19 September 2017

European Banking Authority
Isabelle Vaillant, Director of Regulation
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA
United Kingdom

AFME: Response to the EBA's Discussion Paper on Structural FX

Dear Isabelle,

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the discussion paper on the treatment of structural FX under Article 352(2) of the CRR (EBA/DP/2017/01). AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

In this response, we provide feedback on areas that do not relate to bank specific practices and where it has been possible to provide an industry response. We provide a summary of our key positions, direct answers to most questions as well as further thoughts on issues that are not directly addressed by the questions.

We very much hope that the concerns and recommendations we have outline will be considered and addressed by the EBA. We further suggest that our feedback is escalated to the Basel Committee's Market Risk Group so that the significant limitations introduced in the Fundamental Review of the Trading Book are reviewed.

Please do not hesitate to contact Jouni Aaltonen, Jouni.aaltonen@afme.eu , should you wish to further discuss any of our comments.

Overarching comments

We generally support the EBA's views presented in the paper regarding the nature and scope of structural FX risk, and the way firms hedge the exposures. We also agree that to promote level playing field, there is a need to address supervisory divergences in how to define a structural FX position and how the exemption is applied across the EU.

AFME and our member believe that indeed structural FX positions can span trading and banking books, as well as to monetary and non-monetary items. In our view, the position that is of a non-trading and structural nature depends on a management choice realised by the top management of the bank, independently from whether standard approach or internal models are used to calculate the risk weights. These decisions are agreed in the Asset and Liability Management Committee (ALCO) and formally documented. The ALCO process could be used/leveraged also for regulatory purposes.

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. We believe that the firm specific current or target value of the capital ratio (whether risk or leverage based) at a consolidated level should be considered as the starting point from which to define the magnitude of remaining open position to be kept by currency to minimize ratio sensitivity. The FX position to be considered "structural" can be a partial or the maximum FX position that reduces or neutralises the sensitivity of the current or target capital ratio to FX movements. In this regard, it would be unhelpful if the determination of the net FX position and structural FX exclusion should depend on supervisory minimum requirements and/or the approach used for the calculation of FX own-funds requirements. Similarly, the concept 'deliberately taken', also include 'deliberately not closed' or 'maintained'. Banks' internal specific processes are designed to determine the amount of positions that are deliberately maintained to protect the capital ratio. Therefore, the framework should be sufficiently flexible for the supervisors and firms to agree on the most relevant capital ratio to be hedged based on bank specific circumstances.

We agree with the EBA that the net structural open FX position can only be 'long'. However, the hedge that is maintained to protect the capital ratio can be either long or short, depending on firm specific circumstances. There are wide divergences in firm specific structural FX positions, depending on the business mixes, chosen reporting currencies and regional footprints.

With regards to the revisions stemming from the Basel Committee's FRTB rules that are incorporated in the CRR II proposal by the European Commission, we believe that

the structural FX section was not adequately considered in the process and as proposed, would significantly restrict banks' ability to manage structural FX risk without a real prudential reason for doing so. For example, branches in certain jurisdictions are treated in the same way as subsidiaries and it would be odd to not allow banks to take structural FX positions resulting from those entities into account for the position.

Similarly, the hedge eligibility according to the CRR II definition appears to be much more restrictive than the existing structural FX hedge limitations. The criteria need to be reviewed and aligned with the broader open position terms as described in the discussion paper and in our response. In our view, the restrictions are not required from a supervisory viewpoint nor do we believe that they result in more efficient hedging practices. In addition to this and in regard of the exclusion of the hedge there is a new requirement that it must remain 'in place for the life of the assets or other items'. For example equities, by definition, do not have a maturity and therefore more flexibility is required.

More generally speaking, ECB's authorization should not be required on a case-by-case basis but should be applied for a general hedging policy in order for banks to have sufficient flexibility to manage their exchange rate positions efficiently.

Answers to the EBA's 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?~~

This is a bank specific question and therefore we are unable to respond to this question.

Question 2. *Do you share the 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 broadly support EBA's view. All net open FX positions should be considered in the net FX position, whether managed in the trading book or in the banking book. Only the positions that are of a non-trading or structural nature are excluded, whatever the portfolio in which it is booked (banking book or trading book). In our view, the position that is of a non-trading or structural nature depends on a management choice realised by the top management of the bank, independently from whether the standardized approach or an advanced method is used.

We note that hedging strategies are designed and executed with the main purpose of controlling the potential negative effects of exchange-rate fluctuations on capital ratios, considering transactions according to market expectations and their cost. The hedging strategies do not distinguish between exposures that are subject to the standardized approach and exposures that are subject to IRB approach, as both types of exposures can in fact generate fluctuations on capital ratios. In this regard, the determination of the net FX position and structural FX exclusion should not depend on the approach used for the calculation of FX own-funds requirements.

Additionally, while we support EBA's view on the structural FX exclusion we disagree on the relevance of open net foreign exchange position (ONFEP) as defined in Article 352 for IMA Bank. Indeed, the ONFEP is a standardised metric to be applied to the set of positions generating FX Risk on the balance-sheet (from which structural positions can be carved out subject to permission by the competent authorities). IMA is an alternative and more accurate way of capturing such risk on the same positions. An IMA institution should not be expected to compute ONFEP.

In the case an institution has permission by the competent authority to use internal models to calculate own funds requirements for market risk in accordance with chapter 5 of Title IV of Part three CRR, the risk weighting for currency risk is included. To prevent a double risk weighting for FX risk, these trading book positions should be excluded from the risk weighting in accordance to chapter 3 of Title IV of Part three CRR.

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 be acceptable only for long FX positions? If you consider that it should be allowed for short positions please provide rationale and examples.*

Structural FX hedges depend on long term choices with the objective to reduce the sensitivity of own funds to FX variations. Structural FX hedges are normally put on considering the aggregate banking book and trading book positions, rather than being limited to banking book.

While banking and trading book risks are considered risks of different nature and are typically managed differently, it may suit some banks to only address banking book open position with structural hedges. It is, however, important to note that the fundamental review of the trading book will modify the way banks classify portfolios. We highlight that the new provisions include standards to assign instruments to the trading book and banking book but these standards may not be fully aligned with the day to day management of the structural FX positions. The possibility to reclassify positions is limited and always subject to supervisory approval. Furthermore, the way FX positions are measured in order to be risk weighted in accordance to chapter 3 of Title IV of Part three CRR, does not make a distinction between trading and banking book positions, consequently banking and trading book positions should both qualify for structural FX positions. Any position in the banking and trading book which is not earmarked as structural is subject to RWA calculation. In this regard, we consider that the concept "structural nature" will have to be sufficiently flexible to ensure that sound structural FX management methods are permissible. Even if they primarily concern banking book positions, they should not in principle be limited to banking book.

