Just in Time

Structural FX Provision

Final Guidelines (EBA/GL/2020/09) on the Treatment of Structural FX

Giacomo Vigo
Dante Carbone
Andrea Principe

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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/GL/2020/09 (1 July 2020): guidelines in order to ensure an 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

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Jun 2013	Dec 2017	Jan 2019	Oct 2019	Jul 2020	Jan 2022
EU Reg. 575/2013 (CRR)	**EBA/DP/ 2017/01**	**BCBS d457**	**EBA/CP/ 2019/11**	**EBA/GL/ 2020/09**	***EBA guidelines application from 01.01.2022***
Article 352(2) on calculation of the overall net foreign exchange position	*EBA Discussion Paper on the treatment of structural FX under Article 352(2) of the CRR*	*Last version of the minimum capital requirements for market risk (FRTB)*	*EBA Consultation paper on the treatment of structural FX under 352(2) of the CRR.*	*EBA Guidelines on the treatment of structural FX under 352(2) of the CRR*	

Guidelines (**EBA/GL/2020/09**), on the treatment of structural FX under 352(2) of the CRR, has been developed considering both the feedback of the industry on Discussion (EBA/DP/2017/01), Consultation Paper (EBA/CP/2019/11) and the new treatment of the structural FX in the 2019 version of the Fundamental Review of the Trading Book (FRTB - BCBS d457). Twenty-one respondents provided feedback on the consultation paper, EBA considered the feedback provided by all respondents in developing the final draft.
5 main points of the guidelines:

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

03

FX Position 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 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 with Article 325 granted for all entities in the group
  - at *consolidated* level with Article 325 not granted for some entities in the group

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

CET1 Ratio	Tier 1 Ratio	Total Capital Ratio

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Clarifications around the Structural FX Provision

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) is expected to assess:
  - if a FX position is of a structural nature and if it is deliberately taken (deliberately not closed or 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 **identifications 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**:
    - Quantitative criteria (*absolute threshold*): **Top-5 currencies** of the business of the bank are material, obtained by calculating the **first five largest net open positions** in accordance with Article 352(1), without considering any waiver
    - In addition, when calculating **the MaxOP for a specific currency**, institutions should not consider any waiver (even if already granted) to minimize the possibility of regulatory arbitrage
- The capital ratio hedged (i.e. CET1, T1 or total capital ratio) by the institution should be the same for different currencies

EBA do not set any limit to the number of currencies for which an institution may apply for the waiver. To demonstrate the material of currencies that is not among the top five, an institution can use **relative measures** as well:

- **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*
- **Measure C:** *% of total credit risk RWAs in the foreign currency with respect to the total RWAs of the institution*

These measures allow a more risk sensitive assessment of the materiality of a currency, as they take into account the actual business of the institution.

