Consultation response

Structural FX
January 2020

Executive summary

AFME and our members appreciate the significant work by the European Banking Authority (EBA) in harmonising the treatment of structural Foreign Exchange (S-FX) under currently applicable European Capital Requirement Regulation (CRR) and note that EBA takes into account the updated Fundamental Review of the Trading Book (FRTB) standard by the Basel Committee of Banking Supervision (BCBS), although it would become applicable in Europe only once included in the future CRR (i.e. CRR#3). We commend the changes made since the earlier consultation, particularly on areas such as allowing banks to hedge their most relevant capital ratio and regulatory approval being sought for risk management strategy rather than at transactional level.

However, we believe that the proposals still go beyond just harmonising the supervisory approvals for S-FX exemptions, namely in the areas of consolidation and transactions that are in scope for the net open position (NOP) and their reflection in the bank's S-FX management policy. We summarise below our main concerns in terms of areas where the proposals could lead to undesired outcomes and our recommendations in order to ensure that the EBA's objective of a consistent supervisory implementation of the S-FX framework is achieved whilst ensuring the harmonisation efforts do not contradict banks' structure in their organisations and in the S-FX is managed.

Firstly, we highlight below our key messages in relation to the EBA's questions:

- We understand that the definition type A positions – if applied on a consolidated basis - is based on a look-through to the assets and liabilities of the subsidiary, excluding trading book positions. In our view the type A positions should not be defined by means of a look-through and instead should be defined as the amount of the equity investment in the subsidiary or branch. The amount of this equity investment is of a structural nature as it is centrally managed via capital injections or repatriations and FX spot conversions.

- We believe investments in subsidiaries and capital allocation to branches as well as associates and joint ventures and any positions stemming from such investments should not form part of the Net Open Position (NOP) under article 352 (1) CRR subject to Pillar 1 capital charge as they do not affect P&L and are of a structural nature. We note that elsewhere in the CRR or the Basel framework there is no example of a Pillar 1 capital charge that would not relate to an impact on profit and loss accounts (P&L). The proposal to subject net investment (Type A translation risk) to a Pillar 1 capital requirement would go beyond the existing regulatory requirements.

- In our view the role of article 352(2) CRR is to exempt some Type B foreign exchange transactions affecting the P&L that would otherwise be subject to Pillar 1 capital charge, to the extent that they have been '*deliberately taken in order to hedge against adverse effect of the exchange rate on its ratios*'. The Net Open Position (NOP) comprises all transactions whose foreign exchange risk affects P&L. [For example, Additional Tier One securities issued by that bank should not be part of the *NOP]*.

- Based on the above two points and the EBA's mandate of harmonising principles that banks should apply when hedging the ratio for FX fluctuations, we recommend that the focus of the supervisory guidelines should be on harmonising the standards in relation to exemptions for Type B risk positions that are transactional in nature.

- the envisaged requirements for exempting hedging transactions whose foreign exchange risk would affect P&L but have been taken in order to hedge the capital ratios of the bank are overly prescriptive and difficult to operationalise. We are concerned that it would be difficult for banks to implement the proposed guidelines for actual management of banks (e.g. limitation to significant currencies, narrow volatility tolerance, articulation between solo and consolidated level, transition period from the current framework to the target framework), or for supervisors to cope with significant number of exemption requests and reviews. Indeed, requesting approval from supervisors for each individual change will in our view not work, as the ECB and other regulators are not set-up or currently require constant approval requests. This may create a risk that banks are not able to apply the option given by article 352 (2) CRR.

  Those requirements could have many detrimental consequences, most of which we believe are unintended. AFME and our members believe that the requirements should be substituted with guidelines for the articulation of a bank policy for the management of non-trading foreign exchange risk including the criteria for evidencing the risk mitigating *against adverse effect of the exchange rate* on the ratio it elects to mitigate. The policy should also describe the relationship between solo and consolidated levels, notably for the transactions that are booked in the parent entity mitigating against adverse effect of the exchange rate of the consolidated ratio. The Policy would be submitted for approval to supervisors, and, once approved and adhered to it, the relevant transactions would be exempted from Pillar 1 capital charge. We believe that this recommendation is fully aligned with the intention of the BCBS market risk standard that is expected to be implemented through a future CRR (i.e. CRR#3).

- Considering the above, the Draft Guidelines should be reconsidered. AFME and our members are willing to contribute to the articulation of a practical, operational and sound supervisory framework for the management of non-trading foreign exchange risk, including the exemption of some transactions that help mitigating the adverse effect of the exchange rate on ratios. The redrafted Guidelines should follow more closely the FRTB requirements, specifically in the area of defining the bank's S-FX risk management policy content (BIS MAR11.3(5).

- There is a need for grandfathering existing S-FX policies until banks and supervisors transition into the new framework. The envisaged timeline for the implementation of *Draft Guideline* is impractical for both banks and supervisors as it would create a bottleneck for reviewing the updated S-FX policies and scope of transactions that should be exempted from market risk.

  Considering the potential ramifications in terms of additional capital requirements, a Quantitative Impact Study (QIS) should be implemented to inform the potential consequences of impact analysis that is a requirement for implementing a new guideline.

Secondly, the industry has a concern on EBA's implied suggestions to divert prudential regulations further away from commonly used accounting practices, e.g. with regard to:

a. different levels of consolidation and the overall consolidated balance sheet;
b. accounting P&L vs. direct shareholders' equity (other comprehensive income) impact of various FX positions; and
c. distinction between accounting currency transaction and translation risks.

We believe that this is a critically important issue and want to highlight our views in this summary. Furthermore, this diversion contradicts the Memorandum of Understanding for mutual co-operation between the Basel Committee on Banking Supervision and the IFRS Foundation issued in September 2017.

