FÉDÉRATION BANCAIRE FRANÇAISE

2020.01.17

FBF RESPONSE TO EUROPEAN BANKING AUTHORITY CONSULTATION PAPER ON DRAFT GUIDELINES ON THE TREATMENT OF STRUCTURAL FX UNDER 352(2) OF THE CRR

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, i.e. more than 340 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 340,000 people in France and around the world, and serve 48 million customers.

The FBF welcomes the opportunity to comment on the European Banking Authority consultation[1] EBA/CP/2019/11 on draft Guidelines on the treatment of structural FX under 352(2) of the CRR.

French banks urge the EBA review its proposed Guidelines as they are well beyond applicable level 1 CRR, overly complex and prescriptive compared to Basel guidance and applicable regulatory and supervisory standards in other jurisdictions. The envisaged requirements for exempting transactions taken in order to hedge the capital ratios of the bank are too prescriptive and difficult to operationalize. French banks deem that it would be difficult to implement the proposed standards for actual management of banks (e.g. limitation to significant currencies, too narrow volatility tolerance, articulation between solo and consolidated level, transition period from the current framework to the target framework), or for supervisors to cope with significant number of exemption requests and reviews. Those requirements could have many detrimental consequences, most of which we believe as unintended.

Credit institutions need flexibility in their management framework to operationally manage the various forms of structural FX positions, once they have defined and documented the way they manage the position.

We believe that the requirements should be substituted with Guidelines for the articulation of a bank Policy for the management of non-trading foreign exchange risk including the criteria for evidencing the risk mitigating against adverse effect of the exchange rate on the ratio it elects to mitigate.

Hence, the revised Guidelines should be based on pre-approved internal *Policy* that describes:

- the scope of application. It is defined either for an individual entity, or for a consolidated / sub-consolidated group of entities.
- the elected prudential ratio whose impact from foreign exchange rate is mitigated. For each defined scope, there should be one designated prudential ratio among Common Equity Tier One, Tier One, Total Capital as well as other prudential ratios such as TLAC, MREL, Leverage Ratio. Below, the chosen ratio is named *Elected Ratio*.

  Note that within the same Group, an entity and a sub-group might elect different prudential ratios as the most binding ratio might be different at different levels of the Group:

[1] https://eba.europa.eu/eba-launches-consultation-on-guidelines-on-the-application-of-the-structural-fx-provision

- the description of the Net Open Position (NOP), for which a bank might elect to consider that investment in subsidiaries or capital allocation to branches have been deliberately taken for the purpose of mitigating the sensitivity of the elected ratio to foreign exchange rate sensitivity.
- the currency (‘c’), or group thereof, whose foreign exchange rate is being mitigated.
- the metric used to evidence that there is a *reduction of adverse effect* of the foreign exchange rate.
- the governance for foreign exchange risk management:
- the prudential treatment of foreign exchange position when adhering to the Policy.

Considering the potential ramifications in terms of additional capital requirements, a Quantitative Impact Study (QIS) should be implemented to inform the potential consequences of impact analysis that is a requirement for implementing any new Guidelines.

As the envisaged timeline for the implementation of the proposed *Guidelines* is impractical for both banks and supervisors, notably for the created bottleneck in instructing the exemption requests, there should be at least a two-year transition period between the final publication of the *Guidelines* and its implementation.

Finally, the currently applicable framework should be maintained within the transition period.

I. Hedging of a ratio

Question 1: Would you consider beneficial to limit the S-FX provision to hedge the CET1 ratio aiming at creating a level playing field in the EU? Please provide a rationale.

FBF answer: EU institutions should be free to hedge the sensitivity of any one of their regulatory ratios (Common Equity Tier 1, Tier 1, total capital ratio, or Total Loss Absorbing Capital Ratio / Minimum Requirement on own funds and Eligible Ratio) once they document and manage their choice in their risk management policies.

As banks and their subsidiaries are subject to several ratios that are different, the ratio which is binding at group level is not necessary the one binding at individual level. And as a consequence, it is not possible to perfectly offset the sensitivities of all ratios to changes to all foreign exchange rates. There would be no conceptual grounds to require that the very same ratio is the same across a group of entities and at individual and consolidated levels. Hence, banks should be able to elect different ratios for different scope (individual, consolidated, sub-consolidated…) and different entities within the very same group.

Limiting the S-FX provision to hedge only the CET1 ratio, even if this might correspond to what are doing most institutions in, would represent undue supervisory provisions overriding the level 1 CRR text.

Question 2: Which of the three ratios is your institution hedging?

