

Guidelines

on capital measures for foreign currency lending to unhedged borrowers
under the supervisory review and evaluation process (SREP)



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1. Executive summary

These guidelines are focused on capital measures for foreign currency lending (FX lending) to unhedged borrowers under the supervisory review and evaluation process (SREP) and provide guidance to national competent authorities on how to address the specific risk of FX lending to unhedged borrowers as part of the SREP with capital measures where applicable. The intention of these guidelines is to harmonise supervisory practices for addressing this risk in Member States.

In line with the scope of Recommendation E of the European Systemic Risk Board (ESRB) report on lending in foreign currencies¹ which is addressed to the EBA, these guidelines specifically address FX lending to those borrowers that are considered unhedged (borrowers without a natural or financial hedge, meaning agents that are exposed to a currency mismatch). As corporate borrowers are likely to have their foreign currency exposures or cash flows hedged through income in the foreign currency or through an ability to effectively manage the underlying financial risk they tend not to fall under the definition of unhedged borrowers. Furthermore, as the ESRB report highlighted that risks to financial stability are predominantly high in countries with large stock of FX loans to unhedged borrowers, particularly households and some non-financial corporations, i.e. small and medium-sized enterprises (SMEs) as their income is generally in local currency, the guidelines specifically address the risk of FX lending to *unhedged retail and SME borrowers*. The scope set out in Title I.2 of these guidelines is not intended to prevent competent authorities from also applying them to FX lending to other unhedged borrowers, but this is not subject to comply or explain with these guidelines.

As the focus of the SREP should be on the risks which are material to an institution, the guidelines include a materiality threshold whereby if FX lending risk to unhedged retail and SME borrowers exceeds the threshold specified in the guidelines, competent authorities should expect institutions to include FX lending risks in their internal capital adequacy assessment processes ('ICAAP') and, also, to adequately account for FX lending risks in their governance arrangements which competent authorities will review as part of the SREP. The guidelines provide guidance on both the supervisory review of FX lending governance arrangements and of capital adequacy in accordance with Article 97 of Directive 2013/36/EU (CRD)², and culminate in guiding supervisors on how to calculate the additional own funds requirements for this risk, where applicable, as a result of the SREP.

These guidelines also recognise the use by competent authorities of other supervisory measures outlined in Article 104(1) of the CRD which may be used to address this specific FX lending risk if deemed appropriate by the competent authorities. Nonetheless, in line with the scope of the ESRB mandate, the guidance contained herein is on the assessment of the appropriateness of the FX lending risk management and the capital adequacy for this risk and how to apply additional own funds requirements if deemed necessary.

¹Recommendation of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (ESRB/2011/1). (OJ C 342/1, 22.11.2011).

²Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC

These guidelines were published for a three month consultation and a public hearing was also convened to discuss with stakeholders. The comments received have been published on the EBA website unless the respondents requested otherwise. A summary of the comments received and the feedback on the responses received can be found in the annex to these guidelines.

These guidelines are closely related to other technical standards and guidelines drafted by the EBA, focusing on the specificities of FX lending in particular they complement existing guidelines and proposed technical standards on the subject of the supervisory review process internal governance, concentration risk, stress testing and home-host supervisory cooperation. They also take into account the provisions of Article 354 of Regulation (EU) No 575/2013 (CRR)³ and the proposed ITS on closely correlated currencies⁴. It should be noted that the list of closely correlated currencies in those proposed ITS should not be relied upon as fixed, as the list will be updated at least annually.

These guidelines will form part of the suite of EBA guidelines setting out common procedures and methodologies for the supervisory review and evaluation process (SREP) being developed pursuant to Article 107(3) of the CRD. These guidelines are subject to the finalisation of the SREP guidelines and may therefore be revised in due course.

In accordance with the mandate set out in the ESRB Recommendation of 21 September 2011 on foreign currency lending, the guidelines will be issued on 1 January 2014 and will apply from 30 June 2014 (as per Title III – Final provisions and implementation of the guidelines).

³Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012

⁴ To be submitted to the Commission by 1 January 2014.

2. Background and rationale

The risks associated with FX lending derive from the fact that exchange rate movements, essentially a market risk driver, in the case of loans denominated in a foreign currency, can strongly influence a borrower's debt-servicing capacity, thus impacting credit risk. Additionally, an institution may have significant credit risk concentrations if a material part of an institution's lending portfolio is denominated in the same foreign currency or highly correlated foreign currencies while FX lending may also cause higher residual risk in the case that the value of the collateral (e.g. mortgage value) does not change in line with FX movements. In addition to the above, FX lending is of particular concern where FX lending towards borrowers who do not have a natural or financial hedge in place, i.e. 'unhedged' borrowers, is particularly high.

FX lending risk is characterised by a non-linear relation between market risk and credit risk where exchange rates (market risk) can have a more than proportional impact on the credit risk of an institution's FX loans portfolio. As a result of this relationship it is challenging to adequately include the impact of potential exchange rate movements when assessing credit risk. This means that FX lending can influence an institutions' overall risk profile via several unobvious channels which must be taken into account by addressing FX lending risk. This non-linear relation needs to be adequately captured by the risk measurement framework meaning that the exchange rate effects on credit risk and market risk must not necessarily be simply added, but instead they require an integrated measurement of this market risk driver on credit risk components in an institutions' credit portfolio.

Beyond this micro-prudential dimension, justifying the need for competent authorities to take FX lending risk into account in their review and evaluation of individual institutions, there is a macro-prudential dimension to FX lending risk also identified by the ESRB in September 2011. In its report published in 2011, the ESRB highlighted the fact that excessive FX lending can lead to systemic consequences for national economies and can create conditions for negative cross-border spill-over effects, adversely affecting financial stability within and across Member States. The ESRB subsequently issued seven Recommendations, one of which mandated the EBA to draft and address guidelines to national competent authorities regarding capital requirements under Pillar 2 to address risk related to FX lending.

One of the ESRB's seven Recommendations⁵ (Recommendation E) recommends that the EBA drafts and addresses guidelines to competent authorities regarding capital requirements under Pillar 2 to address risks related to FX lending to unhedged borrowers. The ESRB recommends that competent authorities should assess institutions' capital adequacy in this regard as part of their SREP. Furthermore, it recommends a two-stage approach towards the treatment of FX lending risks for cross-border institutions based on home/host cooperation.

Although these guidelines address FX lending to unhedged borrowers, they focus on prudential requirements and not on the consumer protection elements of FX lending. There are two further Recommendations published by the ESRB in 2011 and addressed to competent authorities for

⁵ Recommendation of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (ESRB/2011/1). (OJ C 342/1. 22.11.2011)

treating concerns related to consumers. These guidelines therefore contribute indirectly to consumer protection by avoiding bubble-like FX lending behaviour, by making FX lending more costly in terms of capital. FX lending rates are thus more likely to reflect actual risks, and therefore potentially reduce the likelihood of unaffordable borrowing in the system.

The EBA has developed these draft guidelines on the basis of the ESRB report on FX lending taking account of the relevant provisions of the CRR and of the CRD and also takes into account the comments received in the consultation process.

3. EBA guidelines on capital measures for foreign currency lending to unhedged borrowers under the supervisory review and evaluation process (SREP)

Status of these guidelines

This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (the EBA Regulation). In accordance with Article 16(3) of the EBA Regulation, competent authorities must make every effort to comply with the guidelines.

Guidelines set out the EBA's view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. The EBA therefore expects all competent authorities to whom these guidelines are addressed to comply with them. Competent authorities to whom guidelines apply should comply by incorporating them into their supervisory practices as appropriate (e.g. by amending their legal framework or their supervisory processes).

Reporting requirements

Pursuant to Article 16(3) of the Regulation (EU) 1093/2010, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by 28 February 2014. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form provided at Section 5 to compliance@eba.europa.eu with the reference 'EBA/GL/2013/02. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities.

Notifications will be published on the EBA website, in line with Article 16(3) of the EBA Regulation.

Title I - Subject matter, scope and definitions

1. In accordance with the Recommendation of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (ESRB/2011/1), in particular Recommendation E – Capital requirements, these guidelines deal with capital measures for foreign currency lending (FX lending) to unhedged borrowers under the supervisory review and evaluation process (SREP) of Article 97 of the CRD.
2. These guidelines apply to FX lending to unhedged retail and SME borrowers. For the purposes of these guidelines, the following definitions apply:

‘FX’ means any currency other than the legal tender of the country in which the borrower is domiciled;

‘FX lending’ means lending to borrowers notwithstanding the legal form of the credit facility (e.g. including deferred payments or similar financial accommodations) in currencies other than the legal tender of the country in which the borrower is domiciled;

‘unhedged borrowers’ means retail and SME borrowers without a natural or financial hedge which are exposed to a currency mismatch between the loan currency and the hedge currency; natural hedges include in particular cases where borrowers receive income in foreign currency (e.g. remittances/export receipts), while financial hedges normally presume there is a contract with a financial institution;

‘non-linear relation between credit and market risk’ means where changes in the exchange rate, the market risk driver, may cause disproportionate effects on the overall level of credit risk; in this context, fluctuations in the exchange rate can affect borrowers’ debt-servicing capacity, potentially the exposure at default and the value of collaterals, thus resulting in large changes to credit risk.