We agree with EBA that, as it is a consequence of the business model the bank operates in, the accounting framework an institution applies will have an effect on the way that it hedges the ratio for adverse effect of the exchange rate in accordance to article 352 CRR. This is because the valuation principles as well as hedge accounting principles in the accounting framework and prudential filters (or absence thereof) have a direct effect on own funds. Although the EBA is referring in paragraph 2 of the CP to "the accounting framework" AFME likes to highlight that the CRR is referring to the 'applicable accounting framework' meaning the accounting standards to which the institution is subject under Regulation (EC) No 1606/2002 or Directive 86/635/EEC. In case an institution is subject to Directive 86/635/EEC, the assumptions and examples made by EBA in their Consultation Paper (CP) do not fully hold as the impact on own funds can be different than when applying Regulation (EC) No 1606/2002. We consider this a major shortcoming of the CP as EBA here does not fully respects EU law.

We also note that bringing in the consolidated balance sheet would either require provisions so that positions and investments are not duplicated in the process, and another entity within the group (that has access to markets and is regulated) can hedge on behalf of the consolidated group and use the exemption in line with the exposure at consolidated group level (subject to removing the double-counting). To avoid the aforementioned issues, we strongly recommend that the waiver obtained for the consolidated group should be automatically applied to solo entities when the solo entity is a parent to a group or sub-group of legal entities, the solo entity carries net asset hedging activities on behalf of the consolidated group.

We thank you in advance for your consideration and please do not hesitate to contact us with questions or if you would like to discuss our recommendations further. We remain committed to assisting policymakers in achieving the objectives of these important guidelines.

Kind regards,

Jouni Aaltonen
Managing Director, Prudential Regulation
AFME

Responses to EBA's questions

Q1. Would you consider beneficial to limit the S-FX provision to hedge the CET1 ratio aiming at creating a level playing field in the EU? Please provide a rationale.

We appreciate the EBA's intention to achieve a level playing field in terms of how the S-FX provisions are applied across the EU, within the applicable regulatory and accounting framework. We suggest that limiting the S-FX provisions to CET1 would not create level playing field benefits as the key concern being addressed is a bank specific capital structure, binding capital constraint, currency footprint and legal entity structure.

While most institutions may be hedging the CET1 ratio in practice, limiting the S-FX provision to hedge the CET1 ratio would represent an undue regulatory provision that would override the Level 1 text, exceeding the role of an EBA Guideline. There are no elements on the Level 1 CRR text that would justify limiting the S-FX provision only to hedging the CET1 ratio.

It should be said that under the current prudential regime, there is not one single accounting framework required, where the accounting framework is a driver of how FX exposures are impacting P&L. This as well as other reasons, like how the bank operates in terms of its legal structure is why banks can opt for different strategies when dealing with the FX risk, and the amount of the structural position to be excluded depends on the strategy followed by the bank. We believe that the firm specific current *or* target value of the capital ratio (whether risk or leverage based) at a consolidated level could be considered by the institution. For example, firms may prefer to calculate their position with respect to a target ratio to avoid monthly fluctuations they may see in their current ratio. This approach would broadly neutralize the sensitivity of FX on the current ratio provided the current ratio and the target ratio are not too dissimilar, while providing a more stable foundation for S-FX management.

We recommend that the article 92 CRR, as amended by the CRR2 (including leverage ratio) should provide the relevant ratios that can be used for the formulas. Additionally, firms should be free to hedge a combination of two or more ratios simultaneously, which calls for more flexible framework than the EBA proposal. The waiver should be granted when this hedging strategy is properly documented in the internal S-FX management policy and meets all other regulatory waiver requirements.

The overall objective of achieving a harmonised EU interpretation and implementation of treatment of structural FX positions can be achieved by placing greater emphasis on articulation of an entity's risk management strategy and internal governance framework around monitoring and ongoing management of structural FX risk. The CP in our opinion is focussed on an overly prescriptive and formulaic approach around management of structural FX risk. As pointed out in BIS MAR11.3(5) the pre-approved risk management policy should ideally cover the process to establish the bank's S-FX risk position and define the framework for any acceptable changes in this position.

Q2. Which of the three ratios is your institution hedging?

Institution specific question.

However, most institutions tend to hedge the most binding constraint – typically the CET1 ratio but could be other ratios and hence this flexibility should be preserved. We also note that within the formulaic approach, simultaneous management of several ratios with a predefined proportion within the provided risk appetite framework would not be possible.

Please review our answer to question 1.

Q3. For how many and for which currencies do you currently have the permission to exclude some positions from the corresponding net open position? For how many and for which currencies do you plan to request the permission following the adoption of these guidelines?

Institution specific question.

As a generic comment, we note that the Level 1 text does not limit the scope of the exemption of article 352(2) to only the most material currencies. AFME believes that firms should be provided with the flexibility of including currencies beyond the most material currencies based on their geographical footprints and activities without a requirement to extend the scope of currencies as there is no prudential basis for such limitation. The S-FX policy should form the basis for supervisory discussion on what is the most sensible approach for the bank.

Q4. Could you please provide the list of the 10 most material currencies if the materiality of a currency were assessed in accordance with measure A and measure B? Please provide also the value taken by measure A and measure B for those currencies.

Measure A: *percentage of the open position in the foreign currency (without considering any waiver) with respect to the open position in the reporting currency.*

Measure B: *percentage of the open position in the foreign currency (without considering any waiver) with respect to the total own funds of the institution*

Institution specific question.

See the answer to question 5 below.

Q5: Do you agree with the policy included in paragraph 25? Please elaborate.

