



BANKING STAKEHOLDER GROUP

EBA DISCUSSION PAPER ON THE TREATMENT OF STRUCTURAL FX

Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP

London, September 22, 2017

The EBA Banking Stakeholder Group (BSG) welcomes the opportunity to comment on the EBA Discussion Paper on the Treatment of Structural FX (EBA/DP/2017/01).

This response has been prepared on the basis of comments circulated and shared among the BSG members. It outlines some general comments by the BSG, as well as our answers to the questions included in the Discussion Paper,

General comments

The BSG is of the opinion that historic cost instruments should not be included in the overall net foreign position and hence supports the alternative view as outlined in Paragraph 22 of the Discussion Paper.

Limiting the size of the structural position to the minimal capital requirements is not considering the increasing importance that competent authorities put on capital buffers as well as their increased volumes.

In addition the provisions in Article 352 CRR are deemed as appropriate and the opportunity should be used to clarify the ambiguous wording between Article 325c (1a) and 325c (2). In particular it is important that the bank is able to define the time horizon for the application. For a more detailed point of view on this, please see our response at Q9

Replies to Questions

Question 1. What is your current practice regarding the treatment of FX non-monetary items held at the historic FX? In particular, do you include these items in the overall net foreign exchange position pursuant to Article 352 CRR? If you include them, what value (i.e. historic or last FX rate) do you use for the purpose of computing them? How do you manage such positions from an FX point of view?

The treatment as outlined in Paragraph 22 of the DP (“alternative view”) that historic cost instruments should not be included in the overall net foreign exchange position is supported.

In this case no regulatory exemption is required for such instruments. If a bank intends to hedge capital ratios instead of capital amounts the exemption should be granted to the positions that are taken as a hedge.

Investments in non-monetary items at historic costs are generally funded in the functional currency (EUR) and therefore there is no off-setting FX liability. They do not create any P/L volatility from FX movements and therefore do not impact the amount of own funds (held in functional currency) due to FX movements.

The Basel framework clearly states in 718(xxxix) that no capital charge is needed to be applied for long-term participations. Although the paragraph mentions the relation to structural positions in the last sentence this is not applicable in context to the CRR text. The CRR text relates to structural positions explicitly considered in the context of capital ratio protection. As stated above the reason for funding historic cost items is to protect capital amounts (by avoiding adverse effects in case of FX rate volatility) but not capital ratios.

On consolidated level these instruments give rise to translation risk: all assets and liabilities of the subsidiary are translated into the local currency of the parent institution on the consolidated financial statement using the exchange rate at the closing date of the period. This leads to volatility in the consolidated equity denominated in this currency but does not influence the P/L statement. The equity position denominated in foreign currency consists of paid-in capital, retained earnings and net-income of the current year. The paid-in capital and the retained earnings from previous year are translated into the local currency by using the historical exchange rate (i.e. the rate when the capital was paid in or historical yearly average exchange rate for retained earnings). Any difference between the historic/average rates and the current exchange rate at the date of consolidation is shown under the line "currency translation" in the consolidated total equity statement.

The effects on consolidated equity are typically covered in the Pillar 2 risk calculation.

Question 2. Do you share EBA's view that there is no clear risk justification for making the determination of the net FX position as well as of the structural FX exclusion dependent on the approach for the calculation of FX own funds requirements?

We agree with the EBA that there are no dependencies, ie the approach for the calculation of FX own funds requirements has no impact on the way the net FX position as well as the structural FX exclusion are determined.

When considering the determination of the net FX position as well as the structural FX exclusion the following aspects besides the risk justification need to be reflected:

For banks using internal models, the interaction with back-testing for the determination of overshootings is not clear. It is unclear if and how structural FX positions should be included into the (economic/actual) back-testing framework for the determination of the number of overshootings in the model. Inconsistencies between theoretical and actual back-testing created by the inclusion or exclusion of hypothetical positions need to be addressed.