3. The guidelines are addressed to competent authorities. They focus on the SREP to ensure that institutions have adequate arrangements, strategies, processes and mechanisms to identify, quantify and manage FX lending risk, and that they have adequate amounts, types and distribution of internal capital with respect to FX lending risk. If, as a result of the process, competent authorities identify deficiencies in risk management arrangements, strategies, processes and mechanisms and conclude that capital held by an institution is inadequate, the guidelines set out that competent authorities should require institutions to manage their FX lending risk more effectively using measures outlined in Article 104 of the CRD and if deemed necessary, cover these risks with an adequate level of capital as appropriate thereby increasing the resilience of the institution to exchange rate changes.
4. Wherever recent data on the hedging status of the respective customer is unavailable, the borrowers should be treated as unhedged.
5. These guidelines apply on an institution-by-institution basis wherever the threshold of materiality as laid down in Title II, Section 1 is met.

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6. The guidelines should be applied on a consolidated, solo, and where applicable, sub-consolidated level, and in accordance with the SREP level of application of the CRD (Article 110).
 7. These guidelines provide for an institution-specific assessment and application of additional own funds requirements. They complement other supervisory measures, including macro-prudential measures, implemented by competent authorities with respect to FX lending, for example higher minimum regulatory capital requirements. Competent authorities should, under the SREP, continue to assess the overall adequacy of all such measures.

Title II- Requirements regarding capital measures for FX lending to unhedged borrowers under the SREP

8. In line with Article 97 of the CRD, competent authorities should, under the SREP, determine whether the arrangements, strategies, processes and mechanisms implemented by the institutions and the own funds held by them ensure a sound management and coverage of their FX lending risk. This clearly implies that competent authorities should review the adequacy of the ICAAP arrangements and internal capital calculation for FX lending risks. Member States should apply the following requirements taking into account the closely correlated currencies listed in the proposed ITS on closely correlated currencies under Article 354(3) of the CRR, and the provisions of Article 354 of the CRR⁶.

II.1 Threshold of application

9. These guidelines apply on an institution-by-institution basis wherever the following threshold of materiality is met⁷:

Loans denominated in foreign currency to unhedged borrowers constitute at least 10% of an institution's total loan book (total loans to non-financial corporations and households), where such total loan book constitutes at least 25% of the institution's total assets.

Competent authorities should also apply the guidelines where an institution does not meet the threshold set out above but the FX lending risk to unhedged borrowers is nevertheless considered by them to be material. Competent authorities should, in this case, justify and document any decision to override the threshold set out above, on the basis of criteria including but not limited to the following: a significant increase of the institution's FX lending since the last calculation; a negative trend of the exchange rate of a significant foreign currency in which the institution's loans are denominated.

II.2 Process

10. The process established by the guidelines is as follows:

- (i) competent authorities should require institutions to identify their FX lending risk to unhedged borrowers;

⁶ The currencies contained in these ITS will be updated annually therefore this list should not be considered as fixed.

⁷ Calculated when requested by the competent authority, no more frequently than annually.

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- (ii) competent authorities should determine whether this risk is material either because it meets the threshold or because they have nevertheless deem it to be material;
 - (iii) wherever FX lending risk is material above, then competent authorities should expect the institutions to reflect the risk in their ICAAP;
 - (iv) competent authorities should review the treatment of FX lending risk in the ICAAP as part of the SREP (Title II, Section 3 and 4 below);
 - (v) if the arrangements, strategies, processes and mechanisms to identify, quantify and manage FX lending risk are considered to be inadequate and existing levels of capital are considered to be insufficient to cover FX lending risk to unhedged borrowers, then competent authorities should impose appropriate measures under Article 104 of the CRD to address these deficiencies, including requiring an institution to hold additional capital (Title II, Section 5);
 - (vi) if the institution is part of a cross-border group, the outcomes of the assessment of FX lending risk will feed into the joint decision process, as specified in Article 113(1) of the CRD.

II.3 Supervisory review of FX lending risk management

11. In relation to FX lending risk as part of the SREP, competent authorities should assess the following:

- The type of exchange rate regime:
 - Competent authorities should consider the extent of FX lending risk in light of the currency regimes in which exposures to unhedged borrowers are denominated and should take particular account of where (i) the domestic and the foreign currency are closely linked (either by law or through the proximity of respective economies or monetary systems); (ii) currency board or pegged exchange rate regimes exist; and (iii) where there is a 'free floating' regime. The extent and pattern of potential future exchange rate changes generally depends on the currency and the currency regime.
 - Competent authorities should ensure that institutions have a sound understanding of the possible future trends and volatility of exchange rates on an ongoing basis on economic(real) exchange risk i.e. not relying only on a de jure classification of an exchange rate regime. In particular, they should ensure that institutions undertake a regular assessment of exchange rates against the creditworthiness of borrowers, since exchange rate movements pose a continuous risk irrespective of the exchange rate regime.
- Institutions' FX lending risk-related processes:
 - Competent authorities should ensure that institutions have FX lending policies in place, which include an explicit statement on FX lending risk tolerance, taking into account institutions' own risk bearing capacity, and determine absolute and relative limits for FX loan portfolios and currencies. Competent authorities should undertake reviews of institutions' risk management policies and processes on FX lending and assess whether, despite those policies and processes, material levels of FX lending risk are still not adequately addressed by these processes.

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- Competent authorities should ensure that the risk identification processes in institutions adequately cover FX lending risks.
 - Competent authorities should ensure that institutions have sound risk control methodologies in place to account for FX lending risk when scoring clients and underwriting FX loans e.g. by means of adequate risk pricing and collateral requirements. In particular competent authorities should ensure that institutions have incorporated the exchange rate risk driver into their risk assessment methods.
 - Competent authorities should ensure that institutions specifically include FX lending risk in their ongoing monitoring and therefore that they determine appropriate exposure-specific thresholds. Competent authorities should ensure that institutions' processes effectively stipulate prompt and adequate pre-emptive measures (e.g. request the provision of additional collateral etc.) whenever such thresholds are exceeded.
- The impact of exchange rate movements:
 - Competent authorities should ensure that institutions take adequate account of exchange rate movements on borrowers' credit rating/scoring and debt servicing capacity including in their internal risk pricing and capital allocation processes.
 - Competent authorities should ensure that institutions have adequate procedures in place for continuous monitoring of relevant exchange rate movements and assessing these potential effects on the outstanding debt and associated credit risks on both individual exposures and at portfolio level.
 - Additionally, competent authorities should ensure that institutions periodically review the hedging status of borrowers as this may vary over time and institutions should avoid incorrect classification of borrowers whose situation has changed. As far as legally possible, such status monitoring should be included in the terms of the lending arrangements between institutions and borrowers. Whenever no recent hedging status is available to the institution, competent authorities should ensure that the borrower is treated as unhedged in their risk measurement systems and ICAAP.

II.4 Supervisory review of capital adequacy

12. Competent authorities should ascertain that institutions adequately incorporate FX lending risk to unhedged borrowers into their risk measurement systems and ICAAP. In particular, competent authorities should ensure that:

- institutions' FX lending risk exposures do not exceed their risk appetite; and
- FX lending risk, including risk concentration in one or more currencies is appropriately addressed in the ICAAP.

13. Regardless of how institutions classify risks stemming from FX lending in terms of credit and market risk, competent authorities should investigate how the non-linear relation between credit risk and market risk has been addressed and should assess whether this treatment is adequate.

14. Competent authorities should ensure that institutions:

- maintain an overall consistency of the whole risk measurement framework by ensuring that the underlying hypotheses (confidence level, holding period etc.) used to measure market and credit risk are defined in a consistent way;
- recognise that portfolios denominated in foreign and domestic currencies may exhibit markedly different default patterns and should therefore account for potential future credit losses as a result of exchange rate fluctuations separately for different currencies;
- account for the impact of exchange rate movements on default probabilities;
- account for the fact that they may become exposed to market risk through borrowers even if they hedge themselves against exchange rate movements in relation to their FX lending activities. (The market risk hedge may become ineffective when FX borrowers default, especially if the loans were collateralised in local currency. In that case, institutions would suffer credit losses from borrowers' defaults and at the same time they would be exposed to market risk losses from the hedge which was broken up by the defaults).

15. Additionally, competent authorities should ensure that institutions quantify the capital needed to cover FX lending risk, including the concentration risk aspect, in a prudent and forward-looking manner, in particular focusing on concentrations due to the dominance of one (or more) currency(ies) (as the movements in exchange rates are a common risk factor simultaneously driving defaults of many borrowers). Competent authorities should ensure that institutions provide a reasoned assessment of their internal capital level allocated to FX lending risk.

16. Competent authorities should assess whether institutions hold adequate capital to cover risk associated with FX lending by assessing whether institutions are able to identify underlying causes of changes in their capital position and whether they adequately prepare for potential additional capital needs.

17. Competent authorities should ensure that institutions carry out capital planning thoroughly also to take into account stressed conditions and account for possible exchange rate movements. Competent authorities should ensure that institutions do this by focusing not only on the direct effect of nominal adjustments but also taking into account the indirect consequences on credit risk parameters. Where an institution has advanced models in place, competent authorities are expected to assess the reliability of banks' internal models for the treatment of FX lending risk.