AFME and our members believe translation risk of Type A positions should not be included in the scope of this policy that relates to exemption. Instead, the aim of the framework and paragraph 25 should be to assess transaction risk and the validity of the firm specific S-FX management policy and methods. This should be assessed at the initiation and in ongoing basis when changes are made to the group structure and or S-FX management policy, subject to supervisory monitoring. The currencies in scope should be determined within the S-FX policy. Furthermore, the exclusion of an currency from the scope of potential exemption has no legal or prudential basis and could prevent the prudential framework from recognizing actual S-FX management. We believe that institutions should be provided with the flexibility of deciding the currencies for which they would like to have Article 352(2) exemption in their S-FX management policy, without any prejudice.

Restricting exemptions to the top few currencies calculated based on the methods set out without a separate supervisory approval to extend the scope of material currencies to the requirements and footprint of the institution appears counterintuitive and does not serve a prudential or legal purpose. In our view, a structural position deliberately taken in a currency and a hedge to protect the ratios against adverse effect of exchange rate move is unrelated to whether the currency is material. We recommend that instead of limiting the number of currencies, a categorisation of currencies (into active/passive/not used for structural FX management) could be provided under the structural FX risk management policy/strategy and considered relevant to the institution. This would avoid the potential inefficiency created by a separate approval process.

With regard to position eligibility, in a complex international group, regulatory reporting and ratio measurement takes place on a number of levels: solo entity level (which includes branches as well as associates and joint ventures), overall group consolidated level, and sub-group consolidated level. The structural exposure could be also impacted by:

1) historical accounting or net asset value treatment of underlying value of investments on the balance sheet of the parent; and
2) historical performance of the subsidiary within the firm (e.g. accumulated losses in some subsidiaries and branches may result in net liabilities, which are still of structural nature).

Hence, the exemption regime should accommodate hedges that an institution may put in place to counter structural FX risk at all points in the reporting hierarchy, regardless of the position being net long or short.

> *Example:*
> *Consider a business combination where P (EUR reporting currency) is the parent entity within the regulated Group 1. S1 (USD reporting currency) and S2 (GBP reporting currency) are subsidiaries of P. Simultaneously, S1 is a parent of the regulated Group 2 (which is a subset of Group1) and B (GBP reporting currency) is its branch. In cases where the firm choses to manage/neutralize only the capital ratio for Group 1, the capital ratio of Group 2 may not be possible to neutralize simultaneously (e.g. due to accumulated losses and therefore the net liability position in B). Based on the proposed regulations, Group 2 will have to capitalize the short GBP position even though it is 100% structural in its nature.*

Q6: Are the structural positions for which you plan to ask the permission mainly positions of type A (i.e. meeting the condition in the paragraph above), or positions of type B? Could you please provide a rough estimation of the percentage of positions of type A on the total foreign-exchange position that you will potentially include in the request to the competent authority? For example, if the institution plans to request to exclude a net position = 100, and 80 of such net open position is due to positions of type A, then the percentage of positions of type A on the total foreign- exchange position that the institution will potentially include in the request to the competent authority is 80%.

The definition of Type A and Type B currency exposure is not very clear in the proposed S-FX framework and differs from industry common practice, which mainly follows the accounting rules. The concept of transaction foreign exchange risk (affecting P&L) and foreign exchange translation (not affecting P&L) would be a clearer, more widely understood and more consistent with the prudential framework (for which Pillar 1 capital charge relates to potential P&L losses. Indeed, in CRR and in the Basel framework, there is no example of Pillar 1 capital charge that would not relate to an impact on P&L. The proposal to subject net investment (Type A) to Pillar 1 capital requirement would go beyond regulatory requirements.). The requirement to apply for permission in order to exclude Type A at a consolidated level would assume that foreign exchange translation would be capitalized for market risk purposes even though it does not affect P&L. This is detailed below.

Defining NOP: *Transaction foreign exchange risk vs. foreign exchange translation*

With regard to the NOP, we note that the provisions of the *CRR* are based on the valuation of assets, liabilities and off-balance sheet items, according to the applicable accounting framework, i.e. *International Financial Reporting Standards* for European groups or national GAAP (cf. CRR s. 24, art. 111 and art. 166). The IAS21 distinguishes the principles on the effects of changes in foreign exchange rates to be applied to:

1. Transactions which are in foreign currency (namely in a currency different from the functional currency of the entity); and

2. The translation of the results and financial statements of subsidiaries, branches, joint ventures, associates which functional currency is different from the presentation currency, to the presentation currency.

The determination of the functional currency mainly relies on the primary economic environment in which an entity operates - considered to be the one in which it primarily generates and expends cash. An entity's chosen functional currency reflects the underlying business and economic reality relevant to its business model. Accordingly, once determined it is not expected to be changed unless there is a change in those underlying business, events and conditions (cf. IAS 21§13).

The presentation currency is merely a numerical convention necessary for the preparation of financial statements that include a foreign operation (cf. IFRS standards IFRIC 16 BC13). While functional currencies create an economic exposure to changes in cash flows or fair values, a presentation currency never will. The standard furthermore clarifies that exchange differences are not recognized in P&L because the changes in exchange rates have little or no direct effect on the present and future cash flows from operations (cf. IAS 21§41).

It is worthwhile to be noted that nothing in the standards prevents an entity from changing its presentation currency while the determination of the functional currency once determined is not expected to be changed as mentioned above.

Accordingly, the notion of foreign exchange position can only be assessed by entity, in relation to the entity's functional currency (or currencies) in the IFRS or local GAAP framework and the translation to the representational currency does not affect the Net Open Position ('NOP') beyond the existing NOP at the entity level.

Hence:

- at individual entity level the *NOP* comprises all transactions with foreign exchange risk different from the entity functional currency CRR art. 352(1))
- at consolidated level, the *NOP* is constituted by the sum of the *NOP* of the different entities in the consolidated perimeter.