In addition, while we agree that the net open structural FX position can only be long, we do not believe that there is a valid reason just to limit the exclusion to long FX hedges. In this regard, we provide examples of short and long hedge positions below, which help to preserve the capital ratio:

Example 1: A European entity invests in a USD entity and fully fund the investment with debt in USD. The FX movements in the investment is tax exempt but the FX movements in the liability is taxable/deductible. If the USD appreciates the bank pays less taxes, if the USD depreciates, the bank pays more taxes. In order to hedge this position, the bank enters into a short USD/EUR FX position. This short position neutralises the CET1 ratio and should be excluded as it is a structural tax position. So, if the tax treatment is different to cover the ratio you need to take an open position (could be long or short). Then the short positions taken in this sense are covering the ratio, so they should be eligible for the exclusion.

Example 2: Short positions on the balance sheet as a result of negative mark to market of cash flow hedge derivatives. This short position is left open (when managing the structural FX position of the bank) because there is a capital filter that eliminates the impact in reserves. This short position should be eliminated from the structural risk position of the bank as it neutralises the capital ratio as a result of the filter.

We have also included in Annex II, as part of the response to Q8 how to assess the consolidated ratio and an example that shows a short structural FX position hedging the capital ratio.

Example 3: Group's reporting currency (USD) appreciates against all other currencies.

A holding company with USD as functional currency has two subsidiaries A with functional currency EUR and subsidiary B with functional currency GBP. Subsidiary A has all its assets and liabilities in EUR and B in GBP. Therefore, the US holding needs to hedge the RWA in EUR and USD in a manner that the speed of RWA increase or decrease due to an appreciation or depreciation of the EUR/USD or GBP/USD is the same as the speed of the Capital of the US holding due to an appreciation/ depreciation of the EUR/USD or GBP/USD.

This has an adverse impact on the Group's capital ratio, as capital provided by subsidiaries A and B, denominated in foreign currencies, support both foreign currency and USD RWAs at the consolidated level. If the foreign currency capital depreciates against USD, the foreign currency capital is unable to support the same level of USD RWAs and the Group ratio depreciates. In order to hedge the Group's capital ratio in this scenario, a short FX position is required for both GBP and EUR (i.e. GBP a EUR are sold for USD).

Parent Consolidation (USD Denominated)			
Fx Assets (MIX)	1,000	Fx Liabilities (MIX)	880
DC Assets (USD)	1,600.0	DC Liabilities (USD)	1,480.0
		FX Capital (MIX)	240.0
		DC Capital (USD)	80.0
Sum	2,600		2,600
Capital Ratio	11.2%		

Bank A (EUR Denominated)			
Fx Assets (USD)	500	Fx Liabilities (USD)	440.0
DC Assets (EUR)	500	DC Liabilities (EUR)	440.0
		Capital (EUR)	120.0
Sum	1,000		1,000.0
Capital Ratio	12.0%		

Bank B (GBP Denominated)			
Fx Assets (USD)	500	Fx Liabilities (USD)	440
DC Assets (GBP)	500	DC Liabilities (GBP)	440
		Capital (GBP)	120
Sum	1,000		1,000
Capital Ratio	12.0%		

Following appreciation of USD against all other currencies (20%)

Parent Consolidation (USD Denominated)			
Fx Assets (MIX)	800	Fx Liabilities (MIX)	728
DC Assets (USD)	1,600.0	DC Liabilities (USD)	1,480.0
		FX Capital (MIX)	192.0
		DC Capital (USD)	80.0
Sum	2,400		2,400
Capital Ratio	10.1%		

Bank A (EUR Denominated)			
Fx Assets (USD)	500	Fx Liabilities (USD)	440
DC Assets (EUR)	400.0	DC Liabilities (EUR)	364.0
		Capital (EUR)	96.0
Sum	900		900
Capital Ratio	10.7%		

Bank B (GBP Denominated)			
Fx Assets (USD)	500	Fx Liabilities (USD)	440
DC Assets (GBP)	400.0	DC Liabilities (GBP)	364.0
		Capital (GBP)	96.0
Sum	900		900
Capital Ratio	10.7%		

Example 4: Inclusion of trading book positions in structural FX.

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. An illustrative example would be as follows:

In a group structure, the EU parent holds a participation in a US subsidiary denoted in USD. The USD subsidiary operates only a trading book, i.e. there is no banking book, and it is only funded by the USD investment of the parent. The market risk RWA calculation of the consolidated group is performed based on CRR Article 325 (1), i.e. allowing for a netting of positions held in different legal entities. In order to determine the open FX risk position for market risk RWA purposes, a long USD position in the amount of the USD investment in the subsidiary is excluded as a structural FX position.

Note that from the perspective of the consolidated group, this group internal USD investment is replaced by all external assets and liabilities of the US subsidiary as part of the consolidation process. In the illustrative example, the only external assets and liability result from the trading book. Note however that there is no direct link between the USD investments and a specific trading book position. In this scenario, the structural FX position at the consolidated level (in the amount of the USD investment) effectively results from all trading book position. Note however that only an FX position in the amount of the FX investment is classified as structural FX position. Any additional trading book long or short USD position and any non-USD FX position resulting from the consolidation of the US subsidiary are captured in the market risk RWA.

The above example demonstrates that although the structural FX position effectively results from trading book positions (in a consolidated group view) it is of a non-trading and structural nature as

- from a management perspective, it relates to an investment in a subsidiary that clearly is of a non-trading and structural nature, and
- there is clearly no trading intent with respect to the subsidiary but that this FX position arises on consolidated level when we take all trading book positions of the subsidiary into account; and
- any additional open FX position that the USD subsidiary incurs (that then is of a trading nature) is included in the market risk RWA calculation

Please note that the above example was on purpose simplified to stress the argument that trading book positions may qualify as structural FX positions. In all practical cases, the US subsidiary will also operate a banking book and will not only be funded by the USD investment. In such a scenario, it would then not even be possible to trace the structural FX position back to either a trading or a banking book 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?*

The structural FX positions should not be limited to hedging positions but should also be viewed as FX positions maintained from subsidiaries and branches with a view to hedging the capital ratio of the bank. The firm specific current or target value of the capital ratio at a consolidated level should be considered as the starting point from which to define the magnitude of remaining open position to be kept by currency to minimize ratio sensitivity. Such positions mainly stem from subsidiaries and branches, tangible & intangible assets and capital operations.