18. For institutions with a cross-border presence, FX lending risk and its management should also be reflected in the joint decisions required under Article 113 of the CRD and associated EBA technical standards and discussed in colleges of supervisors established pursuant to Articles 51 and 116 of the CRD. Consolidating supervisors should be informed promptly by host supervisors if FX lending risk is material at a subsidiary level.

II.4.1 Supervisory review of stress testing

19. In line with the 'Guidelines on Stress Testing' (GL 32) and to enable institutions to withstand severe exchange rate movements, competent authorities should ensure that institutions include FX-related shocks in their stress testing scenarios, both as a part of their ICAAP stress tests and stress tests at portfolio level.

20. Stress tests should, where appropriate, include shocks to the currency arrangements and resulting changes to borrowers' ability to repay for the whole portfolio and for each individual currency.

21. Competent authorities should review the stress tests carried out by institutions, including scenario selection, methodologies, infrastructure and the results of such stress tests and their use in risk management. Competent authorities should ensure that institutions' stress tests sufficiently cover FX lending risk and that institutions take appropriate mitigating measures to address the results of the stress tests.

22. Where stress tests are not carried out or the results of the review of institutions' stress testing programmes reveal that they are insufficient, competent authorities should request institutions to take remedial actions. In addition, competent authorities may do the following:

- recommend scenarios to institutions;
- undertake supervisory stress tests on an institution-specific basis;
- implement system-wide supervisory stress tests based on common scenarios.

II.5 Application of supervisory measures

23. Based on the outcome of the supervisory reviews outlined in Title II, Sections 3 and 4 above, there is no need for further supervisory measures for those institutions whose arrangements, strategies, processes and mechanisms and own funds to cover FX lending risks are assessed as adequate by competent authorities. Where these points are considered to be inadequate, competent authorities should apply the most appropriate measures to address specific deficiencies (such as requiring reinforcement of the relevant arrangements, processes, mechanisms and strategies, requiring additional provisioning and/or requesting improvements to the ICAAP methodologies, or other measures specified in Article 104 of the CRD).

24. If competent authorities consider that institutions do not hold capital which adequately covers FX lending risk, they should require institutions to hold additional own funds in excess of the minimum regulatory capital requirements in line with Article 104(1) of the CRD. Such additional own funds requirements for FX lending risk to unhedged borrowers can be imposed alone, or with other supervisory measures aimed at improving arrangements, strategies, processes and mechanisms implemented for FX lending risk management as a part of the supervisory actions and measures to be taken based on the outcomes of SREP. In case of cross-border banking groups and with EEA subsidiaries, the imposition of additional own funds requirements is subject to the procedure outlined in the ITS on Article 112 of the CRD and should be communicated to the institution explaining the decision.

25. Additional own funds requirements should be calculated as part of the SREP outcomes using the following method, whereby competent authorities should apply an FX lending-specific own funds requirements, linked to the risk assessment framework and to the results of the SREP:

- Competent authorities should apply the additional own funds requirements on top of the minimum regulatory capital requirement for credit risk in proportion to the share of FX loans to unhedged borrowers using the following formula:

*The percentage proportion of the stock of FX denominated loans to unhedged borrowers * Pillar 1 capital requirement for credit risk * additional own funds requirement multiplier based on the results of the SREP assessment of the FX lending risk,*

where:

- the 'additional own funds requirement multiplier' will be linked to the results of the SREP assessment of FX lending risk for an institution in line with GL 39 and the Implementing Regulation on Article 113(1)(a)⁸:
 - SREP risk scores of '1' (i.e. FX lending risk is assessed as 'Low') would attract additional own funds requirements of between 0 and 25%;
 - SREP risk score of '2' – (i.e. FX lending risk is assessed as 'Medium-Low') would attract additional own funds requirements of between 25.1% and 50%,
 - for score '3' – (i.e. FX lending risk is assessed as 'Medium-High') would attract additional own funds requirements of between 50.1% and 75%, and
 - for score '4' – (i.e. FX lending risk is assessed as 'High') would attract additional own funds requirements of over 75.1% (this figure can be over 100%)
- When deciding on the additional own funds requirements to be applied, competent authorities should take into account the level of concentration of institutions' FX lending towards certain currencies, historic volatility of exchange rates for currencies where concentration is observed, exchange rate arrangements and any volatilities incorporated into such arrangements.
- Where the additional own funds requirements is combined with the use of other measures in line with paragraph 24, the percentages noted above should be used as indicators so as not to be punitive to the institutions.
- The method can also be applied on a portfolio by portfolio basis if the competent authorities use SREP scores for particular portfolios. In this case the formula for computing additional own funds requirements for individual portfolios is as follows:

*The percentage proportion of the stock of FX denominated loans to unhedged borrowers in a specific portfolio * Pillar 1 capital requirement for credit risk in a specific portfolio * additional own funds requirement multiplier based on the results of the SREP assessment of FX lending risk to unhedged borrowers in a specific portfolio*

⁸ Pending finalisation of the guidelines for 'common procedure and methodologies for the supervisory review and evaluation process' under Article 107(3) of the CRD, the reference and calibration is based on the common scoring methodology in GL 39. Once the guidelines under Article 107(3) are finalised, this will be revised accordingly.

26.If the institution is part of a cross-border banking group, the actual levels of additional own funds requirements shall be agreed in the context of the joint decision process as required by Article 113(1) of the CRD.

27.The approach of defining the additional own funds requirements based on the SREP is appropriate for calculating institution-specific additional own funds requirements. This approach should however be without prejudice of competent or designated authorities using Pillar 2 in the context of Article 103 of the CRD, namely in what concerns institutions with similar risk profiles or which might be exposed to similar risks or pose similar risks to the financial system, which may warrant higher levels of additional own funds requirements implemented throughout the system.

II.6 Interaction with macro-prudential measures

28.In order to avoid duplication of additional own funds requirements to address this risk, competent authorities should also take into account, when applying the method above, any macro-prudential measures or other policy measures imposed by relevant authorities (i.e. macro-prudential authorities) that require institutions to hold additional capital for FX lending risk.

29.Where these measures are in place competent authorities should assess:

- (i) whether other institutions that have the risk or business profile targeted by the macro-prudential measure are omitted from the effects of the measure due to its design (for example, if the macro-prudential measure means that competent authorities address FX lending risk through increased risk weights applicable to FX denominated loans, the measure would only cover institutions applying the standardised approach to the calculation of minimum capital requirements for credit risk, and therefore institutions applying IRB approaches would not be directly affected); and
- (ii) whether the macro-prudential measure adequately addresses the underlying level of FX lending risk of individual institutions.

30.Based on these assessments, competent authorities should:

- (i) in the case that the macro-prudential measure, due to its design specificities, does not capture a particular institution (as discussed in 27(i)), the competent authorities may consider extending the macro-prudential measure directly to institutions not captured, for example, by applying the same floor to risk weights for FX denominated loans used by IRB institutions in their risk models at the same level as the increased risk weights of the macro-prudential measure for similar exposures of institutions using the standardised approach. IRB institutions would then be expected to apply those floors in their risk models and the difference between the normal own funds requirement calculation (before the application of the floor) and the subsequent calculation would be considered as the additional own funds requirementsfor FX lending risk. This can be illustrated by the following example:

	Bank using standardised approach for credit risk	Bank using IRB approach for credit risk capital
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	capital requirement calculation	requirement calculation
Nominal amount of exposure in foreign currency	100	100
Risk weight (either regulatory or as coming from the IRB exposure)	35%	15.6%
Macro-prudential measure	70% risk weight for FX denominated exposures	
Extension of the macro-prudential measure (Pillar 2 additional own funds requirements)		70% floor to IRB risk weights applied to FX denominated exposures
additional own funds requirements	$((100*0.7)-(100*0.35))*\min$ capital requirement	$((100*0.7)-(100*0.156))*\min$ capital requirement

- (ii) if the SREP outcomes indicate that the macro-prudential measure does not adequately address the underlying level of FX lending risk of a particular institution (i.e. FX lending risk in institutions is higher than the average level targeted by the macro-prudential measure) then the measure should be supplemented with the institution-specific capital add-on using the method as described in Title II.3

Title III- Final provisions and implementation

31. Competent authorities should implement these guidelines by incorporating them in their supervisory procedures by 30 June 2014 after publication of the final version. Thereafter, competent authorities should ensure that institutions comply with them effectively.

4. Accompanying documents

4.1 Cost-benefit analysis / impact assessment

4.1.1 Impact assessment on the threshold of application

Introduction

32. In November 2011, the ESRB issued seven Recommendations on foreign currency (FX) lending. Of these, Recommendation E requests that the EBA draft guidelines for competent authorities regarding capital requirements under the supervisory review and evaluation process (SREP) to mitigate risks related to FX lending to unhedged borrowers.

33. Article 16(2) of the EBA Regulation requires that draft guidelines be accompanied, where appropriate, by an analysis of the related potential costs and benefits, thus producing an impact assessment (IA).