Transactions that are accounted to hedge under IFRS[1] for foreign exchange risk, be they fair value hedge or cash flow hedge, branch net investment hedge (at solo level) or subsidiary and/or branch net investment hedge (at consolidated level), do not generate transaction *foreign exchange risk* as the foreign exchange component is offset by the foreign exchange risk component of the hedged item. Hence, those transactions do not contribute to the *NOP* component.

- NB1: For example, if a net investment is hedged from an accounting standpoint (at consolidated level), the gain or loss on the hedging instrument is recognized in Other Comprehensive Income (as foreign exchange reserves stemming from the consolidation process of subsidiaries which functional currency is different from the presentation currency)
- NB2: Hedge accounting is an exception in the IFRS framework subject to meeting stringent criteria as defined in IAS 39§88 or IFRS 9§6.4.1, notably in terms of hedge effectiveness.
- NB3: Financial statements are subject to the review of auditors. They have to publish a report and express their opinion on the financial statements that engage their responsibility.

[1] We emphasise that under national GAAP additional hedge accounting models are applicable in addition to the once listed by IFRS that EBA should take into account

At least, in the current CRR and in the Basel framework, there is no example of Pillar 1 capital charge that would not relate to an impact on P&L. The proposal to subject net investment (Type A) to Pillar 1 capital requirement would go beyond existing regulatory requirements.

Therefore, AFME and our members believe that positions stemming from investment in subsidiaries and investments in branches (capital allocations and other structural net investments) as well as associates and joint ventures (Type A) should not be subject to an exemption requirement. They should be viewed as simply not being part of the Net Open Position under article 352 (1) CRR. A Level 2 interpretation or supervisory guidance that would require banks to apply for exemptions for investments in subsidiaries or investments in branches would be at odds with the Level 1 CRR and the spirit of the BCBS FRTB, as these investments do not relate to foreign exchange risk that would not materialize through Profit and Loss statement (P&L) and accordingly do not affect the Net Open Position. The *Draft Guidelines* should be revised to avoid any undue deviation and override of level 1 text by clarifying that *Type A* are excluded from the Net Open Position.

Articulation with CRR Article 352(2)

The *CRR* Article 352 belongs to the '*Chapter 3 – Own funds requirements for foreign exchange risk*' within '*Title IV – Own funds requirements for Market Risk*'. It aims at identifying the portion of the balance sheet that will be subject to a Pillar 1 capital charge for foreign exchange risk. In the Basel framework, Pillar 1 capital charge relates to potential losses through the profit and loss statement (*P&L*) in adverse circumstances.

Naturally, no capital charge should be associated to investments in subsidiaries and capital allocations to branches as well as associates and joint ventures as they do not trigger *P&L*. Foreign exchange variations trigger adjustments in the balance sheet for equity, through other comprehensive income, and as a consequence some volatility of the capital ratios that banks may wish to hedge against. This is why Article 352 (2) CRR enables to exempt from capital charge the foreign exchange transactions that have been '*deliberately taken in order to hedge against adverse effect of the exchange rate on its ratios*'.

Accordingly, positions of *Type A*, including the capital allocation to branches, jointly controlled entities and undertakings for which the equity method is used should not be in scope for the NOP under Article 352 (1) CRR. Consequently, the exemption should relate to Type B financial transactions to mitigate ratio foreign exchange sensitivity whereby Type A positions contribute to the ratios being mitigated.

Exemption for transactions in the Net Open Position

The *Draft Guideline* is overly prescriptive with regard to the requirements for applying for exemption. This will result to its implementation being extremely difficult in practice for both banks and supervisors to manage, as it would force actual foreign exchange risk management to be aligned with the framework with associated inefficiencies rather than reflecting soundest risk management principles relevant to the institution's structural FX management.

- The suggested requirements assume that everything is stable once the exemption is granted is not practical, as it fails to take into account the normal courses of business which cannot be considered fully stable. This would also create supervisory uncertainty if the exemption is permanently reviewed and challenged. We also wonder whether the approval process at the ECB as the main EU regulator for major institutions that are more likely to have S-FX is set-up for constant review process as envisaged in the EBA's guidelines.
- The requirements on risk management are overly prescriptive as they require that banks have a strategy to

1) Stabilize the sensitivity of ratio to changes in foreign exchange rates at constant level over time,
2) Specify a hard coded 5% threshold within which the sensitivity should remain, and
3) Not adapt to facts and circumstances for periods shorter than 6 months.

By definition, the implied S-FX risk management strategy would be fully focused on regulatory ratios only while

I. there is a balance to strike between the sensitivities to foreign exchange of the different regulatory ratios banks are subject to, and
II. regulatory ratios are only one of the dimensions being considered in overall risk management policy of the bank.

- The definition of a cap applied to a specific regulatory ratio would prevent banks from defining their own target, that could be currency dependent, on the level of ratio that they are willing to hedge.
  As an example, a bank might want to target a higher ratio for a specific currency. As another example and in case the ratios are regulatory ratios, a cap would prevent a bank to hedge a higher level of ratio that it aims at maintaining.
- Quantitative criteria suggested through the proposed formula for risk management requirements cannot be met simply due to the evolutions of the balance sheet.
  As the max open position relates to the 'amount of FX risk position that neutralises the sensitivity of the capital ratio to movements in the exchange rate', it covers all the balance sheet, including trading and net open position.

$$MaxOP = CET1 * \frac{\frac{RWA_{NoFX_{FC}}(1.01 * FX_{FC_0}) - RWA_{NoFX_{FC}}(FX_{FC_0})}{0.01 * FX_{FC_0}}}{RWA_{NoFX_{FC}}(FX_{FC_0})}$$

This can be written as:

$$MaxOP = \frac{CET1}{RWA_{NoFX_{FC}}(FX_{FC_0})} * \frac{RWA_{NoFX_{FC}}(1.01 * FX_{FC_0}) - RWA_{NoFX_{FC}}(FX_{FC_0})}{0.01 * FX_{FC_0}}$$

The first term is the ratio of CET1 to RWA excluding the need of RWA due to FX risk of the considered currency. The second term basically enables to identify the RWA relating to FX denominated items. The CET1 relates to the actual CET1 that the bank has elected to build up. This CET1 is greater than the prudential requirement for CET1 and is a choice of the bank. Hence, the definition of the max open position embeds strong assumptions that the bank has elected an actual CET1 that is *proportionate* to the RWA in the different currencies it operates in. However, there is no regulatory requirement to cover prudential CET1 requirement in proportion of the RWA in different currencies, and there is no reason to assume that the actual CET1 beyond the prudential CET1 requirement has to be proportionate to the RWA's in the different currencies.

