Just in Time

Structural FX (S-FX) Provision

EBA CP on the treatment of structural FX under 352(2) CRR

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ESSENTIAL SERVICES FOR FINANCIAL INSTITUTIONS

At a Glance

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Overview

Overview

Article 352(2) Regulation EU No 575/2013 (CRR)
'Any positions which an institution ***has deliberately taken in order to hedge*** *against the adverse effect of the exchange rate on its* ***ratios*** *in accordance with Article 92(1) may, subject to permission by the competent authorities, be excluded from the calculation of* ***net open currency positions****. Such positions shall be of a* ***non-trading or structural nature*** *and any variation of the terms of their exclusion, subject to separate permission by the competent authorities. The same treatment subject to the same conditions may be applied to positions which an institution has which relate to items that are already deducted in the calculation of own funds.'*

Various interpretations of the Article 352(2) across supervisory authorities and the industry

Increasing interest of banks in the application of structural FX exemptions

New treatment of Structural FX in FRTB (BCBS d457 - January 2019)

EBA/CP/2019/11 (October 2019): draft guidelines in order to ensure a harmonized EU interpretation and implementation of Structural FX (S-FX) provision contemplated in Article 352(2) → avoid regulatory arbitrage

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Timeline

Timeline

Jun 2013
EU Reg. 575/2013 (CRR)
Article 352(2) on calculation of the overall net foreign exchange position (FX position exemptions)

Dec 2017
EBA/DP/2017/01
EBA Discussion Paper on treatment of structural FX under Article 352(2) of the CRR

Jan 2019
BCBS d457
Last version of the minimum capital requirements for market risk (FRTB)

Oct 2019
EBA/CP/2019/11
Draft guidelines on the treatment of structural FX under 352(2) of the CRR (Consultation launch)

Jan 2020
EBA Consultation end

Jan 2021
EBA guidelines application from 01.01.2021

Draft Guidelines in the last EBA Consultation Paper (**EBA/CP/2019/11**) have been developed considering both the feedback of the industry on the 2017 Discussion Paper (EBA/DB/2017/01) and the new treatment of the structural FX in the 2019 version of the Fundamental Review of the Trading Book (FRTB - BCBS d457).

5 main points of the draft guidelines:

1. **Minimum requirements for FX position suitability**
2. **Clarifications around the structural FX provision**
3. **Governance and risk management strategy**
4. **Treatment of items at historical cost**
5. **Approval and review processes**

03

FX Positions Suitability

FX position suitability

Minimum requirements: if not fulfilled, position is not suitable for the exemption

Structural Nature

- **Non-trading nature** of the **instruments** from which the FX-risk positions stem from

  Consistent with FRTB definition

- As a consequence, **only FX positions stemming from banking book instruments** may be eligible
- FX positions are divided in **two categories**:
  - **Type A**: positions for which there is *presumption of a structural nature* (typically, **investments in subsidiaries**)
  - **Type B**: all the other positions, for which a deeper analysis to assess their structural nature is needed

Deliberately taken in order to hedge

- The purpose of the S-FX position is to **hedge a capital ratio**
- Accordingly, **only a net long FX position** could qualify for exemption (otherwise maintaining a net short position would generate numerator and denominator of the ratio moving in the opposite direction when foreign currency depreciates/appreciates)
- Depending on the level of application, various requirements are provided:
  - at *individual* level
  - at *consolidated* level (only if permission has been granted for all entities)

Hedging activity must be deliberately taken in order to **hedge against the adverse effect of the exchange rate** on the **ratios** defined in **Article 92(1)** of the CRR

CET1 Ratio | **Tier 1 Ratio** | **Total Capital Ratio**

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Clarifications on the S-FX Provisions

Clarifications around the structural FX provision 1/2

Maximum open position

CA Assessment

- The fulfilment of the minimum requirements does not mean that the position is automatically eligible for exemption
- Competent Authority (CA) are expected to assess:
  - if a FX position is of a structural nature and if it is taken (and maintained) to hedge the ratio
  - if the **application of the waiver** sent by financial institutions is consistent with the EBA requirements
- The **assessment of the CA** should lead to the **identification of the positions that are *eligible* for the exemption**

Even though permission has been granted for the exemption by the CA, a **maximum open position** (**MaxOP**) for each relevant currency is defined as ***the amount of FX-risk position that neutralizes the sensitivity of the capital ratio to movements in the exchange rate***.