34. Some of the information and views expressed in this IA are based on qualitative and quantitative evidence (bank-level data) collected by the EBA from a subset of EU competent authorities, relating to bank-level FX lending exposures and to the current supervisory practices addressing FX lending risk.

35. To ensure there was proportionality and timeliness in the data collection supporting this IA, Member States were selected for inclusion based on the evidence already produced by the ESRB⁹ on the proportion of loans to households denominated in foreign currency at the aggregate (national) level for a subset of EU Member States. The Member States selected were those that according to ESRB data for 2011 held a share of FX loans to households in the total loan portfolio more or less equal to 5%.¹⁰

Scope and nature of the problem

36. The measures set out in these guidelines address the risks related to institutions' FX lending to unhedged borrowers. According to the ESRB Recommendations, FX lending to unhedged borrowers poses risks to the financial system through several different channels. From a micro-prudential perspective, risks related to FX lending mainly stem from the interaction between movements in the foreign currency in which loans are denominated (market risk) and the debt servicing capacity of domestic unhedged borrowers (credit risk).

37. Adverse exchange rate movements (i.e. decreases in the value of the national currency against the currency(ies) in which the loans are denominated) translate into:

- a. an increase in both the outstanding value of debt and the flow of payments to service such debt, determining higher probability of borrowers' default, i.e. higher credit risk;

⁹ See Report on lending in foreign currencies accompanying the Recommendation of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (ESRB/2011/1). (OJ C 342/1, 22.11.2011).

¹⁰ The Member States selected by the EBA were Austria, Bulgaria, Denmark, Croatia, Hungary, Lithuania, Latvia, Poland, Romania and Slovenia. Croatia was not covered by the ESRB report but was included so that data on its exposures in FX lending could be collected for the first time.

-
- b. for FX denominated loans that are collateralised by assets denominated in domestic currency, increases in the value of outstanding debt imply worsening recovery rates, i.e. higher credit risk;
 - c. due to increased risks described under (a) and (b), above, a higher likelihood arises for credit institutions to incur losses and to face deteriorations of their capital positions.

38. In addition, concentration of risk at individual lender level is likely to magnify the effects described under (a), (b) and (c) above. Whenever an individual lender concentrates their unhedged FX lending activity in one single foreign currency, or in a limited number of highly correlated foreign currencies, significant adverse movements in the exchange rates have an impact on the risk level of all the exposures in institutions' FX lending portfolios at the same time.

39. From a macroeconomic perspective, materially high levels of FX lending can lead to:

- a. the emergence of credit bubbles sustained by the availability of foreign bank funds, which are likely to feed asset price bubbles (e.g. housing booms), in turn contributing to encouraging further development of collateral-driven over-borrowing in the economy;
- b. larger impact of external shocks, whenever such shocks cause or are accompanied by a depreciation of the domestic currency. The increased value of the private sector's financial liabilities following a currency depreciation/devaluation turns into financial stress in the private sector, falling aggregate demand and demand-driven fall in output.

Objectives of the guidelines

40. The ESRB Recommendations address the risks identified in relation to FX lending under several different regulatory perspectives. As documented in the IA of the ESRB Recommendation E, FX lending-specific capital add-ons under the SREP and the harmonisation of those requirements in the Single Market, would address the risks of FX lending by ensuring that:

- a. institutions engaged in material volumes of FX lending are adequately resilient to unexpected losses arising from adverse movements in the exchange rates of the currencies in which the lending is denominated;
- b. systemic risk is better tackled, in particular, the risk of contagion due to spill-over effects between highly correlated currencies in which FX loan portfolios are denominated;
- c. regulatory arbitrage practices are avoided for FX lending in the Single Market .

41. In addition, as an indirect consequence of enhanced risk-management practices and more adequate levels of regulatory capital against FX lending risk, institutions are expected to better price in the risk arising from potential adverse exchange rate movements on foreign currency lending exposures. As the interest rate differentials are among the driving factors behind the increased demand for FX loans, a more risk-sensitive (improved) pricing of exchange rate risk could reduce the gap in the costs of domestic and foreign loans, therefore helping mitigate the risk that credit bubbles develop that are financed by foreign currency funds.

Baseline

42. Under the CRD, competent authorities review the arrangements, processes and strategies that institutions implement in order to evaluate and tackle all the risks to which they are or might

become exposed. Among these risks, FX lending risk may already be part of the SREP process and it may be embedded in the ICAAPs and governance arrangements of the institutions.

43. However, in the current regulatory framework there is no harmonisation of the SREP treatment of risks by supervisory authorities such as the one proposed in these guidelines.

44. From the data and qualitative evidence collected from ten competent authorities, it can be inferred that:

- Only three out of ten jurisdictions explicitly require institutions to assess the proportion of FX lending to unhedged borrowers. Such practice is not carried out on a regular basis, although it can be carried sporadically and/or be associated to on-site inspections. Regulatory reporting requirements are not normally applied in these cases.
- Almost half of the consulted jurisdictions do not evaluate FX lending risks as a separate risk category in their SREPs. Only one jurisdiction requires evaluation of the FX lending risk as a standalone risk category and assigns scores to institutions related to FX lending risk; in all the other jurisdictions in our sample where FX lending risk is evaluated, this evaluation is part of either that for credit risk (more frequently) or that for market risk.

45. Besides the focus on unhedged borrowers and a harmonised implementation of potential capital add-ons for FX lending risk, these draft guidelines indicate that competent authorities should ensure that institutions for which FX lending risk is material implement a number of procedures to address FX lending risk, such as: i) assessing future trends and volatility of exchange rates of material currencies; ii) accounting for the effect of foreign currency movements on the borrower's debt servicing capacity and probability of default in the loan underwriting; iii) reviewing the 'hedge' status of borrowers periodically; iv) including bespoke foreign exchange rate movement scenarios in the ICAAP related stress testing and developing FX lending risk specific stress tests at the individual foreign currency portfolio level.

46. Detailed data at the individual jurisdiction level is not available to assess whether, and to what extent, each of those practices is part of the current regulatory and supervisory framework in the Single Market. There is limited evidence on some of those practices, e.g. FX lending ad-hoc stress tests, being currently adopted by some Member States.

Impact on markets, institutions and competent authorities FX lending exposures and scope of application

47. To assess the extent to which individual institutions come under the proposed thresholds thus triggering application of the guidelines, the EBA asked ten competent authorities to provide bank-level data on FX lending exposures in their jurisdictions.¹¹

48. The sample comprised 87 institutions, whose size in terms of total assets as of 2011 varied substantially: total assets of the median institution equalled approximately EUR 5 billion; the

¹¹ See introduction to the impact assessment annex.

smallest institution in the sample held approximately EUR 200 million; and the largest consolidated reported entities held between approximately EUR 100 billion and EUR 400 billion.

49. Two alternative thresholds were considered to establish the level of exposure to FX lending which triggers application of the proposed guidelines:

- **Threshold 1:** (total FX loans to unhedged borrowers)/(total loans) equal or greater than **10%** and (total loans)/(total assets) is equal or larger than **25%**.
- **Threshold 2:** (total FX loans to unhedged borrowers)/(total assets) equal or greater than **10%**.

50. As described in the 'Baseline' section of this annex, only a very limited number of competent authorities reported having data available on the portion of FX loans granted to unhedged borrowers, on an institution-by-institution basis. In addition, no data on such a breakdown was made available during the data collection exercise for this impact assessment.

51. To compute the exposure metrics included in the two thresholds, above, the variable 'FX loans to households' was used as a proxy for 'FX loans to unhedged borrowers', households being considered the most relevant category of borrowers with neither a natural nor a financial hedge against foreign currency risk.

52. Charts 1 and 2 and the corresponding tables below illustrate the exposure of individual institutions in the sample to FX lending to households, by reporting for increasing thresholds of exposure (5%; 10%; 20%; 30%):¹²

- a. the percentage portion of institutions, in the sample, that would fall into (i.e. be captured by) each exposure threshold;
- b. the aggregate percentage portion of assets, in the sample, corresponding to all institutions falling into each exposure threshold;
- c. the distribution of institutions by size¹³ within each exposure threshold.

Chart 1: Threshold 1

¹² The values reported in the charts and tables represent averages over 2009-2011 data. Identical (non-reported) computations were carried out on pre-crisis data, covering years 2006-2007, leading to broadly similar results.

¹³ Institutions are classified as small, medium and large where total assets smaller or equal than EUR 1.8 billion define small institutions; total assets between EUR 1.8 billion and EUR 30 billion define medium institutions; and total assets greater than EUR 30 billion define large institutions.