FBF answer: Please see our response to Question 1.

II. Currencies to which the hedging relates

Question 3: For how many and for which currencies do you currently have the permission to exclude some positions from the corresponding net open position? For how many and for which currencies do you plan to request the permission following the adoption of these guidelines?

FBF answer: The limitations on the number of currencies has no legal or prudential basis and could prevent the prudential framework from recognizing actual structural FX risk management and would penalise international groups with cross border activities and diversified positions.

Institutions (in particular international institutions), whatever they have more banking book or trading book positions, should have the flexibility to choose the currencies they elect to hedge.

No restriction should be defined. We call for a flexible framework.

Question 4: Could you please provide the list of the 10 most material currencies if the materiality of a currency were assessed in accordance with measure A and measure B? Please provide also the value taken by measure A and measure B for those currencies.

FBF answer: It should be possible for each institution to decide if it prefers to use measure A or measure B.

The number and the selected currencies for which the permission has been granted vary from bank to bank and these questions should rather be addressed through a Quantitative Impact Study (QIS) as they don't directly belong to the articulation of a Guideline.

The limitations on the number of currencies has no legal or prudential basis and could prevent the prudential framework from recognizing actual structural FX risk management and would penalise international groups with cross border activities and diversified positions.

III. Positions eligible to be exempted

Question 5: Do you agree with the policy included in paragraph 25? Please elaborate.

FBF answer: We support the policy included in paragraph 25.

Furthermore as banks and their subsidiaries are subject to several ratios that are different, the ratio which is binding at group level is not necessary the one binding at individual level. And as a consequence, it is not possible to perfectly offset the sensitivities of all ratios to changes to all foreign exchange rates. There would be no conceptual grounds to require that the very same ratio is the same across a group of entities and at individual and consolidated levels. Hence, banks should be able to elect different ratios for different scope (individual, consolidated, sub-consolidated…) and different entities within the very same group.

IV. Assessment of the structural nature of a position

Question 6: Are the structural positions for which you plan to ask the permission mainly positions of type A (i.e. meeting the condition in the paragraph above), or positions of type B? Could you please provide a rough estimation of the percentage of positions of type A on the total foreign-exchange position that you will potentially include in the request to the competent authority? For example, if the institution plans to request to exclude a net position = 100, and 80 of such net open position is due to positions of type A, then the percentage of positions of type A on the total foreign-exchange position that the institution will potentially include in the request to the competent authority is 80%.

FBF answer: French banks urge the EBA not to define Guidelines that are overly complex and restrictive compared to level 1 CRR text and frameworks applicable in other jurisdictions. Credit institutions need for a flexible framework to operationally manage the various forms of structural FX positions, once they have defined and documented the way they manage the position.

It is reminded that the role of CRR Article 352(2) enables to exempt positions that would otherwise be subject to Pillar 1 capital requirement due to their foreign exchange components, when they have been '*deliberately taken in order to hedge against adverse effect of the exchange rate on its ratios*'.

FBF members recommend that *Type A* should cover net investments in foreign currencies whether these investments come from subsidiaries, or branches. There should be no differences in the types of activities booked in those entities, e.g. trading activities.

Those investments in subsidiaries or branches are usually not done for the purpose of hedging prudential ratio, and the impacts of foreign exchange rates on those investments do not affect profit and loss (P&L) statement. In CRR and in the Basel framework, there is no example of Pillar 1 capital

charge that would not relate to an impact on P&L. Both reasons evidence that the proposal to subject net investment *(Type A)* to Pillar 1 capital requirement (bar granting of an exemption) would go beyond regulatory requirement. Such a framework would be so inconsistent that, by default (i.e. bar granting of an exemption), it would lead to a capital requirement due to foreign exchange for having well capitalized a subsidiary in a different currency which cannot make sense.

The EBA Guidelines should clarify that, by default, *Type A*, as defined above (i.e. including capital allocation to branches), does not lead to capital requirement due to foreign exchange. For sure, Type A contribute to the sensitivity of the ratio and hence are part of the sensitivity hedging strategy that a bank may be willing to implement with mitigating transactions (e.g. borrowings or derivatives) and for which exemptions are sought. Those mitigating transactions would be of Type B.

As a consequence, exemption should relate to *Type B* financial transactions to mitigate ratio foreign exchange sensitivity whereby Type A positions contribute to the ratios being mitigated.

