Q&A

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977
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Guidelines on treatment of market and counterparty risk exposures in the standard formula
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Question

The second guideline on the treatment of market risk specifies how the influence of call option on duration should be taken into account, however the guideline is not clear on what duration should be used in the credit spread risk module.

The modified duration is calculated assuming that the bond will not be called, while the effective duration is calculated assuming that in certain scenario's the bond will be called.

From this point of view, the modified duration is closer to the guideline: "undertakings should take into account that they may NOT be called by the borrower in the event that its creditworthiness deteriorates, credit spreads widen or interest rates increase".

Our understanding is that the modified duration should be used, and not the effective duration.
Switching from modified duration to effective duration will lead to a material impact on the SCR and therefore we would need advice from EIOPA on the correct interpretation for "duration".

EIOPA answer

According to Article 176(2) Delegated Regulation the risk factor stress i shall depend on the modified duration. In the Appendix "Duration of cash flows" in the (https://eiopa.europa.eu/Publications/Guidelines/Final_Report_Market_Risk...) EIOPA considers that the duration calculation also takes account of stochastic

cash flows, as is the case for bonds and loans with options to repay early or to extend the maturity.

The modified duration used for the calculation of the spread risk charge should take into account the optionality in the bond or loan; this includes the effect of the change in the likelihood of exercising the option included in the bond or loan resulting from a spread increase.