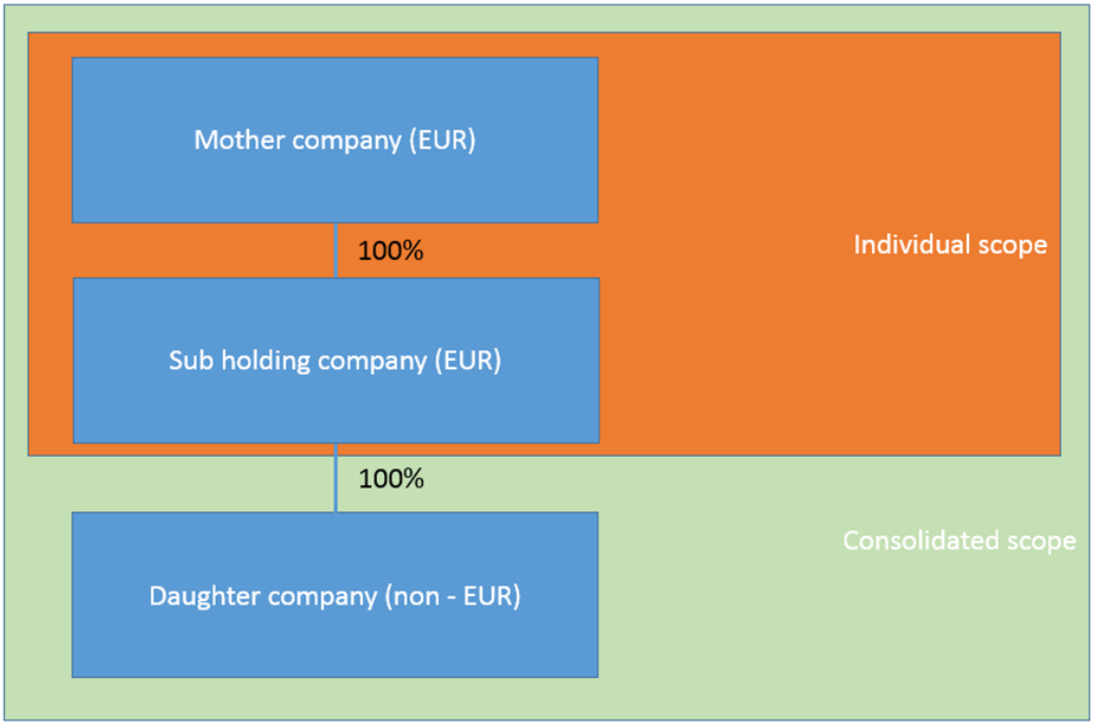
In this context, we note that the consultative document is focused mainly on hedging the ratio sensitivity by taking (or rather maintaining) unhedged net investment positions in subsidiaries or branches. One must note that even within the main operating entity, firms take long positions in the currencies of the exposures from which capital requirements arise (and running an equivalent short position in the base currency, or another relevant currency). In our view, this is also a valid structural FX position and strategy. This is particularly true when the institution runs significant exposures in foreign currencies along with exposures in the domestic currencies, notably:

- For investment banks, that grant facilities in a number of currencies (notably USD) to corporate clients
- For institutions in emerging countries which seldom have subsidiaries or even branches. For many reasons, a number of transactions in those countries are not denominated in the domestic currency.

Similarly, the concept 'deliberately taken', also include 'deliberately not closed' or 'maintained'. Banks' internal specific processes are designed to determine the amount of positions that are deliberately maintained in order to protect the capital ratio. These decisions are agreed in the Asset and Liability Management Committee (ALCO) and formally documented. The ALCO process could be used/leveraged also for regulatory purposes.

Please find in annex I three simplified examples based on an accounting point of view (i.e. IFRS). These examples aim to show how one could define 'deliberately taken in order to hedge the ratio' at the consolidated and at the individual level. As these examples proof, one cannot hedge the consolidated ratio and similarly the induvial ratio or vice versa.

We are of the view that hedging the ratio in particular situations can only be done at a consolidated level and that hedging the ratio at consolidated level could conflict with the ratio at individual level. Suppose that the ultimate EUR mother company does not have branches and has a 100% stake in a EUR sub-holding. When this sub holding holds all subsidiaries in a foreign currency, the individual mother company does not have any foreign currency positions on its individual balance sheet that can be hedged but nonetheless runs a currency risk. The currency risk is included in the EUR net asset value of the EUR sub-holding and therefore affects the CET 1 of the mother company in its individual balance sheet. In this case the consolidated company however has currency positions that can be hedged under article 352.2 CRR. Therefore, we are of the view that article 6 of the CRR cannot solely be applied to Chapter 3 of Title IV of Part three CRR. We also refer to this issue in our answer to question 9.



Association for Financial Markets in Europe
London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971
Frankfurt Office: Skyper Villa, Taunusanlage 1, 60329 Frankfurt am Main, Germany T: +49 (0)69 5050 60590
www.afme.eu

Company Registration No: 6996678 Registered Office: 39th Floor, 25 Canada Square, London E14 5LQ
AFME is registered on the EU Transparency Register, registration number 65110063986-76

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?~~*

The structural FX treatment should be understood as being applicable for "positions" (that can stem from hedging through various FX instruments, including options, with a view to protect the firms' capital ratio from adverse FX movements). The industry believes that both long and short positions are economically acceptable.

~~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.)?~~

No industry response to this question.

Question 7. *Do you share the EBA's view that the maximum FX position that could be considered structural should be the position that would ideally neutralise the sensitivity of the capital ratio to FX movements? Alternatively, in the 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 that would ideally neutralise the sensitivity of the capital ratio post tax effects 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 (Examples explained in Annex IV) with no change in sign.

In the case where the tax rules in a country imply that revaluations of the hedging instrument (i.e. short currency positions) are being taxed, but the revaluation of the (long) net investment is tax exempted, an institution needs to 'over-hedge' with the factor of the tax rate in order to achieve a perfect hedge that neutralises the capital ratio. (See annex III for example).

We believe that in identifying the ratio, the ALCO process and initial supervisory approval are sufficient and should be subject to periodic (at least quarterly, as per the COREP reporting frequency) reviews to assess if the exempted hedges remain appropriate for managing the exposure. An over-hedge identified in the ALCO and supervisory review process that is not related to tax effects should incur a capital charge.