For each relevant currency, MaxOP acts as a **cap** to the exemption:

- **Under-hedges:** *open position suitable for the exemption < MaxOP*
  → the entire open position can be excluded
- **Over-hedges:** *open position suitable for the exemption > MaxOP*
  → the entire open position cannot be excluded, only the size equal to the MaxOP

Clarifications around the structural FX provision 2/2

S-FX provision for more than one currency

Top 3 criteria

- Article 352(2) refers to the adverse effect of the exchange rate as the **exchange rate between the reporting currency and any other currency**
- EBA guidelines clarify that the exemption should be allowed only for **currencies that are relevant for the business of the bank**:
  - <u>Quantitative criteria</u> (*absolute threshold*): **Top-3 currencies** of the business of the bank are material, obtained by calculating the **first three largest net open positions** in accordance with Article 352(1), without considering any waiver. Other currencies might be included only if a justification of their materiality for the bank is provided
  - In addition, when calculating **the MaxOP for a specific currency**, <u>institutions should not consider any waiver</u> for positions in other currencies (even if already granted) to minimize the possibility of regulatory arbitrage

As part of the consultation EBA is asking financial institution to provide a *risk-sensitive measure* (in addition to the absolute threshold already provided) to assess the relevance of a currency in their business with respect to the following measures:

- **Measure A**: *% of the open position in the foreign currency with respect to the «open position» in the reporting currency*
- **Measure B:** *% of the open position in the foreign currency with respect to the total own funds of the institution*

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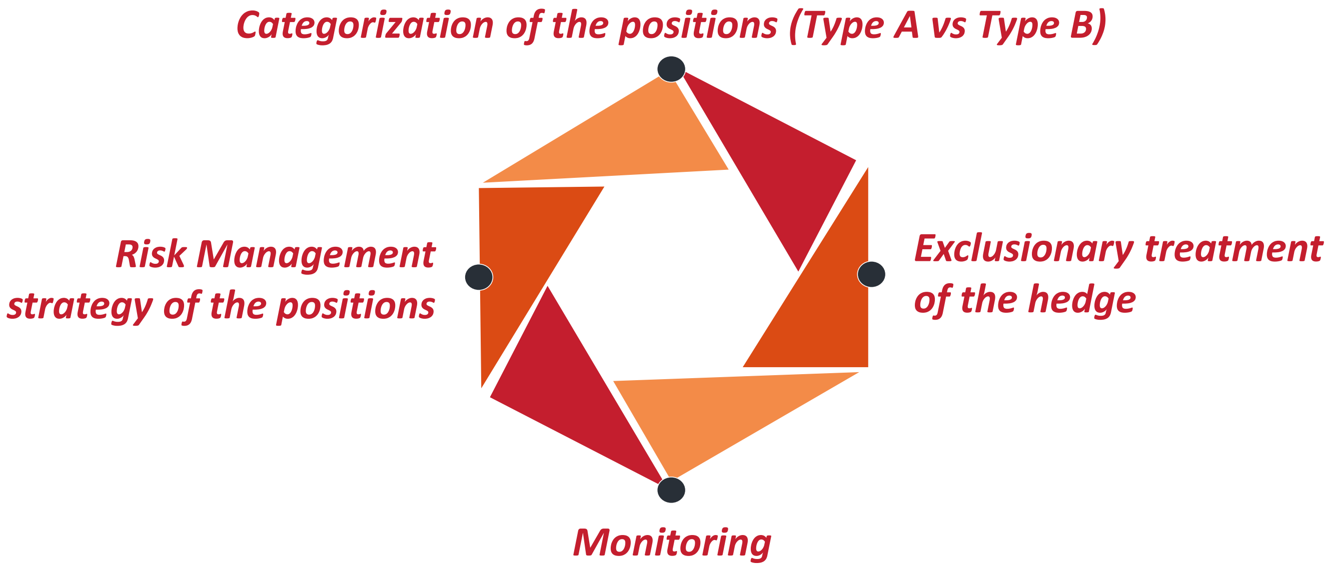
Governance and Risk Management Strategy