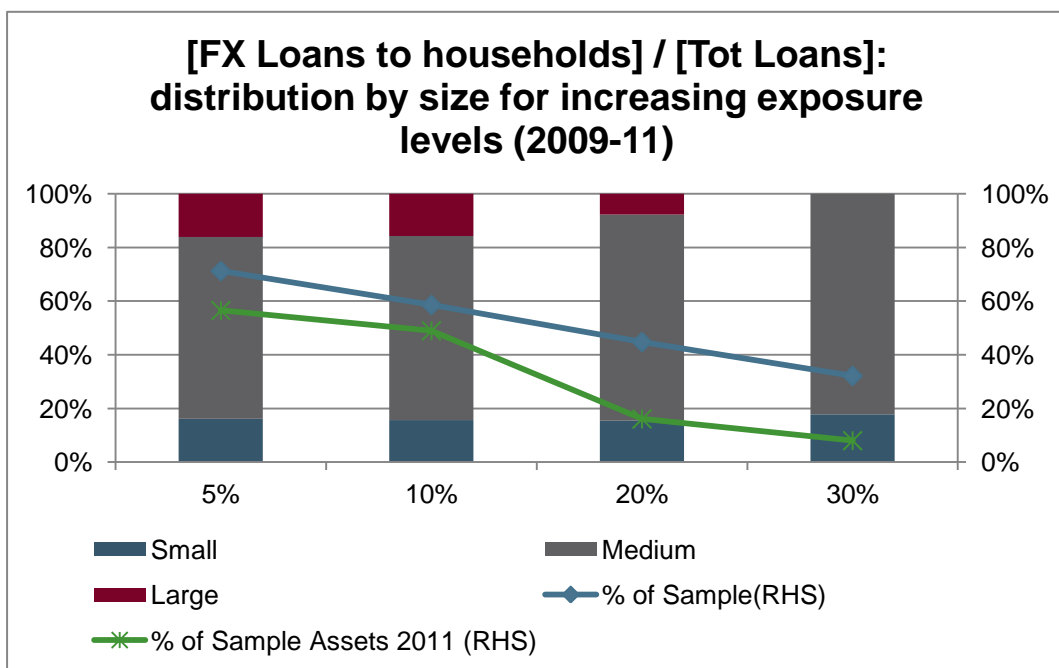


Table 1

	FX Loans to Households / Total Loans (2009-2011)			
	5%	10%	20%	30%
% of institutions within this threshold:	70%	60%	45%	30%
% of total assets within this threshold:	56%	49%	16%	8%
Breakdown by size:				
Small institutions	16%	16%	15%	18%
Medium institutions	81%	80%	85%	82%
Large institutions	3%	4%	0%	0%

Chart 2 – Threshold 2

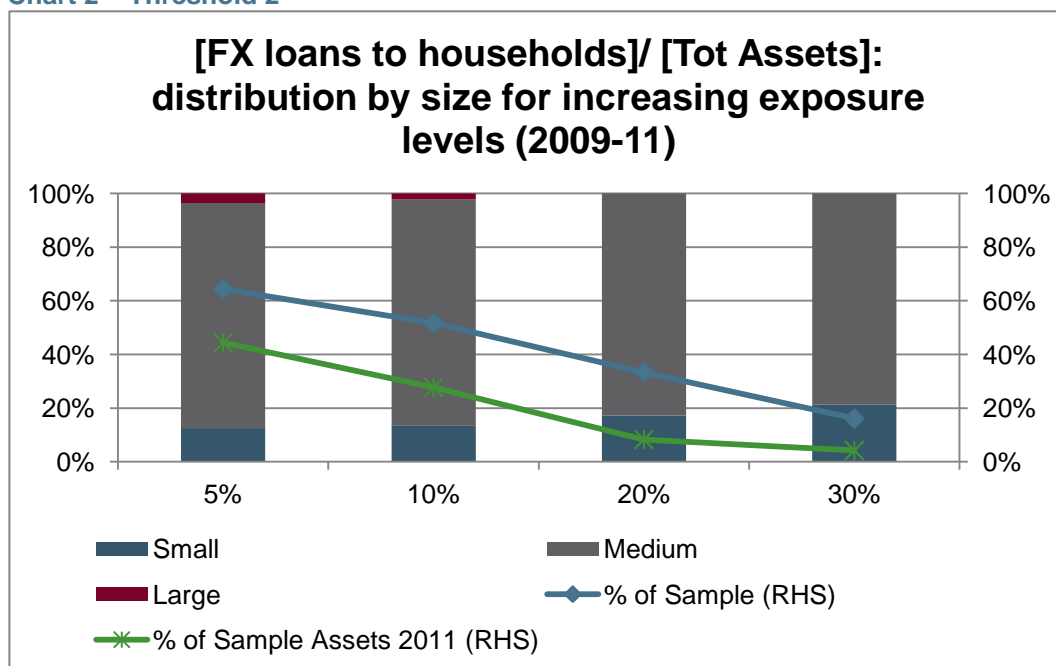


Table 2

	FX Loans to Households / Total Assets (2009-2011)			
	5%	10%	20%	30%
% of institutions within the threshold:	64%	52%	33%	16%
% of total assets within the threshold:	44%	28%	8%	4%
Breakdown by size:				
Small institutions	13%	13%	17%	21%
Medium institutions	84%	84%	83%	79%
Large institutions	4%	2%	0%	0%

53. The ratio (total loans)/(total assets), which represents the importance of lending activities in the business model of the institution, is particularly high for all institutions in the sample. On average data for years 2009-2011, only one in 86 institutions has a (total loans)/(total assets) value of less than 30%, with the lowest quartile of the sample being approximately between 30% and 53% and the median institution at 65%. This result implies that:

- a. the (total loans)/(total assets) condition of Threshold 1 is always satisfied (i.e. always binds) for the institutions in the sample;
- b. the scope of application, with respect to the sample, resulting from Threshold 1 can be fully represented by the exposure levels as measured by the ratio of (total FX loans to households)/(total loans).

54. The FX lending exposures in the sample, as measured by both metrics in Threshold 1 and Threshold 2 are such that the proportion of small institutions falling within the thresholds rises slightly for increasing levels of exposure. This is because when the exposure is 30% or 20% in Thresholds 1 and 2 respectively, there are no large, and mostly consolidated, entities in the sample, meaning that for those levels of exposure, consolidated entities are no longer captured by the thresholds. However, the proportion of small institutions falling under each of the exposure levels appears to be relatively stable (between 15% and 18% under Threshold 1 and between 13% and 21% under Threshold 2), with no exposure 'bucket' being characterised by a particularly large or small presence of small institutions.

55. **Proposed threshold:** The draft guidelines propose identifying material FX lending risk exposures via Threshold 1. According to the data collection exercise carried out for the purposes of an IA, an exposure level measured by the ratio of (total FX loans to unhedged borrowers) / (total loans) at least equal to 10% captures 60% of the institutions in the sample and brings approximately 50% of the total assets held by the institutions in the sample under the guidelines. The second condition in Threshold 1, checking that the ratio of (total loans)/(total assets) is at least equal to 25%, is put forward to ensure that those institutions that have a minor role in lending activities (according to their business model) can be excluded from application of the guidelines even in cases where the loan books of those institutions feature high proportions of exposures denominated in foreign currencies.

Expected costs and benefits

56. The benefits associated with the proposed draft guidelines relate to achieving the regulatory objectives mentioned above in this IA (see 'Objectives of the guidelines'). Such benefits cannot be quantified in this IA as they relate to foregone losses that would have been incurred both at the

level of the macro-economy and the individual institutions, were institutions not adequately risk managed and protected by specific regulatory capital for FX lending, and were the formation of FX lending credit bubbles not addressed by micro-prudential regulation. The analysis presented by the ESRB¹⁴ on the potential consequences of exchange rate movements on mortgage borrowers' debt servicing capacity and on the relationship between exchange rate dynamics and the historical performance of FX lending in a set of EU Member States provided some quantitative evidence about the nature of the micro-prudential risks.

57. As stated in the 'Baseline' section, there is no detailed data on the extent to which most of the risk management practices (e.g. FX risk assessment on borrower's profile at loan underwriting, ongoing monitoring of 'hedge status' of the borrower, FX specific stress testing at portfolio level, etc.) and governance practices proposed by the guidelines are currently implemented in the supervisory practices of competent authorities. In order to comply with those practices, among those proposed in the guidelines, which are not currently being required in their jurisdictions, institutions under the scope of FX lending specific supervision are expected to incur both one-off and on-going compliance costs. The overall level of such costs, however, is not expected to be comparable, in terms of magnitude, with the foregone losses associated with enhanced financial stability and reduced systemic risk.

4.1.2 Further impact assessment of the proposed capital add-ons

58. The proposed guidelines may result in increased capital requirements for some of the institutions exposed to material levels of FX lending risk, to the extent that the current levels of regulatory capital held against FX lending risk are deemed insufficient by the competent authorities following the SREP for FX lending risk. Given the contingent nature of such capital compliance costs, the estimation of the latter was not an initial objective of this IA analysis. Nonetheless, following a call for further IA analysis on the capital add-ons to understand what the quantitative impact might be, the EBA undertook the following analysis to estimate the potential regulatory capital effects of the proposed capital add-ons.

59. Competent authorities were required to provide two different inputs for the same sample of banks that were involved in the IA for the purposes of establishing FX lending exposure thresholds (see above):

- a. a score on the scale from 1 to 4 based on the assessment of the individual institution's FX lending risk to unhedged borrowers against the criteria proposed in the draft guidelines; and
- b. an indication on whether or not, following the assessment of the individual institution against the criteria proposed in the draft guidelines, a capital add-on would be imposed on the institution which would specifically address this type of FX lending risk.

¹⁴ See report on lending in foreign currencies accompanying the Recommendations of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (ESRB/2011/1). (OJ C 342/1, 22.11.2011).

