DP on the treatment of structural FX under Article 352(2) of the CRR

Public Hearing

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Own initiative GL on structural FX – Why?

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EBA Founding Regulation - No 1093/2010 :

Recital 26 — *In areas not covered by regulatory or implementing technical standards, the Authority should have the power to issue guidelines and recommendations on the application of Union law.*

Article 1(5) — *The Authority shall contribute to: (a) improving the functioning of the internal market, including, in particular, a sound, effective and consistent level of regulation and supervision (…) (d) preventing regulatory arbitrage and promoting equal conditions of competition;*

- The concept and specific application of the structural FX provision pursuant to Article 352(2) appear to be subject to several interpretations, across both supervisory authorities and institutions.
- The implementation of this provision seems to be quite uneven across jurisdictions, and there is a lack of clarity around what constitutes a structural position for the purposes of Article 352(2).
- The application of this provision could have a significant effect on capital requirements. This raises potential concerns about the level playing field, as it could lead to significant differences in capital requirements across institutions with similar exposures.
- Finally, the treatment of the structural FX has been modified in the recently published Fundamental Review of the Trading Book (FRTB), which will be incorporated to the EU in the CRR2

1st step: publish this Discussion Paper

Definition of structural FX in the CRR and Basel

Article 352(2) of the CRR states that:

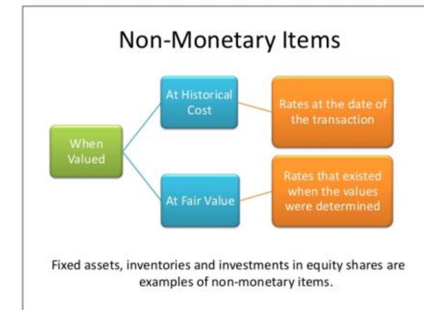
*'Any **positions** which an institution has **deliberately taken** in order **to hedge** against **the adverse effect of the exchange rate on its ratios in accordance with Article 92(1) may, subject to permission** by the competent authorities, **be excluded from the calculation of net open currency positions**. Such positions shall be of a **non-trading or structural nature** and any variation of the terms of their exclusion, subject to separate permission by the competent authorities. **The same treatment subject to the same conditions** may be applied to positions which an institution has which relate to **items that are already deducted** in the calculation of own funds.'*

The wording in Basel also considers that items deducted from capital should be part of the structural position; however, it includes a third case which is not contemplated in the CRR:

*718(xxxix). 'No capital charge need apply to positions related to items that are deducted from a bank's capital(…) **nor to other long-term participations** denominated in foreign currencies which are **reported in the published accounts at historic cost**. These may also be treated as structural positions'*

Broader FX issues – Scope of FX charges

Treatment of non-monetary items:



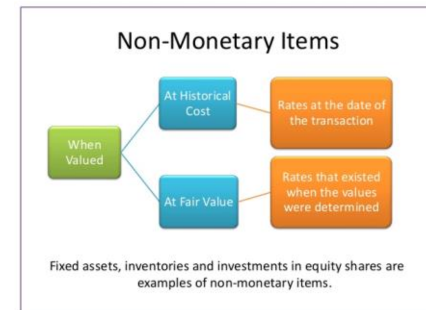
- FX capital charges apply to TB and BB items (Article 90(3)(c)(i))
- Article 352 does not refer at all to monetary / non-monetary items.
- BCBS current treatment: they should be included.

  Paragraph 6 of the original BCBS market risk amendment notes that:

  ‘The capital charges for foreign exchange risk and for commodities risk will apply to banks' total currency and commodity positions, subject to some discretion to exclude structural foreign exchange positions. It is understood that some of these positions will be reported and hence evaluated at market value, but some may be reported and evaluated at book value.’

- In addition, the fact that Basel allows the exclusion of items held at historic cost as part of the structural FX treatment, clearly implies that these positions should be included in the calculation of the net open position in the first place.

Broader FX issues – Scope of FX charges



Fixed assets, inventories and investments in equity shares are examples of non-monetary items.

Treatment of non-monetary items:

- Alternative view: they should not be considered in the determination of the net FX position.
  - for the purpose of IFRS 7, currency risk would not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency (reporting currency)
  - positions booked at the time of their acquisition using historic exchange rate would be considered as positions in the bank's reporting currency.
- This interpretation would make compulsory the exclusion (or rather 'non-inclusion') of all items held at historic cost for the purpose of calculating the net FX position.
- However, in the context of the accounting discussion, it is also worth considering the impairment rule (IAS 21.25), whereby an FX loss might be recognised as impairment instead of market loss, and would still affect the P&L of the relevant institution (though would not be considered as a 'market' loss).