Governance and Risk Management strategy 1/4

Application phase

Application of the waiver

- **Governance requirements and Risk Management strategy** of the S-FX positions are expected to be the basis of CA assessment
- This basis should be formalized by the financial institution with an **application of the waiver** that specifies:
  - The **level** (or levels) at which the exemption is searched for (*individual* vs *consolidated* or both)
  - The **capital ratio** among the three in Article 92 to be hedged (with the justification of the choice)
  - The **currency** (or currencies) of the FX positions for which exemption is searched for



Governance and Risk Management strategy 2/4

Sensitivity and hedging strategy

Risk management strategy of the positions seeking for exemption

- The financial institution must provide the **business strategy** used for S-FX positions management, referring to the intentions of **hedging** the capital ratio
- In particular, the main focus is on:
  - the **definition** of the **target**, i.e. to keep into a **determined range** the **sensitivity** of the capital ratio against movements in the relevant exchange rate → *"stabilization" of the hedging*
  - the **strategy** in order to maintain stable the hedging and its **time-horizon** (at least **6 months**)

- EBA provides the formula to calculate the **sensitivity** of the capital ratio to FX-movements:

$$Sensitivity = \frac{S\_OP - MaxOP}{RWA_{NoFX\_FC}}$$

with

  - $S\_OP = \frac{V(1.01 * FX_{FC}) - V(FX_{FC})}{0.01 * FX_{FC}}$: the size of the net open position stemming from positions suitable for exemption (expressed in foreign ccy)
  - $MaxOP$: the maximum open position calculated with EBA methodology and expressed in foreign ccy
  - RWA_{NoFX_FC} : the risk-weighted assets amount calculated as prescribed by CRR and excluding the FX own fund requirements for the ccy subject to application of the waiver

- EBA also provides the formula to determine the **range** within which the sensitivity should be maintained:

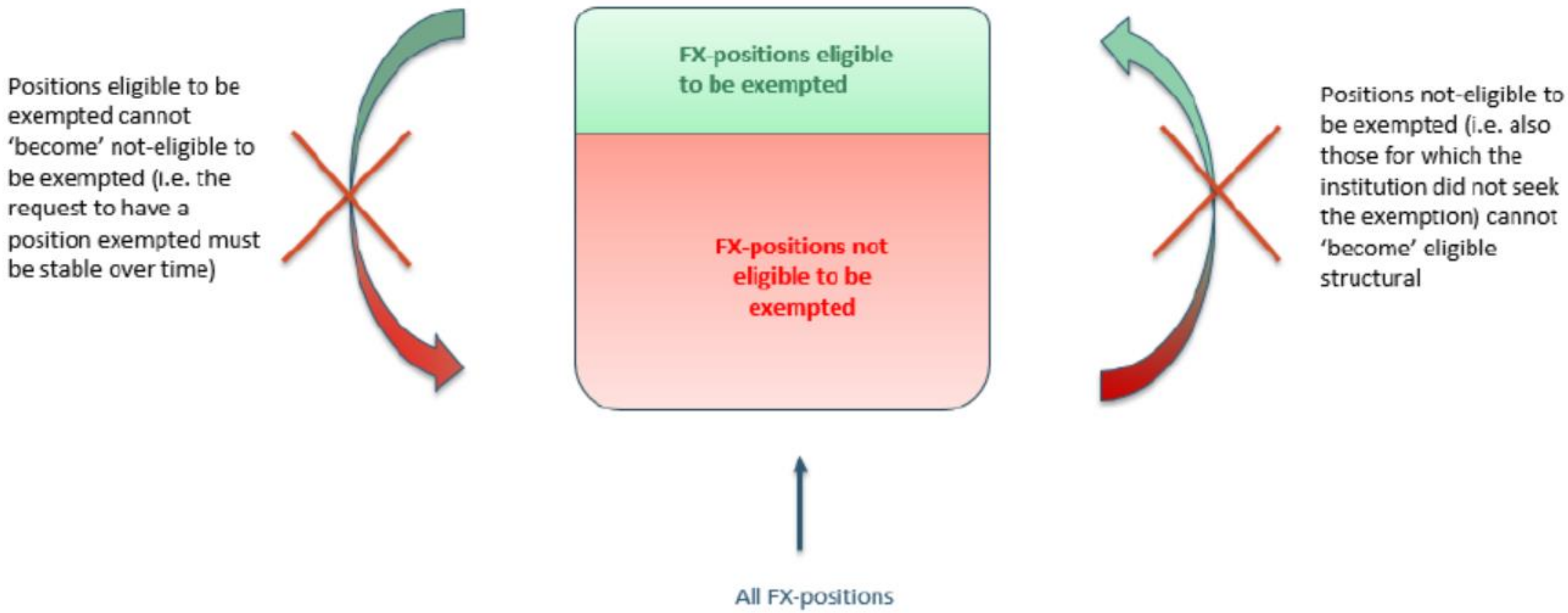
$$Sensitivity \in \left[Target - \frac{0.05 * S\_OP_{inception}}{RWA_{NoFX_{inception}}} ; Target + \frac{0.05 * S\_OP_{inception}}{RWA_{NoFX_{inception}}} \right]$$