60. Responses to the above requests were mixed;

- ▶ two out of ten competent authorities did not provide any scores for the banks in the sample that are under their jurisdictions (15¹⁵ banks overall); while
- ▶ four out of ten authorities provided scores for their institutions which explicitly result from the assessment of each institution against the FX lending risk management criteria proposed in the draft guidelines; and
- ▶ the remaining four competent authorities provided scores for their institutions which reflect the 2011 assessment of credit risk in the overall SREP framework, taking into account the FX lending risk profile of the institution according to jurisdiction specific criteria, not necessarily mirroring the proposed provisions of these guidelines.

61. Excluding from the sample all the institutions for which no score was made available by the two competent authorities, 72 out of 87 institutions were included in the estimate of the potential impact on regulatory capital of the proposed capital measures.

62. As can be seen from the distribution of the scores, among the 72 institutions for which a score was made available, more than 60% of the institutions in the sample scored 2 or below and fewer than 10% of the institutions in the sample were assigned 4, the most severe score:

Table 3

Scores	No of institutions	% of total scored institutions
1	19	26%
2	26	36%
3	22	31%
4	5	7%

63. Among these, only those institutions were used for which the competent authorities flagged the need for FX lending risk capital add-ons. This is because the guidelines do not automatically require a capital add-on but they allow the competent authority to decide whether a capital add-on is the most appropriate measure to take or whether another measure listed under Article 104 (1) of the CRD is more suitable.

64. Only 35 out of the 72 scored institutions (49%) were flagged by competent authorities as requiring an FX lending risk capital add-on. A further 10 institutions belonged to a jurisdiction that explicitly imposes an additional Pillar 1 type of risk-weight on the FX lending portfolio and therefore considered that no further add-on was required.

¹⁵There were twelve from the two authorities and a further two from another authority.

65. The capital add-on attributed to each of the 35 institutions was computed based on the score provided and following the formulae and the add-on bands proposed in the draft guidelines¹⁶. The resulting aggregate capital add-on for FX lending risk in the sample was computed under three different assumptions, as follows:

- a. Each institution required to have a capital add-on was assigned the minimum capital add-on percentage within the add-on band corresponding to the risk management score it received.
- b. Each institution required to have a capital add-on was assigned the maximum capital add-on percentage within the add-on band associated to the risk management score it received.
- c. Each institution required to have a capital add-on was assigned the mid capital add-on percentage within the add-on band associated to the risk management score it received.

66. The % capital add-ons attributed under each score are summarised in the table below:

Table 4

Scores	Lower band add-on	Upper band add-on	Mid band add-on
1	0.0%	25.0%	12.5%
2	25.1%	50.0%	37.6%
3	50.1%	75.0%	62.6%
4	75.1%	100.0%	87.6%

67. The estimated aggregate costs for all 35 institutions requiring an add-on under the three different (a), (b) and (c) scenarios, are reported in Table 5, while Table 6 shows the range of capital add-ons for each score:

Table 5

Scenario	Aggregate capital costs for the 35 institutions EUR m(rounded)
Minimum additional own funds requirements in the relevant band	4 600
Mid additional own funds requirements in the relevant band	6 600
Maximum additional own funds requirements in the relevant band	8 600

¹⁶ See Title II, Section 3 of the guidelines.

Table 6

	EUR m
SCORE 1	
Lowest	0
Highest	424
SCORE 2	
Lowest	0.6
Highest	2120
SCORE 3	
Lowest	1
Highest	454
SCORE 4	
Lowest	4
Highest (calculated at 100%, although this can be any number)	127

68. In conclusion, whether the additional capital requirements imputed to institutions against FX lending risk will result in a capital shortfall and hence in the need to raise additional capital depends on the current levels of capitalisation of the banks in the sample, which was not disclosed for the purposes of this IA. Nonetheless, of the 87 institutions in this sample there would be a capital impact on only 35 (approximately 40%). This is significant in that it demonstrates that by no means all institutions would be subject to capital costs following the implementation of the guidelines, since the capital impact for 60% of institutions in this sample is zero.

69. Where capital requirement is imposed however, the additional requirements range from a total of EUR 4.6 billion to EUR 8.6 billion for the 35 institutions. This IA also illustrated that four out of ten institutions have already implemented the provisions of these guidelines for assessing FX lending risk which is a positive sign for future implementation and compliance.

70. The figures in Table 6 also demonstrate the wide range of possible outcomes per score given the flexibility from the range of percentages for each score.

4.2 Views of the Banking Stakeholder Group (BSG)

No comments were received from the Banking Stakeholder Group.

4.3 Feedback on the public consultation

The EBA publicly consulted on the draft proposal contained in this paper.

The consultation period lasted for three months and ended on 23 August 2013. Nine responses were received, of which eight were published on the EBA website.

This paper presents a summary of the key points and other comments arising from the consultation, the analysis and discussion triggered by these comments and the actions taken to address them if deemed necessary.

In many cases, several industry bodies made similar comments. In such cases, the comments and EBA analysis are included in the section of this paper where EBA considers them most appropriate.

Changes to the draft guidelines were made as a result of the responses received during the public consultation.

Summary of key issues and the EBA's response

In total, nine responses were received, one asked not to be published but the remainder were published on the EBA website.

On the whole, the comments welcomed the guidelines and the efforts to harmonise supervisory practices for this risk, noting the ESRB initiative to address systemic risk associated with FX lending. The framework of the guidelines was well received, particularly the use of the materiality threshold to identify whether the guidelines would be applicable, as this promotes a proportional approach to application.

The majority of comments focus on requesting clarification about the scope of the guidelines, in particular, the definition of unhedged borrowers. It is clear that so far it has not been easy to identify the unhedged borrowers mentioned in the title, and comments from the public consultation indicated that institutions believed the scope to be broader than desired. It was felt that noting in the 'Executive summary' and 'Background and rationale' that the term 'unhedged borrowers' tends to refer to 'retail and SME borrowers' was insufficient to indicate that this FX lending risk is a major concern, and that a driving force for these guidelines was in fact the FX lending to non-financial private sector. The guidelines were amended to limit their scope to unhedged retail and SME borrowers, thereby specifically excluding large corporations.

Similarly, more concrete definitions were requested for FX lending and FX lending risk, these were deemed reasonable and amendments to provide clarification were made. Comments requesting

recognition of the proposed ITS on closely correlated currencies were also taken into account in the guidelines.

Another point causing comment was the use of additional own funds requirements; there was a misunderstanding that capital add-ons are systematically required for this risk. This is clarified in paragraph 26 which says that competent authorities should apply the most appropriate measures if deficiencies have been identified and if additional own funds requirements are deemed appropriate then these guidelines specify how to apply this measure. This approach is also clarified in the 'Executive summary' and paragraph 4 of the guidelines.

Finally, a number of comments were deemed beyond the EBA's mandate, for example, requesting details on how an institution should check a hedge with another institution, and specifying application of other measures for the purpose of FX lending risk. As the EBA's mandate is to address guidelines to competent authorities and to propose guidelines on capital measures under the SREP process the guidelines did not address these comments.

Summary of responses to the consultation and the EBA's analysis

	Comments	Summary of responses received	EBA analysis	Amendments to the proposals
General comments				
1	Definition of unhedged borrowers	<p>Please give a more precise definition of both hedged and unhedged borrowers. The current definition is not clarified by the proxy definition and a clearer definition is required in the context of transaction criteria with hedged transactions that are excluded from the scope of the guidelines.</p> <p>The guidelines should distinguish between retail and business clients more clearly, clarifying that for the purposes of these guidelines we are not focusing on corporates. One suggestion is to narrow the scope of the definition of unhedged borrowers to individual retail clients as defined by MiFID. Make the scope of application clearer in the guidelines with a specific carve out for large corporate clients and counterparties, international companies with subsidiaries in various countries as well as funding transactions in different foreign currencies should be classed as hedged.</p> <p>A clear definition should also address the fact that larger companies' or sophisticated clients' loans in different currencies may be bundled together and risks hedged through other products making it hard to segregate the FX hedging effect of lending products from a clients overall portfolio FX risk.</p>	<p>The definition of unhedged is designed to specify how to identify an unhedged borrower, not to specify hedged transactions that are excluded from the scope of the guidelines. The scope has been amended to clarify that in line with the ESRB report on FX lending, the guidelines recognise that the risk tends to derive from FX lending to unhedged borrowers who tend to be retail and SME customers. The guidelines now exclude large corporates based on the conclusion that they are hedged either through income or through an ability to manage the underlying risk and focus solely on unhedged retail and SME clients thus requesting an assessment of whether the retail and SME clients are hedged or not.</p> <p>Due to this narrowed scope on the retail and SME portfolio i.e. by categorically excluding large corporates, the guidelines no longer include the proxy, as this would be misleading.</p>	- This is in the Executive summary, Background and rationale in paragraph 2 of the guidelines and in paragraph 3 – definition of 'unhedged borrowers'.
2	Hedging status in the definition of unhedged	The definition of 'unhedged borrower' should also specify how one bank can check the extent of a borrower's financial hedge with other financial institutions. The guidelines should avoid	The guidelines are addressed to competent authorities and therefore will not specify internal processes for banks. The guidelines	No change