Broader FX issues – FX risk under SA / IMA

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Differences between the standardised and internal model regulatory frameworks.

- The current treatment of structural FX is established in Article 352, located in Title IV, Chapter 3 of the CRR which deals with the FX treatment under the SA.
- The same article also specifies the requirements for the calculation of the 'net foreign exchange position'.
- There are no rules in the IMA part of the CRR (Chapter 5) regarding the calculation of the net FX position or the possible exclusion of structural FX.
- The CRR2 proposal incorporates in Article 325c the updated treatment for the structural FX established in the FRTB. The existing treatment for structural FX, as well as for the determination of the net FX position, remains.

The EBA considers that there should be a single treatment for the structural FX provision as well as for the determination of the net FX position – Scope of application.

Elements of the definition to be clarified

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Is it possible to identify 'position' with 'instrument', or alternatively, position stemming from a certain instrument?
Maximum size of the position?
Directionality of the position?

Should it be 'positions maintained'?
Is it possible to argue that 'positions' stemming from subsidiaries have been 'deliberately taken in order to hedge ' the capital ratio(s)?

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Long fx positions might protect the ratio from a rise in the foreign currency, but it will also eliminate the potential benefit from a drop. Shall the provision contemplate only the use of options to allow the upside?

Article 92 establishes different minimum levels of the institution's capital ratio, expressed in terms of (i) CET1, (ii) Tier 1 and (iii) overall capital, which one(s) should be assessed? Individual and/or consolidated ratio(s)?

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What about positions that are subject to 1.250 RWAs?

Is this the same as 'banking book' positions?
Should they be stable?
What documentation should be required regarding the 'terms of their exclusion'?

Elements to be considered in the assessment

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Individual ratio perspective:

- Annex 1 provides some 'simplified' examples to illustrate how an FX position may affect the capital ratio, from an individual perspective, under different circumstances.
- The simplified examples try to assess the various elements that may have an influence in the size of the FX position that should be maintained to hedge the capital ratio, such as:

  i. the level of the capital ratio,

  ii. the accounting treatment, and in particular the presence of items held at historic cost

  iii. the 'density' of the RWAs stemming from the positions denominated in the foreign currency and

  iv. the existence of items deducted from capital

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Elements to be considered in the assessment

Consolidated ratio perspective:

- In the case of a consolidated group there are two capital ratios that need to be assessed when determining whether an FX position acts as a partial or total hedge of the ratio(s):
    i. at individual level, where there is a long FX position that 'naturally' stems from the participation in the foreign subsidiary.
    ii. at consolidated level, once the elimination of the investment versus equity has taken place and the RWAs stemming from the subsidiary's risks have been integrated in the consolidated capital ratio.
- Section 2.2 of Annex 1 consider the case of a consolidated group with subsidiaries located in countries with a currency different from the group's reporting currency.
- Like in the individual ratio case, if the bank decides to 'hedge' the long FX position stemming from the value of the investment in the subsidiary, then the consolidated capital ratio will be 'open' to movements in the exchange rate.
- The structural FX 'position' held by the parent bank should intend to work as a hedge of both the parent bank's and the group's consolidated capital ratios.

Treatment of the structural FX under the CRR2

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- The recently published CRR2 proposal incorporates the new BCBS FRTB market risk framework. It maintains in the possibility of excluding FX positions, though some additional restrictions have been introduced:
    1. the exclusion is limited to the largest of (i) the amount of investment in affiliated entities denominated in foreign currencies but which are not consolidated with the institution (ii) the amount of investment in consolidated subsidiaries denominated in foreign currencies.
    2. the wording restricts the exclusion to investments in affiliates, which might imply restrictions for institutions with non-equity assets denominated in a foreign currency, as well as for institutions that maintain branches in foreign jurisdictions.
- In addition, the two ‘other’ cases contemplated in the current Basel text are not included in the CRR2 text: (i) positions deducted from capital and/or (ii) other long-term participations at historic cost.
- Finally, there is a new requirement that the exclusion of the hedge must remain ‘in place for the life of the assets or other items’. This might be problematic, since, by definition, equities do not have a maturity and the ‘hedge’ is actually the position which is maintained (i.e. not necessarily an instrument).

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