The envisaged requirements for exempting transactions taken in order to hedge the capital ratios of the bank are overly prescriptive and difficult to operationalize. French banks deem that it would be difficult to implement the proposed standards for actual management of banks (e.g. limitation to significant currencies, too narrow tolerance, articulation between solo and consolidated level, transition period from the current framework to the target framework), or for supervisors to cope with significant number of exemption requests and reviews. Those requirements could have many detrimental consequences, most of which we believe as unintended.

The overall objective of achieving a harmonised EU interpretation and implementation of treatment of structural FX positions should be more robustly achieved by placing greater emphasis on the articulation of an entity's risk management strategy and internal governance framework.

Credit institutions need flexibility in their management framework to operationally manage the various forms of structural FX positions, once they have defined and documented the way they manage the position.

We believe that the requirements should be substituted with Guidelines for the articulation of a bank Policy for the management of non-trading foreign exchange risk including the criteria for evidencing the risk mitigating *against adverse effect of the exchange rate* on the ratio it elects to mitigate.
Hence, the revised Guidelines should be based on pre-approved internal *Policy* that describes:

- the scope of application. It is defined either for an individual entity, or for a consolidated / sub-consolidated group of entities.
- the elected prudential ratio whose impact from foreign exchange rate is mitigated. For each defined scope, there should be one designated prudential ratio among Common Equity Tier One, Tier One or Total Capital. Below, the chosen ratio is named Elected Ratio.

  Note that within the same Group, an entity and a sub-group might elect different prudential ratios as the most binding ratio might be different at different levels of the Group.
- the description of the Net Open Position (NOP), for which a bank might elect to consider that investment in subsidiaries or capital allocation to branches have been deliberately taken for the purpose of mitigating the sensitivity of the elected ratio to foreign exchange rate sensitivity.
- the currency ('c'), or group thereof, whose foreign exchange rate is being mitigated.
- the metric used to evidence that there is a reduction of adverse effect of the foreign exchange rate.

- the governance for foreign exchange risk management:
  - roles and responsibilities with first, second and third *Lines of Defense* ('*LoD'*), the relevant Committees defining and monitoring the execution of the strategy for foreign exchange risk. The information to supervisor when breaching
  - monitoring the above described metrics that should be calculated no less frequently than the accounting data (i.e. usually quarterly)
- the prudential treatment of foreign exchange position when adhering to the Policy.

> **Question 7:** Could you please provide the percentage of the net open position that you plan to request to exclude with respect to the net open position that your institution has without any waiver?

FBF answer: This question has been answered by French banks on an individual basis. Confer also to comments provided in Question 6.

V. Assessment of the intention to hedge the ratio- governance and risk-management strategy of the structural positions

> **Question 8:** Do you agree with the exclusion of positions that are not eligible to be structural from the sensitivity that is used for assessing the intention of the institution to hedge the ratio, or would you prefer to have those positions included although they cannot be exempted? Please elaborate.

FBF answer: It is rather unclear what would be the positions excluded from the sensitivity and from which part of the formula they should be excluded (cf. example 6 in Appendix of the guidelines which provides an example of sensitivity and where all the Risk-Weighted Asset (RWA), including those stemming from trading book positions are considered in the denominator).

The proposed Guidelines seem confusing the non-eligibility of hedging positions with excluding positions contributing to the sensitivity of the elected ratio.

Excluding positions that are non-eligible for exemption from the sensitivity would basically make impossible to hedge the *Elected Ratio*, since they actually contribute to this *Elected Ratio*. As such, it would contradict the level 1 CRR text that refers to hedging a ratio, not part of a ratio. This is an illustration of the overly prescriptive perspective of the proposed Guidelines.

The proposed Guidelines should be substituted with a Policy centric Guidelines, as articulated in Question 6.

It should be noted that investment in a subsidiary or a branch doing only trading book activities should be considered as *Type A*.

Question 9: Are there currently FX-risk positions that you kept open in the trading book for the purpose of hedging the ratio? Why did you not include such positions as part of the banking book since the main purpose of those positions is to hedge the ratio?

FBF answer: Institutions do not use trading book positions to hedge the ratio.

Question 10: Do you think that by excluding positions that are non-eligible to be exempted, it will be easier for institutions to meet the requirement of keeping the sensitivity stable over time? Please elaborate.

FBF answer: The proposed Guidelines seem confusing the non-eligibility of hedging positions with excluding positions contributing to the sensitivity of the elected ratio.

While the FBF agrees that trading book positions should be non-eligible to be exempted, the exclusion of Risk-Weighted Asset (RWA) of trading book positions from the sensitivity calculation with the purpose to ease keeping the sensitivity of the ratio stable overtime overrides level 1 RR text requirements and wouldn't be consistent with the objective to hedge the ratio and not part of it.