	borrowers	<p>making it a condition of a FX loan that a borrower has in place a demonstrable hedge as this may lead to the borrower without a natural hedge taking out a complex product that may not necessarily be suitable for the borrower.</p> <p>To address the concern that individual financial hedging products might be sold to unhedged retail and SME borrowers for which products may not be suited the EBA could instead focus on there being a hedge at bank level (e.g. against the whole exposure book) and also seek to ensure that any suitability rules pertaining to such products are strengthened.</p> <p>The definition of natural hedge is considered to be oversimplified and does not consider households where one person takes a loan in a foreign currency and the other person receives income in the other currency. In this case the suggestion is to exclude from the definition of unhedged borrowers, borrowers who receive most of their income in the foreign currency (this should be considered as hedged) i.e. is the extent of the natural and/or financial hedge of the borrower of any relevance in the categorisation of an unhedged borrower?</p>	<p>categorically do not require a borrower to have a demonstrable hedge in place but instead require competent authorities to ensure that banks are sufficiently capitalised using the SREP methodology to mitigate risks stemming from FX lending to unhedged borrowers. The guidelines also require a review of an institution's risk related processes but do not give guidance on the suitability rules that an institution has in place as this is outside the scope of the guidelines.</p> <p>For the example given in the comment where one person in a household/couple takes a loan and the other receives income in the foreign currency, the borrower is considered unhedged and this is indeed in line with the guideline interpretation. However, in terms of the extent of the hedge, no specification was deemed necessary for the guidelines.</p>	
3	Definition of FX	<p>The current definition states that this is the currency other than the legal tender of the Member States in which the borrower is domiciled which limits these guidelines to borrowers domiciled in the EEA. While this addresses consumer protection in the EU it does not take into account cross-border spill over effects.</p>	<p>The definition of FX was too narrow and did not take into account lending to borrowers living outside the Member States. The guidelines apply to competent authorities and the entities they supervise in those Member States regardless of where the borrower is domiciled.</p>	<p>Paragraph 3 – definition of 'FX'</p>

4	Definition of FX lending	<p>Please narrow the definition of all FX lending; it should exclude secured lending and lending for investment purposes. By referring to the purpose of the foreign currency loan this will refine the coverage of the guidelines.</p> <p>Make clear also that the guidelines do not refer to a broad definition of lending in the sense of any kind of exposure but in the sense of granting credits/loans for its own accounts (Article 4 of the CRD. This would then exclude deposits held at other credit institutions.</p>	<p>It is not the intention of these guidelines to specify the purpose of the loan but the definition of FX lending will be made clearer.</p> <p>If secured lending is considered a hedge for the borrower then the borrower will not be considered unhedged for the purposes of the guidelines. Lending for investment purposes will also be treated in the same way.</p>	Paragraph 3 – Definition of ‘FX lending’
5	Definition of FX and FX lending	<p>Define FX lending risk as a mismatch of the loan currency and the currency of the hedge. This is more definitive than the current definition which does not take into account cross-border commuters.</p>	<p>The definitions of ‘FX’ and ‘FX lending’ do not take into account the hedged status of the borrower but the definition of unhedged borrower does address the currency mismatch. The definition of ‘unhedged borrowers’ addresses loans to cross-border commuters as they will be considered as having a natural hedge.</p>	Paragraph 3 - Definition of ‘unhedged borrower’
6	Materiality threshold	<p>Ensure that this is simple by using more defined definitions, as without precise definitions, it is considered to be costly to implement for both institutions and competent authorities.</p> <p>Request for clarification on the conditions of application of the threshold e.g. cut-off date, also should the complete FX exposure of a partially hedged borrower be regarded as an FX loan to an unhedged borrower, or is the exposure calculated on a pro-rata basis. Leave to the discretion of the institution.</p> <p>The materiality threshold is defined on an institution basis, and then the guidelines are mainly defined on a currency basis, therefore it would be helpful if the threshold was also on currency level so that the guidelines apply only for those</p>	<p>The definition of unhedged borrowers has been refined.</p> <p>There is no cut-off date specified as this is dependent on the SREP process of each competent authority, however some clarification is now provided. The level of hedge in comparison to the loan will not be specified in the guidelines.</p> <p>The guidelines apply for FX lending risk; the requirements on the currency basis are for the purpose of identifying the risk and the risk</p>	<p>Definitions in Paragraph 3</p> <p>Footnote 9</p>

		<p>currencies where the materiality threshold is met by the individual institution.</p> <p>Additionally, the materiality threshold is set as a percentage of an institution's total loan book (total loans to non-financial corps and households) whereas, in the formula for calculating the capital add-on, reference is made to the proportion of the Pillar 1 capital requirement for credit risk which implicitly refers to the whole loan book. This means that the proportions are not consistent with each other.</p>	<p>management in place. The materiality threshold is for the purpose of identifying a quantitative cut-off for applying the guidelines. Pillar 1 credit risk for the institution is a minimum capital requirement which is used as a basis for this calculation, therefore we do not need to provide a change.</p>	
7	Use of the proxy for unhedged borrowers	<p>By using the proxy there is a residual risk of underestimation as it may be expected that also a portion of lending to non-financial corporations (e.g. small and medium-sized companies, local municipalities) may also be unhedged and therefore trigger sizeable exchange rate risks.</p> <p>Use the proxy to determine the overall unhedged lending activity to all borrowers but the guidelines should include a system of incentives to ensure that credit institutions rely less on such a proxy concept and increasingly collect real information on their overall level of lending to unhedged borrowers. Therefore request that the guidelines emphasise that institutions adequately reflect material risks stemming from FX lending to unhedged borrowers in their ICAAP.</p>	<p>Due to the focus on unhedged retail and SME borrowers, the use of the proxy has been removed.</p>	Deletion
8	Application of Threshold	<p>Remove flexibility afforded to competent authorities to apply the guidelines to an institution which does not meet the materiality threshold as this is not considered to be in line with European harmonisation and the EBA's efforts to harmonise</p>	<p>The intention of this provision is not for competent authorities to apply this to any institution regardless of any other criteria but that competent authorities may apply this to</p>	Paragraph 10 – Materiality threshold - The criteria are also

		<p>supervisory practices. It also opens the door to unlimited discretionary interpretations by supervisors who can override the objective criterion rendering the threshold void. This may also create the risk that institutions face multiplication of local standards with respect to FX lending risk.</p> <p>Refine this discretionary provision by:</p> <ul style="list-style-type: none"> - providing an indicative list of macro and/or micro economic criteria (e.g. Significant increase of institution's FX lending over a relevant period of time; negative trend of FX rate or constraining FX regime of the domestic currency against significant foreign currencies in which institution's loans are denominated) which could lead to the application of the guidelines despite the fact that the materiality threshold is not met; - requesting competent authorities formally to justify any decision to override the materiality threshold, on the basis of the criteria suggested above (or for other reasons which would need to be specifically documented). 	<p>institutions that may fall just below the threshold or based on the fact that the risk is considered to be material. It is not considered likely that an institution will face multiplication of local standards as the same competent authority applying the guidelines will, according to the guidelines, also need to take into account macro-prudential measures.</p> <p>To avoid misuse of the discretion afforded to competent authorities, the request to provide justification is deemed to be a valuable compromise; this has therefore been amended.</p>	<p>included as guidance.</p>
9	Clarification of paragraph 10 (now paragraph 12)	<p>Define explicitly the categories in paragraph 10 (type of exchange rate regime, institution's FX lending risk related processes and the impact of exchange rate movements) and state explicitly which currencies fall into these categories.</p> <p>Clarify in paragraph 10 that credit institutions should fully understand the impact of the foreign exchange rate regime on effective real exchange risk i.e. not rely purely on a <i>de jure</i> classification of exchange rate developments.</p>	<p>We do not consider that there is any further need for defining the categories.</p> <p>The intention is that competent authorities ensure that institutions have a sound understanding of the real exchange risk, therefore this has been clarified.</p>	<p>Paragraph 12-second bullet on 'Type of exchange rate regime'</p>

10	Periodical review of hedging status of borrowers	Clarify this as it may cause disproportionate efforts and is not deemed to be feasible in many cases. Suggest limiting the review of the hedging status to loans exceeding a certain tenor (e.g. 10 years).	The intention is for the review to be periodic i.e. how often the review needs to be done is subjective, thus leaving flexibility to the competent authorities and institutions to agree on what is appropriate.	No change
11	Closely correlated currencies	<p>Closely correlated currencies, as defined in Article 354 of the CRD, should be exempt from the definition FX and FX lending. It is not considered that there is an FX risk if a currency is subject to a legally binding intergovernmental agreement to limit its variation relative to other currencies covered by the same agreement as then adverse exchange rate movements cannot take place.</p> <p>The EBA should state explicitly which currencies fall into this category.</p> <p>Paragraph 10 should also make reference to closely related currencies.</p> <p>Closely related currencies should comprise at least the relations of currencies to the euro and extended to those currencies where official currency boards or managed currency systems exist.</p>	<p>We consider that it would be factually incorrect to exempt closely correlated currencies from the definition of 'FX' and 'FX lending' however closely correlated currencies are now taken into account in both the executive summary and the guidelines.</p> <p>The draft ITS on closely correlated currencies explicitly state which currencies fall into this category and this will not be repeated in these guidelines. It should be noted that the list of these currencies will be updated annually.</p> <p>Paragraph 9 is now clarified with this reference (it was considered that a reference in paragraph 9 would better ensure the reference to closely correlated currencies throughout).</p> <p>These guidelines will not address which currencies fall under the category 'closely correlated currencies' as this is specified in the proposed ITS.</p>	Executive summary and paragraph 9
12	Reference to reputational and legal risks	Delete this sentence as these risks are already covered in the ICAAP, therefore this sentence adds no value.	The intention was to highlight these risks, however we understand that no value has been added and therefore this has been deleted.	Line was deleted from guidelines.