With regards to minimum capital ratios, we strongly believe that their use for determining the right ratio would be sub-optimal. This does not enable banks to neutralise the sensitivity of the current (or target) capital ratio, which is more appropriate economically. In practice, hedges are not put on in reference to minimum ratios, but rather to the actual or target capital ratio. Therefore, we do not support limiting the size of the structural hedge to minimum capital ratio levels as it would fail the objective of neutralization of the own funds to FX movements. In fact, it would penalise banks that hedge structural FX risk prudently.

We would in addition propose to add the leverage ratio to the group of ratios which qualify for hedging by structural FX positions, particularly if that is the binding capital constraint to the bank. Out of such a group of ratios, one ratio would be the key ratio to be hedged. This ratio limits the amount for the maximum FX position. The other solvency ratios can be over- or under-hedged driven by the maximum FX position.

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

We interpret the first part of the question is institution specific question and therefore limit our comments to that which is consistent across our members, namely that structural FX issues must be assessed at different levels, including the minority interest perspective. To this end, we include a worked example in Annex II, to highlight some possible considerations to take into account.

In relation to the latter question, we do believe branches and subsidiaries should be treated equally and set out our reasoning below:

Firstly, the structural FX positions are often taken to cover the own funds' sensitivity at a consolidated level (an open position at the level of the mother company can be compensated by an open position at the level of the subsidiary or the branch), as can be seen from the examples in annex I. Therefore, we believe that there should not be any difference on capital/dotation hedging between subsidiaries and branches.

Secondly, there are some jurisdictions where there is no distinction between a branch and a subsidiary. In India for example, branches in are required to meet capital adequacy requirements which are at par with requirements for subsidiaries in the jurisdiction. Effectively a branch in this jurisdiction is expected to operate with the same level of capital as a subsidiary.

Bearing these in mind, the structural FX treatment at a consolidated level for investment in branches are no different to investment in subsidiaries. Additionally, from an accounting perspective, dependent on the Generally Accepted Accounting Rules used, there is not any difference between subsidiary and branch which means consolidated group is the same regardless of legal structure. We would therefore

request that branches and subsidiaries be treated at par from a structural FX perspective.

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 hedge eligibility according to the CRR II definition appears to be much more restrictive than the existing structural FX hedge limitations. While this is to a large extent reflecting the BCBS's standard in the Fundamental Review of the Trading book, in our view this issue has not been addressed adequately during the consultation process and we believe it needs to be reviewed and aligned with the broader open position terms as described in the discussion paper and in our response above. We do not believe that the restrictions are required from a supervisory viewpoint nor do we believe that they result in more efficient hedging practices. On the contrary, it may result in structural management and level playing field issues between banks depending on their organisational structure.

We also believe that the word "amount of investment" should be clarified and it should be defined how to perform its calculation. At the individual basis, the 'hedge' is actually the position which is maintained; the investment. 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 vein, the concept "investment" is not applicable at consolidated basis.

It is not clear why the amount of investment should be limited to consolidated subsidiaries. Banking groups which operate through a different legal structure in form of a branch system should have the same possibilities to define structural FX positions. Hence, the definition of "investment" should comprise subsidiaries and branches. Furthermore, items resulting in a capital deduction (e.g. goodwill) should be included as well since they provide a natural hedge to the capital ratios. These items are already included in the capital calculation and including them in the RWA calculation would result in double-counting.

More specifically, we believe that while article 325 c, (1) a (i and ii) limits the exclusion to the largest of the two options, it should be instead aggregated across 1) Subsidiaries 2) affiliated entities 3) branches 4) strategic equity stakes. The FX position to be considered "structural" can be a partial or the maximum FX position that reduces or neutralises the sensitivity of the current or target capital ratio to FX movements, taking into account firm specific circumstances and capital planning.

Secondly, we do not believe that the exclusion should be made at least for six months. Both RWA's and own funds calculations vary from month to month and thus the calculation of the structural FX exposure as well. Markets can potentially move even more and banks need to have flexibility in management of the structural FX position. Therefore, it is more economically sound to also update the amount of the 'exclusion' on a monthly basis.

Thirdly, in regard of the exclusion of the hedge there is a new requirement that it must remain 'in place for the life of the assets or other items'. Equities, by definition, do not have a maturity. As we have mentioned before, structural FX position is defined on a higher balance sheet composition level and therefore it would be

inappropriate to tag balance sheet items against the open FX position as they may vary (see our previous answers) and contain trading book as well as banking book assets and liabilities. Furthermore, market movements, strategic ALM decisions, local political circumstances etc. can all be drivers for changes of the capital ratio composition and therefore the hedges have to be managed dynamically.

Consequently, we strongly believe that requiring supervisory approval for individual hedging transactions is overly burdensome and could disincentivise prudent structural FX management. Therefore, we recommend that these requirements are reviewed during the completion of the CRR2 and further aligned more closely with the existing structural FX management and ALCO processes.

We note that participations denominated in foreign currencies which are accounted at historic cost should not bear any capital charge.

Finally, and as also addressed in our answer to question 4, we like to ask your attention for the fact that article 6 CRR is in our view incorrectly applicable to chapter 3 of Title IV of Part three CRR. We like to make you aware that the BCBS stated on page 6 of its revisions of the minimum capital requirements for market risk as issued in January 20161 that their concept is designed for reporting at the consolidated level. They literally state "supervisory authorities will retain the right to continue to monitor the market risks of individual entities on a non-consolidated basis to ensure that significant imbalances within a group do not escape supervision". The BCBS does not give guidance how supervisory authorities should do this. We therefore believe, in the case article 6 CRR is not adapted in a manner that article 6 is not applicable to chapter 3 of Title IV of Part three CRR, EBA should be mandated by the legislator to provide in an RTS how supervisors should cope with this market risks of individual entities. One option could be to include this in pillar 2.