The level 1 text refers to *position 'deliberately taken against the adverse effect of the exchange rates'* on the "*total*" ratios which does not mean keeping the sensitivity stable within a fixed range. Accordingly positions deliberately taken which enable to mitigate the sensitivity of the ratio should be eligible for the exemption of a Pillar 1 capital requirement.

The sensitivity formulas and range (with a 0.05 threshold) proposed are too restrictive; the EBA suggest to exclude from the sensitivity formula positions that anyway will affect the sensitivity of the ratios which does not make sense.

As developed in question 6, the FBF therefore considers that **the overall objective of achieving a harmonised EU interpretation and implementation of treatment of structural FX positions should be more robustly achieved by placing greater emphasis on the articulation of an entity's risk management strategy and internal governance framework.**

Credit institutions need flexibility in their management framework to operationally manage the various forms of structural FX positions, once they have defined and documented the way they manage the position.

We believe that the requirements should be substituted with Guidelines for the articulation of a bank Policy for the management of non-trading foreign exchange risk including the criteria for evidencing the risk mitigating *against adverse effect of the exchange rate* on the ratio it elects to mitigate.

Question 11: Is your institution currently required to keep the sensitivity of the ratio stable over time where requesting the permission referred to in Article 352(2)? If not, how do you justify the intention of hedging the ratio? Please elaborate.

FBF answer: No regulation (i.e. level 1 text) require to keep the sensitivity of the ratio stable over time. Hence, level 1 CRR text refers to the sensitivity to *adverse effect*, and does not mention stability of the sensitivity over time. In addition, making a ratio fully insensitive to foreign exchange is operationally impossible (cf. also comments provided to question 10).

Question 12: Do you agree with the definition of the range in paragraph 27(d)? Do you think that 0.05 is an appropriate value?

FBF answer: The 0.05 threshold is overly stringent. Institutions should have leeway to manage their position. The exemption requirements should be flexible enough not to lead to too often reapplication process due to business as usual / normal course of business changes.

The proposal in EBA draft guidelines doesn't work as, the suggested requirements rely implicitly on the assumption that everything is stable once the exemption is granted. Which is overly demanding, as it fails to take into account the normal courses of business which cannot be considered fully stable. If a foreign subsidiary generates some P&L, the sensitivity ratio could fall out of the range defined *at inception*.

Thus what is targeted through these formulas is rather the stability of the hedge ratio (hedge ratio = SOP/Max OP) by currency over time rather than hedging the ratio against adverse effect of the exchange rates as stipulating in level 1 text (and which we read as limiting the sensitivity of the ratio).

As these range and formulas go beyond level 1 text (namely CRR article 352(2)) we require the suppression of these sensitivity and range formulas and to replace them with a reference of bank's risk management policy for structural FX positions.

Please confer comments provided to Questions 6 and 11.

Question 13: Could you provide a description of the risk-management framework within which your institution operates for managing structural positions that have been taken for hedging the ratio (e.g. how your institution currently computes the sensitivity of the ratio to changes in the exchange rate, the level of granularity at which the boundaries referred to in paragraph 27(i)(i) are defined, exc.)? Do you think that these guidelines are in line with the current risk-management within which institution operates for managing SFX positions? If not, which are the differences?

FBF answer: This question will be answered on an individual basis.

The envisaged requirements for exempting transactions taken in order to hedge the capital ratios of the bank are overly prescriptive and difficult to operationalize and not consistent with current risk management frameworks.

French banks deem that it would be difficult to implement the proposed standards for actual management of banks that are too stringent at several levels (e.g. limitation to significant currencies, too narrow tolerance, articulation between solo and consolidated level, transition period from the current framework to the target framework), or for supervisors to cope with significant number of

exemption requests and reviews. Those requirements could have many detrimental consequences, most of which we believe as unintended.

The overall objective of achieving a harmonised EU interpretation and implementation of treatment of structural FX positions should be more robustly achieved by placing greater emphasis on the articulation of an entity's risk management strategy and internal governance framework as detailed in question 6.

At least, we are also in favor of eliminating the end of the point 81 of the Consultation Paper: "Additionally, a maximum limit on the loss, which is deemed acceptable should be part of the approval from the management Board". We believe that the previous provision, suggesting that the Board should be aware of the remaining FX risk on the investments when hedging only the ratio should be sufficient.