Additionally it must be mentioned that the effect on own funds requirement can be very different depending on the approach. For banks with internal models for banking book FX exposure this exposure might be dominant and will distort the diversification benefits with other risk types in the trading book.

A single/dominant exposure in the internal model will be subject to significantly higher capital requirements due to the inclusion of VaR + SVaR , 10-day scaling, model multiplier.

Example:

- FX Internal Model for CZK Position = 24.7% $[(VaR_{10d} + SVaR_{10d}) * multiplier 3]$
- FX Standardized Approach = 8%

Question 3. Do you consider that the ‘structural nature’ wording in the CRR would limit the application of the structural FX provision to those items held in the banking book? Do you agree with the EBA’s view that the potential exclusion should only be acceptable for long FX positions? If you consider that it should be allowed for short positions, please provide rationale and examples.

To the extent that it can be demonstrated that a trading book FX position is of a “non-trading or structural nature”, it should be permissible to also include trading book FX positions. This is the case when trading book positions arise in a consolidated group level (the investment is replaced by all assets and liabilities of the subsidiary as part of the consolidation process) but relate to an investment in a subsidiary, a branch or even an operating entity whose part of the business in non-local currencies clearly is of a non-trading and structural nature, and there is clearly no trading intent with respect to this FX position.

Question 4. How should firms/regulators identify positions that are deliberately taken in order to hedge the capital ratio? What types of positions would this include? Do you consider that foreign exchange positions stemming from subsidiaries with a different

reporting currency can be seen (on a consolidated level) as ‘deliberately taken to hedge against the adverse effect of FX movements’? If yes, how do you argue that this is the case?

We believe that the concept “position deliberately taken” should be understood as a “net open position” maintained and that are coherent with the entity’s hedging strategy, policy and procedures, approved by the relevant bodies, with the permission by the competent authorities.

Yes, we do agree with paragraph 43. in the Discussion Paper and believe that “deliberately taken” is equivalent to “deliberately not closed”. The capital ratio of an institution that maintains its FX assets completely matched with FX liabilities is sensitive to movements in the foreign currency. In this vein, structural positions act as a hedge of the capital ratio as they totally or partially reduce its sensitivity to changes in the foreign exchange rate.

Question 5. Do you consider that the structural FX treatment could be applied to specific instruments instead of being understood as being applicable for ‘positions’? Taking into account the risk rationale of hedging the capital ratio, do you consider that it is acceptable to renounce to potential gains in order to protect the ratio from potential losses? Do you consider that both types of hedging (i.e. reducing the sensitivity of the ratio to movements of FX in both directions, or only if the movement produces losses) are acceptable from an economic perspective? If so, do you consider that both approaches would be acceptable under Article 352?

There should be no differentiation between positions and instruments. It’s relevant to note that the structural FX requirements do apply both at individual and consolidated basis. At the consolidated basis, once the elimination of the investment versus equity has taken place the assets/liabilities stemming from the subsidiary are integrated with the parent’s. In this regard, there is not a specific instrument, but there’re positions (assets, liabilities, derivatives) denominated in the foreign currency and that should be subject to structural FX calculations. Hedging should be understood of reducing sensitivity to both directions. Hedging instruments should be mainly simple/plain vanilla instruments like FX-Spot. Other instruments like options show time dependents effects (e.g. Delta) and would have to be constantly adjusted or renewed.

Question 6. If ‘structural FX’ is used conceptually internally within your organisation (e.g. in risk policies, capital policies, risk appetite frameworks etc.), how do you define the notion of ‘structural FX position’ and ‘structural hedge’? Please describe how any

ratio-hedging strategies are mandated within your organisation. Are ratio-hedging strategies prescribed in risk policies approved by the board? How do you communicate structural FX risk and position taking to your external stakeholders (e.g. in Pillar 3 reports, or reporting to regulators, investors, etc.)?