~~***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:*~~

~~*o the actual level of the capital ratio*~~

~~*o the effect of items deducted from capital / subject to a 1.250% RWA / subject to a 0% RWA*~~

~~*o the effect of items held at the historical FX rate?*~~

~~*Are there any additional elements, not included in the simplified examples, which should be considered in the analysis, both from an individual and a consolidated perspective? Please provide simple examples to illustrate them.*~~

[1] http://www.bis.org/bcbs/publ/d352.pdf

Annex I: accounting examples in relation to question four:

In the examples below, the positions would be the net position of all assets and liabilities in a foreign currency. The amount of the net position dependent on the definition of the 'hedge'. Does an institution hedge the consolidated or the individual ratio? In the example it can be noticed that the deliberately taken open position when one hedges the consolidated ratio amounts to USD 9, while when hedges the individual ratio this amount differs slightly. Therefore in our view the CRR should speak of totally or partially hedge against the adverse effect of the exchange rate. The position of "non-trading or structural nature" can under IFRS be monetary items in a foreign currency, including derivatives. Under IFRS both are monetary items meaning that the impact on the result of the year will not differ2. As one can see in example 1 and 2, the foreign exchange positions from foreign subsidiaries should be taken into account to assess the deliberately open currency position.

The concept explained in these examples include all FX positions in an institution (i.e. including those of a trading a non-structural nature). Within this concept the institution should determine a sub-selection of exposures that are of a non-trading or structural nature to comply with article 352.2 CRR.

In the example 3 we address the case that an asset or liability in a foreign currency is valued at historic cost. As this asset or liability will not impact the ratio at the reporting date, these positions should not be risk weighted for currency risk.

In example 4 we also address the case where an asset or liability in a foreign currency is valued at historic cost. Instead of looking at this topic from an accounting point of view (i.e. no revaluation so no impact on the solvency ratio), we look at it from an economic/risk management objective. One could argue that the currency position at historic cost price should be seen as a deliberately open currency position, as it cannot be (perfectly) hedged with a monetary item. The moment the asset is impaired or the asset or liability is transferred to another party, the institution would incur a currency gain/loss that should be reflected as a foreign exchange risk.

Example 1 hedging the consolidated ratio

A mother in the EU has a daughter in the US. The mother has a loan portfolio (20% risk weighted under A-IRB) of EUR 1.000 and a net investment of USD 22.5 (EUR/USD = 1).

The mother has funded itself with EUR 39 CET 1, EUR 970 deposits and a USD 13.5 loan. The size of the loan of (however this could also be simulated with currency derivatives) is chosen exactly to hedge the consolidated CET 1 ratio of this bank at the target rate 15%. Therefor the position of "non-trading or structural nature" amounts to USD 9 (i.e. 15% of USD 60 RWA).

The EU Supervisor requires the EU bank to risk weight the net investment at 370% in the individual balance sheet.

[2] However under local GAAP this can differ, for example when derivatives needs to be valued at the lower of the fair value and the cost price.

The US daughter has a loan portfolio (100% risk weighted under Standardized Approach) of USD 300. The US daughter has funded itself with USD 22.5 CET1 and USD 277.5 deposits.

The impact of income tax is not included.

As per 31 December the EUR/USD = 1.

This results in the following:

EUR = USD						
Balance sheet Consolidated in EUR 31 Dec 2016						
		Assets	*RWA*		Liability & own funds	CET 1
Receivable (in USD)		300	*60*	Equity	39	15%
Receivable (in EUR)		1000	*200*	Profit of the year	0	
				Revaluation reserve	0	
				Liability (in EUR)	970	
				Liability (in USD)	291	
		1300	*260*		1300	
Balance sheet individual in EUR 31 Dec 2016						
		Assets	*RWA*		Liability & own funds	CET 1
Net investment (USD)		22,5	*83,25*	Equity	39	13,77%
				Profit of the year	0	
Receivable (in EUR)		1000	*200*	Revaluation reserve	0	
				Liability (in EUR)	970	
				Liability (in USD)	13,5	
		1022,5	*283,25*		1022,5	
Balance sheet US daughter in USD 31 Dec 2016						
		Assets	*RWA*		Liability & own funds	CET 1
Receivable (in USD)		300	*300*	Equity	22,5	7,5%
				Profit of the year	0	
				Revaluation reserve	0	
				Liability (in EUR)	0	
				Liability (in USD)	277,5	
		300	*300*		300	

Association for Financial Markets in Europe
London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971
Frankfurt Office: Skyper Villa, Taunusanlage 1, 60329 Frankfurt am Main, Germany T: +49 (0)69 5050 60590
www.afme.eu

Company Registration No: 6996678 Registered Office: 39th Floor, 25 Canada Square, London E14 5LQ
AFME is registered on the EU Transparency Register, registration number 65110063986-76

When as per 30 June 2017 the EUR/USD = 2, the following is the case

EUR = 2 USD					
Balance sheet Consolidated in EUR 30 June 2017					
	Assets	RWA		Liability & own funds	CET 1
Receivable (in USD)	600	120	Equity	39	15%
Receivable (in EUR)	1000	200	Profit of the year	9	
			Revaluation reserve	0	
			Liability (in EUR)	970	
			Liability (in USD)	582	
	1600	320		1600	
Balance sheet individual in EUR 30 June 2017					
	Assets	RWA		Liability & own funds	CET 1
Net investment (USD)	45	166,5	Equity	39	13,10%
			Profit of the year	-13,5	
Receivable (in EUR)	1000	200	Revaluation reserve	22,5	
			Liability (in EUR)	970	
			Liability (in USD)	27	
	1045	366,5		1045	
Balance sheet US daughter in USD 30 June 2017					
	Assets	RWA		Liability & own funds	CET 1
Receivable (in USD)	300	300	Equity	22,5	8%
			Profit of the year	0	
			Revaluation reserve	0	
			Liability (in EUR)	0	
			Liability (in USD)	277,5	
	300	300		300	

When as per 30 June 2017 the EURUSD = 0.5 the following is the case

Association for Financial Markets in Europe
London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971
Frankfurt Office: Skyper Villa, Taunusanlage 1, 60329 Frankfurt am Main, Germany T: +49 (0)69 5050 60590
www.afme.eu

Company Registration No: 6996678 Registered Office: 39th Floor, 25 Canada Square, London E14 5LQ
AFME is registered on the EU Transparency Register, registration number 65110063986-76

EUR = 0,5 USD					
Balance sheet Consolidated in EUR 30 June 2017					
	Assets	RWA		Liability & own funds	CET 1
Receivable (in USD)	150	30	Equity	39	15%
Receivable (in EUR)	1000	200	Profit of the year	-4,5	
			Revaluation reserve	0	
			Liability (in EUR)	970	
			Liability (in USD)	145,5	
	1150	230		1150	
Balance sheet individual in EUR 30 June 2017					
	Assets	RWA		Liability & own funds	CET 1
Net investment (USD)	11,25	41,625	Equity	39	14,28%
			Profit of the year	6,75	
Receivable (in EUR)	1000	200	Revaluation reserve	-11,25	
			Liability (in EUR)	970	
			Liability (in USD)	6,75	
	1011,25	241,625		1011,25	
Balance sheet US daughter in USD 30 June 2017					
	Assets	RWA		Liability & own funds	CET 1
Receivable (in USD)	300	300	Equity	22,5	8%
			Profit of the year	0	
			Revaluation reserve	0	
			Liability (in EUR)	0	
			Liability (in USD)	277,5	
	300	300		300	