Governance and Risk Management strategy 3/4

Exclusionary treatment of the hedge

Minimum requirements to avoid regulatory arbitrage

- Once exemption is granted:
  - financial institutions **cannot change the boundaries** defined in the FX positions categorization (Type A vs Type B)
  - financial institutions **cannot change the scope** of the positions for which they have performed application of waiver



Source: EBA/CP/2019/11 Consultation paper on structural FX guidelines

Governance and Risk Management strategy 4/4

Monitoring

Reporting and data requirements

- EBA guidelines introduce a **monitoring process** in order to force financial institutions to provide **on a monthly basis** an **overview** of the S-FX provision in a *template* format containing some essential information in terms of:
  - net open FX position in the currency previous to any exemption
  - the amount of positions that are not structural
  - the amount of positions that are suitable for the exemption and the amount of those that are not
  - the maximum open position
  - the open position that is excluded from the net open FX position following the permission of the CA
  - the sensitivity of the ratio
  - the economic gain/loss due to movements in FX rates of the open position
- These templates shall be provided **for each relevant currency** by the **end of each month**

EBA intends to include such reporting requirements in **COREP** by 2022 (in line with FRTB implementation deadline) in order to have **a more structured tool** also for **S-FX provisions reporting**

EBA suggests that essential information on S-FX provisions should be regularly reported to senior management within the institution as well

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Historical Cost Items

Historical cost items

Treatment of non-monetary items

- In accordance with Article 92(4) of the CRR, all trading book and banking book positions subject to FX risk of a financial institution are in scope for the calculation of own fund requirements for market risk, irrespective of their accounting treatment
- Exemptions may be derived only from the application of Article 352 of the CRR
- Accounting standards IAS 21 specify that **non-monetary items** should be booked at **historical cost** and translated in the reporting currency using the FX exchange rate at the date of the transaction
- However, sharp movement in the FX rate may generate a significant reduction in the item value generating **impairment loss**
- For a typical financial institution, participations in subsidiaries in the individual balance sheet as well as real estate items would be non-monetary items → *FX positions related to participations in foreign subsidiaries is a common Type A during positions categorization*

EBA does not *deliberately* provide any clarification on non-monetary items held at historical cost in the context of FX risk, leaving banks to assess them within SREP (ICAAP)

The only guidelines specify that non-monetary items held at historical costs:

- are included in the calculation of net open position for exemption
- are excluded from the comparison between the net open position and the MaxOP, due to their negligible effects in case of FX rate movements

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Approval and Review Processes

Approval and review processes

Just in Time

CA approval and change in the risk management strategy

- CA approval for exemption holds only in case the approved specifications remain unchanged
- In case a financial institution plans to change these already approved specifications, it must inform the CA immediately → *institution should not change any specification within the minimum 6 months period from which exemption is granted*
- Only CA can assess the relevance and the feasibility of the change
- The monitoring process defined by EBA guidelines should allow CA to identify misimplementation of the approved specifications or breaches in the risk management strategy to keep sensitivity within the predefined range
- Breaches may be due to:
  - The inability of the bank to actually put in practice the predefined risk strategy
  - The instability of some FX positions recognized as suitable for exemption
  - Relevant changes in the business model of the bank
- Based on the root of the breach, CA can:
  - Withdraw the permission
  - Allow the institution to remediate to the breach
  - Require to the institution a revision of the boundaries defining S-FX position in order to reduce the size of the net open position suitable for exemption

EBA guidelines specify that CA may intervene in permissions already granted regardless of the duration of the granted permission itself

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Company Profile

Iason is an international firm that consults Financial Institutions on Risk Management. Iason integrates deep industry knowledge with specialised expertise in Market, Liquidity, Funding, Credit and Counterparty Risk, in Organisational Set-Up and in Strategic Planning

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