As all components of the formula are variable over time, it does not make practical sense to lock the amounts as of the application date. Banks should be able to decide the currency breakdown of CET1 that they wish to allocate across the RWAs and currencies and hedge. Hence, a bank may be willing to allocate more capital than the prudential minimum required capital for a subsidiary operating in a specific currency (e.g. emerging market subsidiary) and be able to mitigate a portion of the resulting foreign exchange risk. This also applies when the prudential requirements that apply to a subsidiary differ from the Group applicable prudential requirement.

- The tolerance level for ratio volatility is too narrow, notably for currencies with significant volatility and/or limited ability to hedge the currency (restricted currencies).

AFME recommendation for the scope of NOP

- According to what have been developed above, exemption should relate to *Type B* financial transactions to mitigate ratio foreign exchange sensitivity whereby *Type A* positions contribute to the ratios being mitigated. The EBA proposed requirements should be replaced with Guidelines for the articulation of a bank Policy for the management of non-trading foreign exchange risk

- Thus, we recommend the following requirements to be applied to granting exemptions to Type B NOP items:
  1. they should adhere to a defined *Policy* that enables to demonstrate that they are not trading in nature, and that they are shown to prospectively reduce the adverse effect of the foreign exchange rate on the defined prudential ratio;
  2. the Policy should describe:
     - the scope of application. It is defined either for an individual entity, or for a consolidated / sub-consolidated group of entities.
     - the currency ('c'), or group thereof, whose foreign exchange rate is being mitigated.
     - the elected prudential ratio whose impact from foreign exchange rate is mitigated. For each defined scope and currency, there should be one designated prudential ratio among Common Equity Tier One, Tier One, Total Capital, Leverage Ratio as well as *TLAC, MREL Ratios.* Below, the chosen ratio is named *Elected Ratio*.

       Note that within the same Group, an entity and a sub-group might elect different prudential ratios as the most binding ratio might be different at different levels of the Group.
     - the description of the Net Open Position (NOP), for which a bank might elect to consider that investment in subsidiaries or investments in branches (capita allocations or other structural net investments) have been deliberately taken for the purpose of mitigating the sensitivity of the elected ratio to foreign exchange rate sensitivity
     - the metric used to evidence that there is a reduction of adverse effect of the foreign exchange rate.

       The metric is derived from the *Elected Ratio*, calculated with different levels of foreign exchange rate: the current exchange rate (fx_0), the exchange rate increased by +x% ($fx^c_+=(1 + x^c\%)\bullet fx^c_0$), the exchange rate decreased by – x^c% ($fx_-=(1 - x^c\%)\bullet fx^c_0$); for two types of situations: with ('w/') and without ('w/o') the considered mitigating transactions.

       For each currency, the Policy should define the magnitude of the shock ('x^c%') that is applied, consistent with the variability of the foreign exchange rate of the considered currency.

- At least, it should be clarified that type A also includes branches, jointly controlled entities and undertakings for which the equity method is used, consistently with IFRS requirements for the translation of the results and financial statements. Indeed, these translation requirements apply to subsidiaries, joint ventures, associates which functional currency is different from the presentation currency, to the presentation currency. There are no conceptual nor economic reasons to introduce a distinction between branches and subsidiaries. Such a consideration would override level 1 text. Furthermore, in some jurisdictions branches are subject to local capital or liquidity requirements or restrictions.

Q7. Could you please provide the percentage of the net open position that you plan to request to exclude with respect to the net open position that your institution has without any waiver?

Institution specific questions.

Please refer to the comments on question 6. Furthermore, as long as the positions are of a structural nature and meet the tests set out in Art 352(2) they should be considered for exemption (to remove any ambiguities only type B would be eligible for exemptions as type A transactions and the positions stemming therefrom do not affect the Net Open Position).

Q8. Do you agree with the exclusion of positions that are not eligible to be structural from the sensitivity that is used for assessing the intention of the institution to hedge the ratio, or would you prefer to have those positions included although they cannot be exempted? Please elaborate.

Firstly, we note that the intent of Level 1 CRR is to apply foreign exchange transaction that are not of a trading nature. This creates a confusion between the *Draft Guidelines* in relation to the Level 1 *CRR* text which refers to the transactions and positions being exempted (i.e. '*Such positions shall be of a non-trading or structural nature*') and the interpretation in the Draft Guidelines which excludes some positions from the ratios being hedged. In general, if some positions are excluded from the denominator of the ratio whose sensitivity is hedged, the ratio can no longer be fully hedged. As trading book is excluded from structural positions, it is simply impossible to make the ratios insensitive to change in foreign exchange rate. Hence, the NOP volatility requirements would be impossible to meet in presence of trading book.

