.1 General interest rate risk (IRRBB)

General interest rate risk in the banking book is not assessed under Pillar 1.

The FSA has under development new IRRBB benchmarks, based on updated EBA guidelines on the management of interest rate risk arising from non-trading activities ([EBA/GL/2018/02](#)).

The Economic value of equity (EVE) benchmark measures the changes in the net present value of interest rate sensitive instruments over their remaining life resulting from specific interest rate movements, where equity has been excluded from the cash flow, before and after the interest rate movement. The size of the specific interest rate shocks will be calculated in accordance with Annex III of the guidelines and published along with the finalized version of the benchmark.

The new benchmark differs in that it is cash-flow rather than modified-duration based, behaviour modelling is allowed, four new shock scenarios have been added and positions in non-material currencies are excluded.

A new earnings-based benchmark that measures the change of the net interest income over a three year horizon, resulting from the specific sudden interest rate movements previously mentioned will also be added.

A more detailed description of the benchmarks will be published along with a new reporting template, once they have been finalized later in 2020. Until that time, the previous EVE benchmark listed below will apply.

EBA's Guidelines on interest rate risk in the banking book¹ require interest rate risk to be measured against a sudden parallel +/- 200 basis point shift of the yield curve (applying a 0% floor). This is a minimum requirement. If the +/- 200 basis point shift is lower than the actual level of change in interest rates, calculated using the 1st and 99th percentile of observed one-day interest rate changes over a five-year period scaled up to a 240-day year, the higher level of shock arising from the latter calculation should be applied.

Conforming to the Guidelines' prescription, the FSA has calculated the appropriate shifts for the ISK assets and liabilities to be +/-400 basis points for non-indexed ISK and +/- 240 basis points for indexed ISK. For assets and liabilities in other currencies, +/- 200 basis point shift is deemed adequate.

The FSA method for assessment is based on sudden, unexpected and permanent parallel yield curve shifts using +/- 400 basis points for non-indexed ISK, +/- 240 basis points for indexed ISK and +/- 200 basis points for other currencies. The assets and liabilities are discounted using risk-free yield curves and a modified duration approach. Static² model assumptions, no convexity, no optionality and 0% interest rate floor.³ Non-performing loans and interest rate insensitive impaired loans can be excluded. No fair-value vs book-value mitigation is allowed.

¹ See item 24(a) in Chapter 3 of [Guidelines on the management of interest rate risk arising from non-trading activities \(EBA/GL/2015/08\)](#).

² Guidelines on the management of interest rate risk arising from non-trading activities, item (c) on page 15.

³ For the curve shifts, not individual financial instruments.

6.2 Equity risk

The Pillar 1 capital requirement for equity risk in the banking book is calculated at 100-1250% risk weight in accordance with Article 133 of Regulation (EU) No 575/2013, cf. Articles 32 and 92 of Regulation No 233/2017. To assess the suitability of the Pillar 1 capital requirement for equity risk, the FSA uses the 'Simple risk weight approach', in accordance with Article 155 of Regulation (EU) No 575/2013, cf. Article 92 of Regulation No 233/2017. This is an IRB method for calculating capital requirements for equity exposures in the banking book. The supervisory benchmark for equity risk in the banking book is calculated as the sum of the following:

- 370% risk weight for unlisted equities in the banking book.
- 290% risk weight for listed equities in the banking book.
- Look-through approach for fund exposures in the banking book (290% or 370% risk weights) and 370% risk weight if such an approach is not possible.

The capital requirement for equity risk in the banking book, under Pillar 1 is deducted from the result.

7. Assessment of risks originating in both books

The assessment of the Pillar 2 requirement for market risk is based on a calculation of the estimated potential for loss due to adverse changes in critical market risk factors. In the SREP, the loss potential related to exchange rate risk in both books is measured using a VaR model.

7.1 Exchange rate risk

Exchange rate risk in Pillar 1 is based on the higher of, respectively, the sum of short and the sum of long positions across all currencies in accordance with Articles 351-354 of Regulation (EU) No 575/2013, cf. Articles 56 and 92 of Regulation No 233/2017.

To assess the suitability of Pillar 1 capital requirement for an institution's exchange rate risk, the FSA uses a 'Covariance Matrix VaR' benchmark method, unlike the simple historical VaR used for positions in the trading book. The benchmark uses each institutions' net position in each currency (other than ISK) at the reporting date. The confidence level is 99%. The holding period is the most adverse 250 days observed over a specific five-year period, taking into account each institutions FX positions. The choice of a five-year period can prove problematic as for the last nine years the Icelandic krona has been subject to currency-controls, reducing the volatility of the currency. Furthermore, the period from 2007 to the end of 2008 are not suitable due to extreme circumstances. Accordingly, the five-year period used in the benchmark is from the start of 2002 to the end of 2006.

In order to validate whether or not the FX positions at the reporting date are 'normal', the VaR result for the reporting date is compared with the average result using the FX positions from the last 60 business days before the reporting date.

The exchange rate risk capital requirement under Pillar 1 is deducted from the result.

7.2 Indexation risk

Indexation risk is the risk of loss due to unexpected changes in inflation, which derive from an imbalance in indexed assets and liabilities.

Indexation risk is not addressed under Pillar 1 but it is similar to FX risk. Inflation is subject to seasonality and its historical distribution is both skewed and has excess kurtosis. In order to take account of those

characteristics, the historical data set⁴ is adjusted for seasonality and MVaR⁵ is used to calculate a 1-year 99% VaR for negative indexation balance:

$$MVaR = \left[z + \frac{S}{6}(z^2 - 1) + \frac{K}{24}(z^3 - 3z) - \frac{S^2}{36}(2z^3 - 5z) \right] \sigma$$

z: 2.33
 K: Excess kurtosis
 S: Skewness

For MVaR calculation of positive, a negative data set (multiplied by -1) is used.

Capital requirement, as a ratio of indexation balance amount:

Positive balance: 3.53%
 Negative balance: 6.46%

Due to historical correlation, institutions are permitted to model indexation risk and IRRBB risk jointly. However, since the correlation fluctuates and, in some circumstances, breaks down, a floor of 75% has been set to limit the diversification benefits enjoyed by the institutions.

⁴ Monthly inflation from January 2001 till October 2017.

⁵ L. Cavenaile & T. Lejeune (2012). A Note on the Use of Modified Value-at-Risk, *Journal of Alternative Investments*.