VI. Size of the position to be excluded

Question 14: Is it easy for institutions to 'transfer' the concept of net open position in the context of the internal model? What are the methodologies that institutions may use for excluding positions for which they may receive the permission referred to in Article 352(2) from their internal models?

FBF answer: This question has been answered by French banks on an individual basis.

The transfer of the concept of the Net Open Position in the context of internal model should not lead to duplicate the capital requirement for the same underlying risk.

The definition of the Max Open Position embeds strong assumptions that the bank has elected an actual CET1 that is *proportionate* to the RWA in the different currencies it operates in. However, there is no regulatory requirement to cover prudential CET1 requirement in proportion of the RWA in the different currencies, and there is even less substance for assuming that the actual CET1 beyond the prudential CET1 requirement has to be proportionate to the RWA's in the different currencies.

Question 15: What is the size of non-monetary items that are held at historical costs with respect to the size of institution's balance sheet?

FBF answer: The size of non-monetary items differ whatever the structural FX position is managed at the entity level (subsidiary, branch, parent company) or at the highest level of consolidation. The way the structural FX position will be managed will be different whatever you are at the entity level or at the highest level of consolidation of a banking group.

Question 16: Do you think that the formulas presented above provide a good estimate of the position that is offsetting the sensitivity of the ratio with respect to changes in the exchange rate? If no, why? Are there any adjustments that you would recommend? Please elaborate.

FBF answer: Institutions generally manage FX positions within different risk appetites and to specific ratios that are most relevant to the capital and open FX positions of the firm.

There are a number of underlying assumptions in the formulas that are actually too theoretical.

- The reference ratio is current ratio. In many instances, a more appropriate ratio is a target ratio which is generally between the required ratio and the current ratio, and sometimes above the current ratio (for instance when a capital increase is contemplated);

- The examples given in the Consultation paper assume no deductions (or deductions netted against the Common Equity, which is incorrect) and no minority shareholders;
- ***More importantly, the formulas assume that the revaluation on the open positions fully translate into an equal variation of the CET1***. Consequently, the items are regarded as fully fungible. This is not in practice, frictions and drags may arise in certain instances notably for tax or regulatory reasons.

For these reasons, the overall objective of achieving a harmonised EU interpretation and implementation of treatment of structural FX positions should be more robustly achieved by placing greater emphasis on the articulation of an entity's risk management strategy and internal governance framework as detailed in question 6.

The formula should factor each currency as well as correlation and diversification effects.

It should be mentioned elements deducted from the calculation of CET1 embed eligible minority interests.

Question 17: Do you think that is operationally feasible to compute the maximum open position and the sensitivity on a monthly basis?

FBF answer: Reporting and data requirements should be consistent with applicable accounting reporting, e.g. with frequency and remittance derived from financial statement reporting ones. Monthly reporting would usually be inconsistent with financial statements availability.

Question 18: Do you currently include Additional Tier 1 instruments, and Tier 2 instruments that are issued in the foreign currency in the net open position referred to in 352(2)? Please elaborate.

FBF answer: The inclusion of Additional Tier 1 instruments and Tier 2 instruments in the Net Open Position (NOP) depends on their accounting treatment as capital instrument (with foreign exchange rate not impacting the P&L, hence not in the NOP) or as liability instrument (with foreign exchange rate impacting P&L, hence in the NOP).

This comment should also apply to senior non preferred eligible instruments issued in foreign currency when institutions decide to hedge their TLAC or MREL ratio should be considered in the net open position.

Question 19: What is in percentage the amount of Additional Tier 1 instruments, and Tier 2 instruments that your institution issued in foreign currency with respect to the total amount of own funds of your institution?

FBF answer: This question has been answered by French Banks on an individual basis.

Question 20: What is the percentage of the amount of Additional Tier 1 instruments, and Tier 2 instruments that your institution issued in a foreign currency with respect to the net open position that your institution has in that foreign currency?

FBF answer: This question will be answered on an individual basis.

VII. Size of the position to be excluded

Question 21: Is there anything in the approach outlined in these guidelines that could create issues of compatibility with the treatment foreseen in any non-EU jurisdictions in which EU institutions operate? If so, please elaborate.

FBF answer: The EBA proposed Guidelines will raise level playing field issues between EU and non-EU credit institutions, the latter operating with more leeway (cf. FRTB dispositions or the Fed market risk capital rules). The absence of any international agreement will generate operational concerns for the consolidation of foreign subsidiaries with their EU-parent entity. For all these reasons, institutions call for the definition of a principles based policy instead of any rules based policy as detailed in question 6.