Our members are further concerned that some of the methods are too intrusive in the way they force institutions to manage the structural FX. We believe that it should be the risk departments that decide what is appropriate from the risk standpoint and that the supervisory guidelines should be supportive of sound risk management practices. In some cases, as we describe below, the framework would make it difficult to manage structural FX in the most appropriate way. AFME and our members have reservation particularly to the below proposals:

- The interpretation in the consultation paper, stipulating that hedging is limited to 'reducing the volatility' in terms of both appreciation and depreciation is overly prescriptive. The objective of hedging structural FX risk is to mitigate any downside risk to the capital position of the bank. Requiring banks to also hedge any positive movement would increase hedging costs (having to protect for both down and upside risks) and limit potential returns without any prudential or risk management benefit. We therefore do not believe that the volatility metric needs to address appreciation in the capital position.

- The formula is built on the effective ratio of institutions based on a given CET1 ratio which is different from the required ratio (additional management buffers are added to requirements to ensure the institutions to meet ratios requirements). This is counter to the proposal elsewhere to allow hedging of ratios as described in article 92. We believe that the article 92, as updated by the CRR2 (including leverage ratio) should provide the relevant ratios that can be used for the formulas.

Q9. Are there currently FX-risk positions that you kept open in the trading book for the purpose of hedging the ratio? Why did you not include such positions as part of the banking book since the main purpose of those positions is to hedge the ratio?

Institution specific question.

We agree that structural positions subject to exemptions should be of a non-trading nature, although no positions should be excluded from the ratio being hedged.

Please also refer to our answer to Q6.

Q10. Do you think that by excluding positions that are non-eligible to be exempted, it will be easier for institutions to meet the requirement of keeping the sensitivity stable over time? Please elaborate.

Same as Q8.

Q11. Is your institution currently required to keep the sensitivity of the ratio stable over time where requesting the permission referred to in Article 352(2)? If not, how do you justify the intention of hedging the ratio? Please elaborate.

Institution specific question.

Please also refer to comments on question 8.

Q12. Do you agree with the definition of the range in paragraph 27(d)? Do you think that 0.05 is an appropriate value?

The objective of a hedging strategy is to mitigates an adverse impact from a potential market change. This notion is expressed very clearly in FRTB text defining the objective of S-FX management as "the risk position is taken or maintained for the purpose of hedging partially or totally against the potential that changes in exchange rates could have an adverse effect on its capital ratio". Furthermore, paragraph 16 of EBA CP on S-FX proposes "an open position in a foreign currency should be considered to be hedging the ratio where it reduces the adverse effect on that ratio caused by changes in the exchange rate, irrespective of whether that adverse effect derives from an appreciation or a depreciation of that foreign currency with respect to the reporting currency and irrespective of whether the position is maintained for hedging the ratio or taken for hedging the ratio".

The ratio sensitivity depends on three variables:

1) the size of currency shock;

2) the ratio level; and

3) the size of mismatch in currency between numerator and denominator (e.g. CET1 and RWA) as per examples below:

Scenario with perfectly hedged ratio

in EUR	Total	EUR	USD
CET1	100	50	50 *
RWA**	1000	500	500

CET1 ratio 10.0%

Scenarios	USD +10%	USD -10%
CET1 ratio	10.0%	10.0%
Sensitivity	0.0%	0.0%

Scenario with USD mismatch (10% vs. 50%), 10% USD shock and 10% ratio level

in EUR	Total	EUR	USD
CET1	100	90	10 *
RWA**	1000	500	500

CET1 ratio 10.0%

Scenarios	USD +10%	USD -10%
CET1 ratio	9.6%	10.4%
Sensitivity	-0.4%	0.4%

Scenario with USD mismatch (10% vs. 50%), 5% USD shock and 10% ratio level

in EUR	Total	EUR	USD
CET1	100	90	10 *
RWA**	1000	500	500

CET1 ratio 10.0%

Scenarios	USD +5%	USD -5%
CET1 ratio	9.5%	10.5%
Sensitivity	-0.5%	0.5%

Scenario with USD mismatch (10% vs. 50%), 10% USD shock and 16.7% ratio level

in EUR	Total	EUR	USD
CET1	100	90	10 *
RWA**	600	300	300

CET1 ratio 16.7%

Scenarios	USD +10%	USD -10%
CET1 ratio	16.0%	17.4%
Sensitivity	-0.6%	0.7%

* Open S-FX position
** Total risk exposure excluding Open S-FX

It is not clear from the formula provided in paragraph 27(d) how to apply ratio sensitivity and how each of these three variables would be considered. At the same time, it is stated that the purpose of this formula is to define "a range within which the sensitivity calculated in accordance with point (c) should remain over time". By proposing such a range EBA is implicitly limiting banks' ability to reduce ratio sensitivity to the currency to zero and therefore to eliminate potential adverse impact on the ratio. Therefore, it contradicts the original regulatory objective mentioned above.

We recommend each bank should be permitted to quantify its own level of tolerance for ratio sensitivity to support regulatory approval for S-FX exemption and recommend that the prescriptive formula for determining this tolerance should be deleted. At the same time, we welcome the EBA proposal to align the content and qualitative aspects of S-FX risk management policy.

In addition, consistency with Level 1 CRR text should be ensured as it mentions: '*hedge against adverse effect of the exchange rate on its ratios*', i.e. against *adverse* effects, not *all* effects due to exchange rate. Rather than prescribing limitations based on the Net Open Position, or a portion thereof, we recommend that the risk mitigation objective is directly articulated on the Elected Ratio being mitigated. Hence, the transactions being exempted should be evidences to prospectively reduce the adverse effect of change in change of foreign exchange rate on the Elected Ratio. In other words, for a change in foreign exchange rate that is detrimental to the Elected Ratio, e.g. a +5% of foreign exchange rate

for a 's' shock applied to a foreign exchange rate that leads
to a lower Elected Ratio *without* the considered transactions, i.e.
$ElectedRatio_{without}(fx+s) < ElectedRatio_{without}(fx)$,

the Elected Ratio *with* the transactions should be less detrimentally impacted:
$ElectedRatio_{with}(fx+s) < ElectedRatio_{with}(fx)$, and
$ElectedRatio_{with}(fx) - ElectedRatio_{with}(fx+s) \geq ElectedRatio_{without}(fx) - ElectedRatio_{without}(fx+s)$

Q13. Could you provide a description of the risk-management framework within which your institution operates for managing structural positions that have been taken for hedging the ratio (e.g. how your institution currently computes the sensitivity of the ratio to changes in the exchange rate, the level of granularity at which the boundaries referred to in paragraph 27(i)(i) are defined, exc.)? Do you think that these guidelines are in line with the current risk-management within which institution operates for managing SFX positions? If not, which are the differences?