Conclusion example 1

By deliberately not closing the USD 9 (i.e. 15% of USD 60 RWA) position at a consolidated level, but keep this USD 9 "open position of non-trading or structural nature" the bank is fully hedging its CET 1 ratio at consolidated level. The bank is fully indifferent to an increase or decrease of the USD compared to the EUR. However at individual level, the CET1 ratio is not fully but partially hedged. When the USD gets stronger comparted to the EUR, the CET 1 ratio at individual level decreases from 13.77% to 13.10%. When the USD gets weaker, it increases from 13.77% to 14.28%.

Association for Financial Markets in Europe
London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971
Frankfurt Office: Skyper Villa, Taunusanlage 1, 60329 Frankfurt am Main, Germany T: +49 (0)69 5050 60590
www.afme.eu

Company Registration No: 6996678 Registered Office: 39th Floor, 25 Canada Square, London E14 5LQ
AFME is registered on the EU Transparency Register, registration number 65110063986-76

Example 2 hedging the individual ratio

A mother in the EU has a daughter in the US. The mother has a loan portfolio (20% risk weighted under A-IRB) of EUR 1.000 and a net investment of USD 22.5 (EUR/USD = 1).

The mother has funded itself with EUR 39 CET 1, EUR 972.463 deposits and a USD 11.0375 loan. The size of the loan of (however this could also be simulated with currency derivatives) is chosen exactly to hedge the consolidated CET 1 ratio of this bank at the target rate 13.77%. Therefor the position of "non-trading or structural nature" amounts to USD 11.4625 (i.e. 13.77% of USD 83.25 RWA).

The EU Supervisor requires the EU bank to risk weight the net investment at 370% in the individual balance sheet.

The US daughter has a loan portfolio (100% risk weighted under Standardized Approach) of USD 300. The US daughter has funded itself with USD 22.5 CET1 and USD 277.5 deposits.

The impact of income tax is not included.

As per 31 December the EUR/USD = 1.

This results in the following:

EUR = USD					
Balance sheet Consolidated in EUR 31 Dec 2016					
	Assets	RWA		Liability & own funds	CET 1
Receivable (in USD)	300	60	Equity	39	15%
Receivable (in EUR)	1000	200	Profit of the year	0	
			Revaluation reserve	0	
			Liability (in EUR)	972,463	
			Liability (in USD)	288,5375	
	1300	260		1300,0005	
Balance sheet individual in EUR 31 Dec 2016					
	Assets	RWA		Liability & own funds	CET 1
Net investment (USD)	22,5	83,25	Equity	39	13,77%
			Profit of the year	0	
Receivable (in EUR)	1000	200	Revaluation reserve	0	
			Liability (in EUR)	972,463	
			Liability (in USD)	11,0375	
	1022,5	283,25		1022,5005	
Balance sheet US daughter in USD 31 Dec 2016					
	Assets	RWA		Liability & own funds	CET 1
Receivable (in USD)	300	300	Equity	22,5	7,5%
			Profit of the year	0	
			Revaluation reserve	0	
			Liability (in EUR)	0	
			Liability (in USD)	277,5	
	300	300		300	

When as per 30 June 2017 the EUR/USD = 2, the following is the case

EUR = 2 USD					
Balance sheet Consolidated in EUR 30 June 2017					
	Assets	RWA		Liability & own funds	CET 1
Receivable (in USD)	600	600	Equity	39	15,77%
Receivable (in EUR)	1000	1000	Profit of the year	11,4625	
			Revaluation reserve	0	
			Liability (in EUR)	972,463	
			Liability (in USD)	577,075	
	1600	1600		1600,0005	
Balance sheet individual in EUR 30 June 2017					
	Assets	RWA		Liability & own funds	CET 1
Net investment (USD)	45	166,5	Equity	39	13,77%
			Profit of the year	-11,0375	
Receivable (in EUR)	1000	1000	Revaluation reserve	22,5	
			Liability (in EUR)	972,463	
			Liability (in USD)	22,075	
	1045	1166,5		1045,0005	
Balance sheet US daughter in USD 30 June 2017					
	Assets	RWA		Liability & own funds	CET 1
Receivable (in USD)	300	300	Equity	22,5	8%
			Profit of the year	0	
			Revaluation reserve	0	
			Liability (in EUR)	0	
			Liability (in USD)	277,5	
	300	300		300	

When as per 30 June 2017 the EURUSD = 0.5 the following is the case

EUR = 0,5 USD					
Balance sheet Consolidated in EUR 30 June 2017					
	Assets	RWA		Liability & own funds	CET 1
Receivable (in USD)	150	150	Equity	39	14,46%
Receivable (in EUR)	1000	1000	Profit of the year	-5,73125	
			Revaluation reserve	0	
			Liability (in EUR)	972,463	
			Liability (in USD)	144,26875	
	1150	1150		1150,0005	
Balance sheet individual in EUR 30 June 2017					
	Assets	RWA		Liability & own funds	CET 1
Net investment (USD)	11,25	41,625	Equity	39	13,77%
			Profit of the year	5,51875	
Receivable (in EUR)	1000	1000	Revaluation reserve	-11,25	
			Liability (in EUR)	972,463	
			Liability (in USD)	5,51875	
	1011,25	1041,625		1011,2505	
Balance sheet US daughter in USD 30 June 2017					
	Assets	RWA		Liability & own funds	CET 1
Receivable (in USD)	300	300	Equity	22,5	8%
			Profit of the year	0	
			Revaluation reserve	0	
			Liability (in EUR)	0	
			Liability (in USD)	277,5	
	300	300		300	

Association for Financial Markets in Europe
London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971
Frankfurt Office: Skyper Villa, Taunusanlage 1, 60329 Frankfurt am Main, Germany T: +49 (0)69 5050 60590
www.afme.eu

Company Registration No: 6996678 Registered Office: 39th Floor, 25 Canada Square, London E14 5LQ
AFME is registered on the EU Transparency Register, registration number 65110063986-76

Conclusion example 2

By deliberately not closing the USD 11.4625 (i.e. 13,77% of USD 83.25) position at an individual level, but keep this USD 11.4625 open position of "non-trading or structural nature" the bank is fully hedging its CET 1 ratio at the individual level. The bank is fully indifferent to an increase or decrease of the USD compared to the EUR. However, at consolidated level, the CET1 ratio is not fully but partially hedged. When the USD gets stronger comparted to the EUR, the CET 1 ratio at consolidated level increases from 15% to 15.77%. When the USD gets weaker, it increases from 15% to 14.46%.