All the underlying instruments should be considered in the net FX structural position, whether managed in the trading book or in the banking book and irrespective of the booking (in a branch, in a subsidiary, at operating level or at holding level) or the accounting or the underlying instruments. The maximum structural FX position subject to exclusion is therefore the durable net assets that match the capital requirements.

The open structural FX position depends on a management choice. It is a long term choice with the objective to reduce the sensitivity of ratios to FX variations and it should be always possible to hedge structural FX sensitivities both with spot instrument and with derivatives, using the most adequate hedging strategy.

Question 7. Do you share the EBA's view that the maximum FX position that could be considered as structural should be the position that would ideally neutralise the sensitivity of the capital ratio to FX movements? Alternatively, in light of the reference to Article 92(1), do you consider that the size of the structural position should be limited by the minimum capital ratio levels? If this is the case, which one of the three levels established in Article 92(1) do you apply?

Banks can opt for different kind of strategies when dealing with the FX risk, the amount of the structural position to be excluded depends on the strategy followed in terms of the capital ratio. When the capital ratio is fully neutralized to movements in the foreign exchange risk, the amount to be excluded should be the maximum FX position that would ideally neutralise the sensitivity of the capital ratio to FX movements but when the ratio is not fully but partially neutralized, the amount to be excluded should be limited to the amount that would act as a hedge of the capital ratio, meaning partially reducing its sensitivity with no change in sign. The treatment described above is in line with the provisions in the Basel Accord that explicitly take account of this issue and the CRR text, that does not limit the exclusion to perfect hedges.

Ad 2nd question: It should not be limited by the minimum capital ratio. Limiting the size of the structural position to the minimal capital requirements is unduly restrictive since it doesn't take into account the various buffers (including Pillar 2).

The bank should be able to partially or fully protect its current overall capital requirement ratio. The strategy of the bank should be assessed by the competent authority in the decision-making process of the application.

Question 8. How do you assess the consolidated ratio? How does your treatment differ between subsidiaries and branches?

There is no substantial differences between branches, subsidiaries, operating or holding entities. When possible, the FX structural positions should be allocated across the various entities so as to maximize the efficiency of the hedge at consolidated, sub-consolidated or even solo levels.

Branches or operating entity whose part of the business in non-local currencies are treated the same way as (parent) bank positions

Question 9. What are your views on the CRR2 text of the structural FX article? What significant impacts might this have on your current hedging strategies?

The current article 352 is indeed sufficient.

The proposed amendments are too restrictive. And in addition, their wording is ambiguous since:

- according to 325c 1(a) (ii) "the exclusion is made for at least six month" whereas
- according to 325c 2 it shall "remain in place for the life of the assets".

The bank should be able to define the time horizon for the application (floored by e.g. 6 month to support the non-trading nature). The bank's policy should be assessed by the competent authority in the decision-making process of the application.

The application for structural hedges should not be restricted to affiliated entities and consolidated subsidiaries. Banks with significant RWAs from non-domestic currency assets on the solo level should be allowed to exclude structural hedges as the nature of FX-risk to capital ratio is the same as for investments in affiliated or consolidated entities and subsidiaries.

For banks that do not currently apply the structural FX provision, there is no immediate impact on hedging strategies.

Question 10. Do you agree with the analysis in the simplified assessment, from both an individual and a consolidated perspective, of the various elements discussed in this Annex of the DP or do you have any comments? In particular, do you have comments regarding the analysis of:

- the actual level of the capital ratio
- the effect of items deducted from capital / subject to a 1.250% RWA / subject to a 0% RWA
- the effect of items held at the historical FX rate?

The example related to Historic cost (2.1.6) is not realistic in our view. In the example it is assumed that FX assets at HC are funded in foreign currency. In practice the FX Assets at HC are funded in domestic currency to protect capital amounts by avoiding P/L fluctuations from open FX.

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Submitted on behalf of the EBA Banking Stakeholder Group

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