Institution specific question.

The change from 'applying for exemption when relevant'-mode to 'systematic-application' would lead to most probably non-manageable by supervisors as banks would have to apply and update on a constant basis to adapt to changes in their balance sheet. This would basically create a framework that could not be made operational.

We are also in favor of eliminating the end of the point 81 of the Consultation Paper: "Additionally, a maximum limit on the loss, which is deemed acceptable should be part of the approval from the management Board". We believe that the previous provision, suggesting that the Board should be aware of the remaining FX risk on the investments when hedging only the ratio should be sufficient.

Q14. Is it easy for institutions to 'transfer' the concept of net open position in the context of the internal model? What are the methodologies that institutions may use for excluding positions for which they may receive the permission referred to in Article 352(2) from their internal models?

Institution specific question.

Q15. What is the size of non-monetary items that are held at historical costs with respect to the size of institution's balance sheet?

Institution specific question.

Q16. Do you think that the formulas presented above provide a good estimate of the position that is offsetting the sensitivity of the ratio with respect to changes in the exchange rate? If no, why? Are there any adjustments that you would recommend? Please elaborate.

Institutions generally manage FX positions within different risk appetites and to specific ratios that are most relevant to the capital and open FX positions of the firm. There could also be currencies which are difficult or too expensive to hedge. Hence, being unduly restrictive on the open position and hedge eligibility for the exemption is not supported by AFME and our members.

There are a number of underlying assumptions in the formulas and the examples that are theoretical and difficult to apply in practise.

- The calculation of the maximum open position in a given currency assume a move of that currency against the reporting currency. A move of that currency against all other currencies is more correct practically, especially when the contemplated capital base includes various items in different currencies. For instance, the total capital (CET1, AT1, and T2) generally includes instruments (AT1 and T2) that can be issued in a number of different currencies;
- The reference ratio is the current ratio. In many instances, a more appropriate ratio is a target ratio which is generally between the required ratio and the current ratio, and sometimes above the current ratio (for instance when a capital increase is contemplated);
- The examples given in the consultation paper assume no deductions (or deductions netted against the Common Equity, which is incorrect) and no minority shareholders;
- *More importantly, the formulas assume that the revaluation on the open positions translates fully into an equal variation of the CET1*. Consequently, the items are regarded as fully fungible. This is however not the case in practice as frictions and drags may arise in certain instances notably due to tax or regulatory reasons.

For example, some structural positions are subject to a tax drag. We demonstrate this in an example below:

- A European bank carries a business with both EUR and USD denominated exposures and operates at a ratio of CET 1 of 10%
- In order to maintain the 10 per cent ratio, the bank runs an open position in USD. From a tax perspective, the revaluation of the open position is subject to taxation (at 33 1/3%); This is a situation that may arise where the business is carried at headquarter or in some instances in a branch subject to taxation by the home tax authority; And consequently the open position is calibrated accordingly (grossed-up) to compensate the tax drag.

All exposures attract a 100% RW
All items reported in EUR
1 EUR = 1,20 USD

Assets		Liabilities	
USD Loans (USD 1200)	1 000	USD Debt	850
EUR Loans	2 000	EUR Debt	1 850
Other Assets	-	Common Equity	300
Total Assets	3 000	Total Liabilitues and Equity	3 000

Required CET1 for USd exposures	100
Required CET1 for EUR exposures	200
Total required CET1	300

Nominal Structural Open Position in USD	150
Effective Structural Open Position in USD (after tax tax drag)	100

As shown in the example, the formula would allow a EUR100 maximum position in USD, whereas the exemption should allow up to EUR150, to take into account the tax drag.

In addition, some positions arising from minority interests should be excluded since they do not impact the CET. We demonstrate this in the below example:

- A European bank carries a business with both EUR and USD denominated exposures and operates at a CET1 ratio of 10%;
- The USD business is carried out in a subsidiary in the US that is 80% owned by the group. The USD is not subject to local capital requirements and consequently the minority interest is not recognised in the CET1. Although the subsidiary is not subject to banking regulation (e.g. leasing and factoring), it is locally capitalised at 10%.
- In order to maintain the 10% CET1 ratio, the parent company runs an open structural position that comprises i) its interest in the subsidiary (a type A position) and ii) and additional position to compensate for the lack of recognition of minority interest in the CET1.

Exposures attract a 100% RW apart the Other Assets (0%)
No tax drag
All items reported in EUR
1 EUR = 1,20 USD

Condolidated Balance Sheet

Assets		Liabilities	
USD Loans (USD 1200)	1 000	USD Debt	900
EUR Loans	2 000	EUR Debt	1 800
Other Assets in USD (at parent company)	20	Common Equity Group Share	300
		Minority Interests	20
Total Assets	3 020	Total Liabilitues and Equity	3 020

Required CET1 for USd exposures	100
Required CET1 for EUR exposures	200
Total required CET1	300

Nominal Structural Open Position in USD	120
Effective Structural Open Position in USD (after minority	100

These examples show that the net open position in USD can be broken down in the following items:

- A structural position arising from the 80% interest in the US subsidiary (EUR80)
- A structural position arising from 20% minority interest that contributes to the overall position but that has actually no impact on the wealth of the group shareholders nor on the CET1 ratio. Therefore, in our view, this position should be excluded from the regulatory position;

- A Type B position that the parent company must maintain to mitigate the inefficiency of the minority interest due to the regulatory capping.