Please note that in the case between the mother company and the US daughter, a EUR functional currency sub-holding is created. The mother company at a solo level would not be exposed to currency risk, but not to foreign exchange currency positions. In that case hedging the ratio at consolidated level would not result in the hedge of the ratio for FX risk at the individual level.

Example 3 assets (or liabilities) valued at historic cost price – accounting view

The cases in example 1 and 2 were looked upon from an IFRS accounting point of view, knowing that the CRR states in article 111 CRR (Standardized Approach) and article 166 CRR (internal models approach) that the exposure value shall be the accounting value.

In case an entity values an asset in a foreign currency - due to the local accounting requirements - at historic cost price and the foreign currency decreases in value comparted to the EUR, one will not notice this devaluation of the assets in a foreign currency in the solvency ratio at the reporting date. One could argue that the currency position at historic cost price does not impact the solvency ratio at the reporting date and that therefore these positions should not be risk weighted for currency risk. This would mean that a bank should eliminate (or not include) these positions when drawing up the net open position in the C22.00.

Example 4 assets (or liabilities) valued at historic cost price – economic view

In example 3 we addressed that one will not notice the impact of assets (or liabilities) in a foreign currency measured at historic cost in the in the solvency ratio at the reporting date. However, when the institution needs to impair or to sells the assets, the unrealised currency loss has to be recognised. In other words, from an economic/risk management point of view, the bank is running a currency risk. It however does not know when it materialises and depending on the amount of the loss (or gain) this can have an impact on the solvency ratio. One could argue that the currency position at historic cost price should be seen as a deliberately open currency position, as it cannot be (perfectly) hedged with a monetary item.

Annex II: Worked Example re consideration of structural FX issues within a consolidated group

Base Assumptions:

- FX rates 1 GBP = 1.25 EUR = 1.50 USD;
- A UK bank has a subsidiary/branch in the US that carries all the USD-denominated business. The GBP-denominated business is run domestically;
- The target CET1 capital ratio is10%;
- The RWAs in the US business are 15 GUSD, hence the capital requirement of the USD business is 1.5 GUSD (1.0 GGBP). This capital is fully invested in the USD subsidiary;
- The RWAs in the GB business are 30 GGBP. The capital requirement of the GBP business is therefore 3 GGBP; and
- The total equity of the company is 4 GGBP.

The capital structure of this UK-based company is optimal:

- There is no excess capital. The company is operating at the target ratio;
- The CET 1 ratio is immune to the GBP/USD exchange rate. The break-down structural net assets (in currencies) exactly match the break-down of the capital requirements.

Comparison of different scenarios:

We now assume the UK operating company is held by a Euro-based company, whose target CET 1 ratio is also 10%.

Scenario 1 - The UK subsidiary is 100% owned by the EUR holding company.

- The UK bank is the sole asset of the EUR company which carries the investment at tangible book value (no goodwill or bad will);
- The net investment in the UK bank is fully funded by equity (not net investment hedge). Hence, the EUR holding company runs a structural GBP/EUR position
- The net investment of the EUR company is 5 GEUR, and the equity is 5 GEUR;
- By running a long GBP exposure, the holding company hedges its solvency ratio and sensitivity of the solvency ratio is only driven by the USD/GBP parity;
- The actual (structural) net assets of the EUR entity comprises GBP and USD translation risk. However, in the balance sheet of the EUR entity at solo level one only will notice the GBP position because in the GBP net asset value of the USD risk is included.

This example shows that **carefully chosen structural positions that are run at the relevant levels, not necessarily against the base currency can help hedge the solvency ratio**.

Scenario 2 - The UK subsidiary is now 60% owned by the EUR holding. Minority investors own the remainder.

- The net investment (which is the sole asset) of the EUR company is 3 GEUR;
- The total equity can be broken down as follows: 3 GEUR (group share), 0.6 GUSD (minority interest), 1.2 GGBP (minority interest).

This scenario seems quite different, since the consolidated capital structure is different but:

- The minority investors and the group shareholders have the same economic interests;
- The solvency ratios have the same sensitivities;
- Again, running a 1.5 GUSD/3 GGBP structural position at UK level is critical to hedge CET 1 ratios both at operating and consolidated levels;

These examples show that assessing the FX risks on a consolidated basis can be extremely complex:

- Solo balance sheets often poorly reflect the subtlety of currency-related issues (actual risks and net assets).
- **What matters is the adequate congruency between the actual structural net tangible assets and the capital requirements from a currency perspective.**

Annex III: Tax effect example

The maximum size of a structural position (as discussed under question 7) should also cater for the tax effect. The tax will reduce the impact of the hedge, i.e. that any gain/losses from the hedge is recognised after tax, while the revaluation of RWA or equity is unaffected by tax. If banks are not allowed to hedge more than the pre-tax structural position, it is not possible to hedge the CET1 ratio to 100%. Instead banks should be allowed to "over hedge" with the expected tax rate to cater for the tax effect.

Example 1:

At T0 the EUR denominated bank is fully hedge in nominal terms as the USD exposure 200 in RWA is hedged with a 20 open FX position.

At T1 when the USD appreciates by 10%, the hedges realise a gain of 2 EUR. As the realised gain from the hedge is taxed, the actual realised gain is reduced by the tax (-0.7 EUR), and has a net effect of 1.5 EUR or 75% (1-tax) of the hedge.

CET1 ratio	20%				
Tax	25%				
USD move	10%				
With tax effects					
T0	REA	Equity	Hedge	Tax	Sum
EUR	100	40	-20		20
USD	100	0	20		20
Total	200	40	0		40
Hedge ratio (pre-tax)	**100%**				
T1	REA	Equity	Hedge	Tax	Sum
EUR	100	40	-20		20
USD	110	0	22	-0.5	21.5
Total	210	40	2		41.5
CET1 ratio post FX move	19.762%				

Example 2:

At T0 the hedge ratio is now increased to 125% (pre-tax) to compensate for the reduction in hedge effect from the tax.