13	Paragraph 15	Strengthen the wording by stressing that one of the main supervisory tasks is to assess whether institutions cover these risks in their ICAAP and whether institutions provide a reasoned assessment of capital levels.	We agree that this should be strengthened and have reflected this in the guidelines.	Paragraph 16
14	Banks with advanced models for credit risk	Take into account the fact that supervisors can assess if the additional risk generated by the FX lending is correctly dealt with in the banks' internal models.	We agree that this should be highlighted and have reflected this in the guidelines.	Paragraph 18
15	Avoid duplication of current credit and market risk assessment processes	Avoid requiring supervisors to duplicate credit and market risk assessment processes for FX lending.	The intention of the guidelines is to focus specifically on the non-linear relationship between market and credit risk. This is defined in the executive summary, paragraph 3, and paragraph 14 also highlights this.	No change.
16	Requirement for institutions	Where the institution provides an unsecured FX loan to a retail client, suggest including a requirement for the institution to present a sensitivity analysis relating to currency movements to the client associated with the unsecured loan and restating the value of the loan in the base currency of the client.	The guidelines provide for sensitivity analyses in the shape of stress tests in Title II, Section 4.1 and in paragraph 12 (3rd bullet). The guidelines also allow the competent authorities to review the tests carried out and to make recommendations on what they deem appropriate.	No change.
17	SREP assessment of capital	<p>Allow institutions to assess the capital add-on before they apply</p> <p>Competent authorities to justify when they consider that 'institutions do not hold capital which adequately covers FX lending risk' and for institutions to be given the opportunity to comment on this assessment.</p>	<p>The imposition of capital add-ons and other supervisory measures for FX lending risk will form part of the SREP and would follow the same process when dealing with communication with institutions.</p> <p>We agree that a justified decision would be of benefit and this is in line with the requirement for cross-border institutions in Article 113 of</p>	Paragraph 25

			the CRD, whereby a fully reasoned joint decision on capital must be communicated to the institution.	
18	Capital add-on multiplier	<p>Clarify how the criteria in the reference texts (Article 104 of the CRD and GL 39) are used by the competent authority to give scores and how these references can be interpreted for an institution.</p> <p>Clarify how proposed add-ons are calibrated as the approach seems to be quite arbitrary. Request for more transparent methodologies on how the add-ons are calibrated or to use statistical benchmarks to justify the calibration of the add-on multiplier.</p>	<p>GL 39 is referred to in the guidelines and should be referred to for the purpose of the risk scores. Such references will not be further explained in these guidelines.</p> <p>Such an explanation would not fit in the guidelines however it should be clarified that a number of options were considered for the add-ons and this approach was deemed the most appropriate for its flexibility but simultaneously driving harmonised supervisory practices. See also the IA on this.</p>	<p>No change</p> <p>No change</p>
19	Use of internal capital measures	A capital add-on can have a negative impact (bad sign to market participants) so suggest using the method of higher internal capital through internal models i.e. banks applying internal models can include additional capital add-ons in the process of capital planning.	This is not in the scope of these guidelines which are mandated to focus on the capital add-ons under SREP.	No change
20	Use of Capital measures as a 'macro prudential' measure	Please include the following wording at the end of Title II, Section 3: 'The approach of defining the capital add-on based on the SREP is appropriate for calculating institution-specific capital add-ons. This approach should however be without prejudice of competent or designated authorities using Pillar 2 in the context of Articles 103 and 104 of the CRD, namely in what concerns institutions with similar risk profiles or which might be exposed to similar risks or pose similar risks to the financial system, which may warrant higher levels of capital add-ons implemented throughout the system.'	We agree with the use of SREP for this purpose and have included this paragraph in the guidelines.	Paragraph 28

		This wording emphasises that the supervisor can still react in a way they find appropriate for the whole system.		
21	Use of capital measures on unmitigated risk only.	<p>Ensure that the add-on for FX lending risk to unhedged borrowers is applied where there is unmitigated risk rather than just on the basis that the materiality threshold is met i.e. if this risk is effectively mitigated by other means then there should be supervisory discretion as to whether additional provisioning should be applied.</p> <p>Clarify that a high share of FX lending does not result in an application of additional own funds.</p>	<p>The guidelines do indeed specify that even where the materiality threshold is met, a capital add-on will only be applied if firstly deficiencies have been identified <u>and</u> other measures are not used. Paragraph 24 specifies that if deficiencies exist then competent authorities should apply the most appropriate measures; this does not imply capital measures. The guidelines have been amended to relax the add-ons where the capital measures are applied together with other supervisory actions.</p> <p>This has now been clarified in the executive summary and also in paragraph 4.</p>	<p>No change</p> <p>Paragraph 4 and executive summary</p>
22	Use of other measures for low risk	The current method tends to systematically and solely impose capital add-ons while other mitigation measures are only brought forward in the guidelines as part of the SREP expectations. As mitigation measures can be used particularly where the risk score is 1 (low), there is a request to enlarge the set of requirements resulting from the supervisory scores to the whole measures referred to in the guideline (e.g. strengthening internal processes for monitoring and controlling the risk) whereas institutions could be subject to capital add-ons according to a rearranged grid starting from risk score 2 (medium-low)).	<p>As explained above, the guidelines do not systematically and solely impose capital add-ons but the guidelines do provide detail just on capital add-ons in line with the ESRB Recommendation. This is the reason that paragraph 24 states that the most appropriate measures should be used, whereas paragraph 25 indicates the use of capital add-ons where deemed necessary. Paragraphs 4 and 8 also clarify this.</p> <p>Mitigation measures as outlined in Article 104 of the CRD may be used for any score (see</p>	<p>Paragraph 4 and executive summary.</p> <p>Clarified that when additional</p>

			paragraph 24) and the guidelines do not automatically require a capital add-on. The capital add-on percentage ranges are to be used only when the competent authorities deem a capital add-on to be necessary.	own funds requirements are used in combination with other supervisory measures then the percentages should be used as indicators only. Paragraph 26.
23	Implementation	Borrowers are usually expected to show that they have sufficient matched currency income streams to meet their foreign currency obligations. These details are held on an individual level and not an aggregate level therefore systems development may be required in order that an aggregate view can be taken to review against the proposed materiality threshold. The EBA is encouraged to engage with industry regarding the implementation timing of the guidelines. Credit institutions have not yet implemented any technical features for identifying hedged/unhedged borrowers. Please review whether IT implementation of this feature is necessary. There may be a large implementation burden which has not been considered.	The implementation of the guidelines is for competent authorities. Title III of the guidelines currently foresees a 6-month timeframe to implement. Four out of ten competent authorities have already implemented the methodology (see IA). As above, we understand that implementation may require a longer period of time and have tried to address this in footnote 6.	Title III
24	Application of guidelines	Please can the guidelines specify that they only apply to new FX lending contracts.	The guidelines focus on the stock of the FX loans in an institution and the FX lending risk measured as a result. New lending is not in line with the ESRB mandate. These guidelines	No change.

			do not target the process of issuing new loans but rather risks existing in the credit portfolio.	
25	Status of the guidelines	The guidelines should state that local minimum standards should be very closely aligned to the EBA guidelines to ensure there is uniform application.	Part 3 of this document contains a paragraph entitled 'Status of the guidelines', which states clearly that competent authorities must make every effort to comply with the guidelines. This is standard EBA text for guidelines.	No change.
26	Request for correction on page 20, paragraph 46.	Check as the information on size of banks does not appear in this paragraph.	This has been identified and corrected.	Paragraph 47

5. Confirmation of compliance with guidelines and recommendations

Date:

Member/EEA State:

Competent authority:

Guidelines/recommendations:

Name:

Position:

Telephone number:

E-mail address:

I am authorised to confirm compliance with the guidelines/recommendations on behalf of my competent authority: **Yes**

The competent authority complies or intends to comply with the guidelines and recommendations:

Yes **No** **Partial compliance**

My competent authority does not, and does not intend to, comply with the guidelines and recommendations for the following **reasons**¹⁷:

Details of the partial compliance and reasoning:

Please send this notification to compliance@eba.europa.eu¹⁸.

17 In cases of partial compliance, please include the extent of compliance and of non-compliance and provide the reasons for non-compliance for the respective subject matter areas.

18 Please note that other methods of communication of this confirmation of compliance, such as communication to a different e-mail address from the above, or by e-mail that does not contain the required form, shall not be accepted as valid.