Q17. Do you think that is operationally feasible to compute the maximum open position and the sensitivity on a monthly basis?

The measurement frequency should be no higher than the ones applicable to accounts from which they are derived, i.e. usually on a quarterly basis, which is consistent with the ITS that report these positions in the COREP once a quarter.

Hence, a monthly measurement frequency would usually be inconsistent.

Q18. Do you currently include Additional Tier 1 instruments, and Tier 2 instruments that are issued in the foreign currency in the net open position referred to in 352(2)? Please elaborate.

In several countries additional tier 1 securities are accounted for equity at historic cost. Firms tend to exclude these positions from their net open position when calculation capital ratio sensitivity as the additional tier 1 securities do not revalue periodically for FX. However, they do create a capital management challenge as we set out below.

If a firm would like to be economically hedged against downside FX it may retain the foreign currency cash proceeds raised from the issuance of securities. However, this cash revalues periodically giving rise to capital ratio volatility. To avoid this occurrence, some firms sell the foreign currency in return for their functional currency. These transactions however leave firms economically exposed when they decide to call the additional tier 1 security (as they do not have the foreign currency proceeds). Where Additional Tier1 securities are equity accounted for, firms should be provided with the flexibility of including in their maximum open position the cash proceeds raised from the issuance as a structural position eligible for a waiver under Art 352(2).

Tier2 securities are typically debt accounted and are included as part of the net position referred to in Art 352(2). This would also be the case for debt accounted Additional Tier1 securities.

Q19. What is in percentage the amount of Additional Tier 1 instruments, and Tier 2 instruments that your institution issued in foreign currency with respect to the total amount of own funds of your institution?

Institution specific question.

The additional tier 1 and tier 2 requirements are 1.5% and 2% of RWAs, respectively. In some jurisdictions, a portion of the pillar 2 requirement can be met with additional tier 1 and tier 2 raising the minimum levels firms will tend to hold. Furthermore, in cases where firms are leverage constrained they may issue additional tier 1 securities to meet their tier 1 leverage ratio requirements.

Q20. What is the percentage of the amount of Additional Tier 1 instruments, and Tier 2 instruments that your institution issued in a foreign currency with respect to the net open position that your institution has in that foreign currency?

Institution specific question.

Q21. Is there anything in the approach outlined in these guidelines that could create issues of compatibility with the treatment foreseen in any non-EU jurisdictions in which EU institutions operate? If so, please elaborate.

A very formulaic and overly prescriptive approach would result in limitations on the positions that can benefit from the Art 352(2) waiver resulting in higher risk weighted assets as compared to non-EU firms.

EU specific compliance at a solo as well as consolidated levels: In most circumstances, it is impossible to make ratios insensitive to foreign exchange rate at entity as well as consolidated levels simultaneously. This is notably due to different prudential requirements applied at entity and group levels. We provide an example below where the FX currency devalues with 25% compared to the DC and that all assets are risk weighted at 100%.

<u>Example showing that hedging the ratio can only be applied at the consolidated level</u>

Bank A mother (EUR denominated)			
FX assets	0	FX liability	0
DC Assets	745	DC liability	595
		Capital	150
Sum	*745*		*745*
Capital ratio			20.13%

The DC assets includes DC 150 equity position of subidiary B

If FX depreciate by 25%

Bank B - subsidiary of Bank A (EUR denominated)			
FX assets	270	FX liability	230
DC Assets	140	DC liability	30
		Capital	150
Sum	*410*		*410*
Capital ratio			36.59%

FX assets do not comprise EUR

If FX depreciate by 25%

Bank Consolidated (EUR)			
FX assets	270	FX liability	230
DC Assets	735	DC liability	625
		Capital	150
Sum	*1005*		*1005*
Capital ratio			14.93%

If FX depreciate by 25%

Bank A mother (EUR denominated)			
FX assets	0	FX liability	0
DC Assets	745	DC liability	595
		Capital	150
Sum	*745*		*745*
Capital ratio			20.13%

Bank B - subsidiary of Bank A (EUR denominated)			
FX assets	202.5	FX liability	172.5
DC Assets	140	DC liability	30
		Capital	140
Sum	*342.5*		*342.5*
Capital ratio			40.88%

Bank Consolidated (EUR)			
FX assets	202.5	FX liability	172.5
DC Assets	735	DC liability	625
		Capital	140
Sum	*937.5*		*937.5*
Capital ratio			14.93%

DC = Domestic Currency (in this example EUR)
FX = Assets or liabilities (in this example only one currency)

- In the example the FX currency devalues with 25% compared to the DC.
- At consolidated level an open FX position of 40 takes care that the ratio at consolidated level is fully hedged.
- It's assumed that the DC and FX assets are risk weighted at 100%

Conclusion

- The FX position of the bank consolidated amounts to assets 270 and liabilities 230 (net position +40). This open FX positions takes care that the ratio at consolidated level is fully hedged.
- At the bank solo level (mother) we do not see any FX position as the solo entity does not has FX positions.
- The fact that we do not see the full FX position at solo is because IAS 21 does not look through the subsidiary as the solo entity level, but only records the shares (dominated in EUR) of the subsidiary in the balance sheet.
- This means that at solo level we do have a currency position, but it is not visible in the COREP due to the concept of solo and consolidated, making that you cannot hedge the FX position at the solo level, as there is no FX position.
- Hedging the ratio only makes sense at consolidated level.