At T1, as the USD appreciates, the tax reduces the impact of the hedge (by 25%), gives that the hedge will give a 100% hedge post tax.

Association for Financial Markets in Europe
London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971
Frankfurt Office: Skyper Villa, Taunusanlage 1, 60329 Frankfurt am Main, Germany T: +49 (0)69 5050 60590
www.afme.eu

Company Registration No: 6996678 Registered Office: 39th Floor, 25 Canada Square, London E14 5LQ
AFME is registered on the EU Transparency Register, registration number 65110063986-76

CET1 ratio	20%				
Tax	25%				
USD move	10%				
With tax effects included in the full hedge					
T0	REA	Equity	Hedge	Tax	Sum
EUR	100	40	-27		13
USD	100	0	27		27
Total	200	40	0		40
Hedge ratio (pre-tax)	**125%**				
T1	REA	Equity	Hedge	Tax	Sum
EUR	100	40	-27		13
USD	110	0	29	-0.7	29
Total	210	40	3		42
CET1 ratio post FX move	20.000%				

Association for Financial Markets in Europe
London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971
Frankfurt Office: Skyper Villa, Taunusanlage 1, 60329 Frankfurt am Main, Germany T: +49 (0)69 5050 60590
www.afme.eu

Company Registration No: 6996678 Registered Office: 39th Floor, 25 Canada Square, London E14 5LQ
AFME is registered on the EU Transparency Register, registration number 65110063986-76

ANNEX IV: Partial hedge examples

The foreign exchange risk own funds calculation under CRR permits the exclusion of positions deliberately taken in order to hedge against adverse effect of the exchange rate on the capital ratio being the positions to be excluded of a non-trading or structural nature.

The Basel text explicitly clarifies that the positions to be excluded can have their origins both in total or partial hedges but the CRR does not explicitly detail this aspect.

This annex illustrates with four simple cases why partial hedges should be eligible for being excluded from the foreign exchange risk calculation under CRR (being the positions to be excluded of a non-trading or structural nature). Note than an entity can opt for different strategies when dealing with the FX risk:

- Maintain a matched FX balance sheet position and not hedge the capital ratio. The capital ratio is sensitive to movements in the foreign exchange rate;
- Maintain a deliberately open FX balance sheet position that perfectly hedges the capital ratio. The capital ratio is not sensitive to movements in the foreign exchange rate but high P&L volatility arises; and
- Maintain a deliberately open FX balance sheet position that partially hedges the capital ratio. The capital ratio is sensitive to movements in the foreign exchange rate but less than in the first case as well as P&L in comparison with second case.

If we compare the third situation to the first one, in the third, the institution has opted for an active management of the capital ratio reducing the sensitivity of the capital ratio to movements in the foreign exchange rate. The understanding is this strategy should not be penalized comparing to the first one

Please find below 4 different cases for the analysis:

- Case 1: Matched FX position

  In this case there's no FX capital charge as the position in FX is matched but as a consequence the sensitivity of the ratio to movements in the foreign exchange rate is high.

Bank with no FX position				
HIGH ratio sensitivity		No waiver is needed		
No P&L volatility				
NO FX RWA=> no ow n funds requirement				
	FX	1		
100%	Assets FX	1000	1000	Liabilities FX
100%	Assets EUR	2000	1700	Liabilities EUR
			0	P&L
			300	Equity EUR
	Total	3000	3000	Total
	ONFEP	0		
	Waiver			
	RWA Assets FX	0		
	Capital Ratio	10,00%		
	sens 10% deval	32 bp		

- Case 2: Open FX position that neutralizes the sensitivity of the ratio to movements in the foreign exchange rate

  In this case there's no FX capital charge as the amount of the exclusion is equal to the open position (i.e. 100). The sensitivity of the ratio to movements in the foreign exchange rate is zero as this strategy has totally neutralized the capital ratio to movements in the foreign exchange rate.

Bank with FX position. Ratio fully hedged				
NO ratio sensitivity		Waiver is granted		
HIGH P&L volatility				
NO FX RWA=> no own funds requirement				
	FX	1		
100%	Assets FX	1000	900	Liabilities FX
100%	Assets EUR	2000	1800	Liabilities EUR
			0	P&L
			300	Equity EUR
	Total	3000	3000	Total
	ONFEP	100		
	Waiver	-100		
	RWA Assets FX	0		
	Capital Ratio	10,00%		
	sens 10% deval	0 bp		

- Cases 3 and 4: Open FX position that almost reduces to the half the sensitivity of the ratio to movements in the foreign exchange rate comparing to Case 1.

    - Case 3: the amount of the structural position excluded for the FX RWA calculation is the maximum amount that neutralizes the ratio (Position excluded=100, as can be seen in case 2). The exclusion generates a short position bigger than the original long position, provoking higher own capital requirements. In addition the amount of capital requirements for FX is bigger (and lower capital ratio) than the first example with half of CET1 ratio sensitivity.

Bank with FX position. Ratio partially hedged				
		Waiver is granted with no cap		
Lower ratio sensitivity				
Lower P&L volatility				
FX RWA **bigger** than ONFP, own funds requirement				
	FX	1		
100%	Assets FX	1000	955	Liabilities FX
100%	Assets EUR	2000	1745	Liabilities EUR
			0	P&L
			300	Equity EUR
	Total	3000	3000	Total
	ONFEP	45		
	Waiver	-100		
	RWA Assets FX	55		
	Capital Ratio	9,82%		
	sens 10% deval	18.5 bp		

- Case 4: the amount of the structural position excluded for the FX RWA calculation is the amount that partially neutralizes the ratio (Position excluded= structural or non trading open position maintained to reduce the sensitivity). The exclusion does not generate a short position.

Bank with FX position. Ratio partially hedged				
		Waiver con CAP		
Lower ratio sensitivity				
Lower P&L volatility				
NO FX RWA=> no own funds requirement				
	FX	1		
100%	Assets FX	1000	955	Liabilities FX
100%	Assets EUR	2000	1745	Liabilities EUR
			0	P&L
			300	Equity EUR
	Total	3000	3000	Total
	ONFEP	45		
	Waiver	-45		
	RWA Assets FX	0		
	Capital Ratio	**10,00%**		
	sens 10% deval	17.7 bp		

Conclusion: When the ratio is partially hedged, the structural FX exclusion shouldn't be bigger than the original open position, as in any case, is reducing capital ratio sensitivity.