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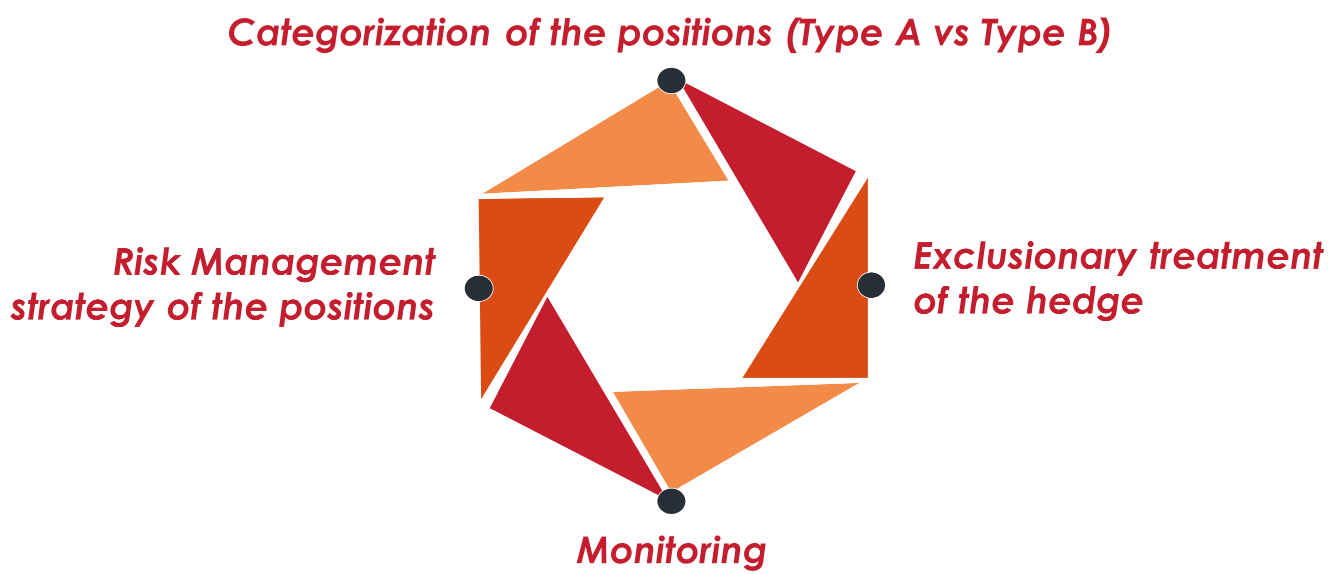
Governance and Risk Management Strategy

Governance and Risk Management Strategy 1/5

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 2/5

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 **objective** of the institution to the reduction of the **sensitivity** of the capital ratio against movements in the relevant exchange rate → *"stabilization" of the hedging*
  - the **strategy**, outlined in a detailed, credible and reliable way, to maintain stable the hedging and its **time-horizon** (at least **6 months**)

Defining the objective, institution must set a level of **tolerance** for the **sensitivity** of the ratio, specifying the criteria and methodology

Risk management strategy should outline:

- the definition of **boundaries** between positions categorized as structural and taken for hedging purpose and those that are no structural
- how the institution plans to meet in a **continuous** matter its objective, in particular
  - state which are the positions to open/close
  - provide evidence that are not impediments in opening/closing such positions

Institution is **not requested** to fully offset the **sensitivity of the ratio** to receive the S-FX waiver. The institution is allowed to set its objective with respect to the risk management of the structural positions:

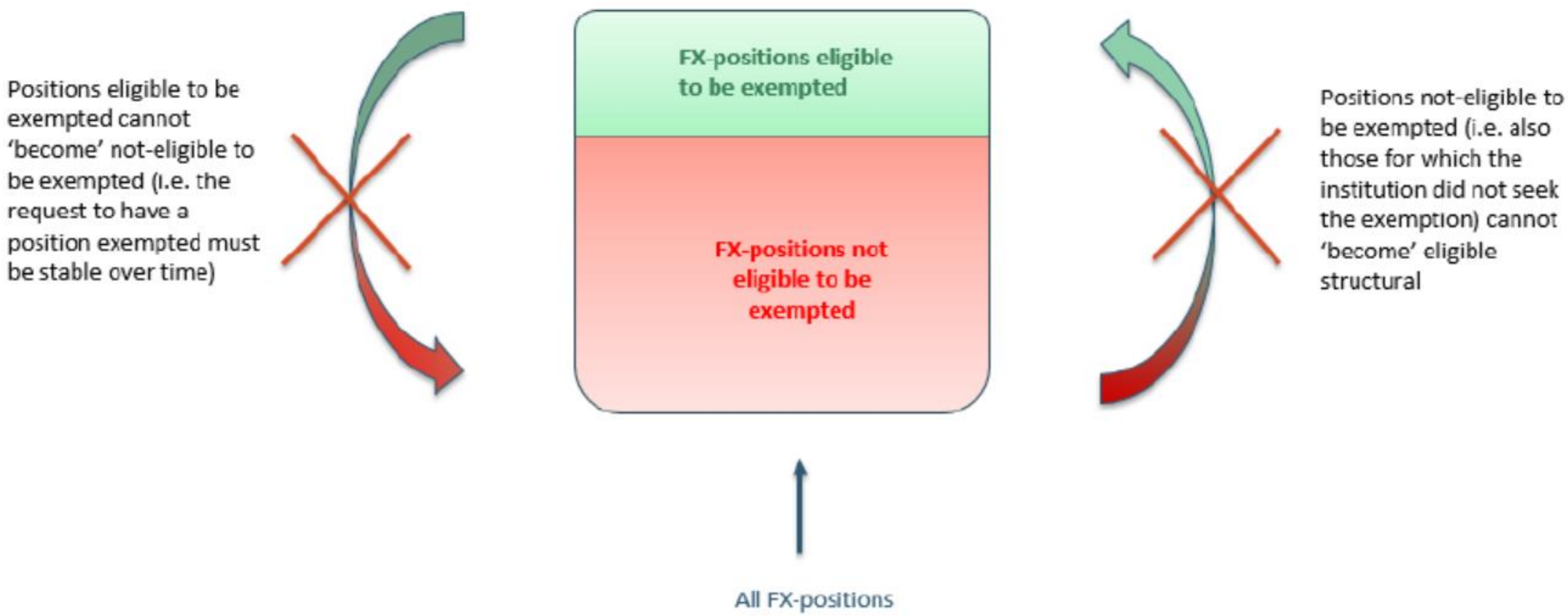
- Institutions are required to provide quantitative criteria for defining the objective at the basis of their strategy
- Institutions are required to report for monitoring purposes the sensitivity

Governance and Risk Management Strategy 3/5

Exclusionary Treatment of the Hedge

Minimum requirements to avoid regulatory arbitrage

- Once exemption is granted:
  - financial institutions **cannot change the boundaries** defined in their own 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/GL/2020/09 Consultation paper on structural FX guidelines

Governance and Risk Management Strategy 4/5

Monitoring

Reporting and data requirements

EBA guidelines introduce a **monitoring process** in order to force financial institutions to provide **on a quarterly basis,** for each currencies CA's permission has been granted, 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
- a qualitative assessment stating the reasons for changes in the amount of the structural net open position and the value taken by the sensitivity
- the percentage of total credit risk RWAs in the foreign currency to the total RWAs

EBA decided to not include such reporting requirements in **COREP** considering that institutions will switch in a few years to the new **FRTB** requirements.

EBA intends to include such requirements in **COREP** in the future in order to have **a more structured tool** also for **S-FX reporting.**

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

Governance and Risk Management Strategy 5/5

Monitoring: Sensitivity Calculation

Prescribed formula

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}: the size of the net open position stemming from positions suitable for exemption (expressed in foreign ccy - FC)
  - Items that have been deducted from own funds
  - Non monetary items that are held at historical cost
  - items that may lead to gains or losses that do not impact the CET1 capital
  - in accordance with Regulation (EU) No 575/2013
- $MaxOP$: 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

The sensitivity must be also calculated using the institution's internal methodologies

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Historical Cost Items

Historical Cost Items

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Treatment of non-monetary items

- 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*
- 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 funds 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 specifies that **non-monetary items** should be booked at **historical cost** and generally 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**

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)

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

- are included in the calculation of net open position for exemption
- are excluded in the comparison between the net open position and the MaxOP, due to their negligible effects in case of FX rate movements (the eligibility to be exempted coincides just with fact of being structural)

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Approval and Review Process

Approval and Review Process

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 and take any supervisory measure it deems appropriate.
- The monitoring process defined by EBA guidelines should allow CA to identify mis implementation 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

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

Giacomo Vigo
Business Analyst

Dante Carbone
Business Analyst

Andrea Principe
Quant Analyst

www.iasonltd.com