POSITION PAPER

ESBG response to the EBA consultation on structural FX provisions

ESBG (European Savings and Retail Banking Group)

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ESBG

Dear Sir/Madam,

Thank you for the opportunity to comment on the EBA consultation on Structural FX Provisions. We would like to share with you the following reflections that we hope will be considered by the EBA.

General remarks:

The issue of Structural FX positions is of a high priority for some ESBG members and for any other cross border banks. Therefore, it is necessary to achieve clarity on the areas that are currently not mentioned or not precisely addressed in the draft EBA GL, also introduce to and change in the GL the following **main points**:

- The **possibility for a phasing-in** and **individual timelines** set by competent authorities are necessary in order **to implement the complex changes** presented in the draft GL and in order **to prepare the exemption application** considering the **different starting points** for the treatment of structural FX. Given the large impact an alignment with the FRTB implementation seems advisable.
- With regards to the future necessity to hedge open currency positions, we would ask to **extend the number of material currencies from 3 to at least 5**.
- In order to foster a level playing field across institutions we propose that all **calculations for MaxOP and Sensitivities should be based on standardized approach methodology** (current STA or FRTB-STA).
- The **partial exemption of items held at historical costs for the calculation of net open position should be explicitly foreseen** considering that the **hedging requirements from consolidated structural positions may not be fully matching the book values on the solo level**.
- We propose to **include a paragraph that banks need to include only material contributions** in the **sensitivity calculation**.
- We believe that due to the structural nature of the position a **quarterly computation process** for **the maximum open position and the sensitivity** should be sufficient.
- The **efficiency threshold for the target boundary** should be set on **the overall target range using a multiplier of 25% instead of 5%** in alignment with similar thresholds (e. g. threshold of hedge efficiency in hedge accounting).

Timing and phase-in:

Given the foreseen changes in the calculation of capital requirements with FRTB we propose to align the implementation of the guidelines for Structural FX with FRTB implementation.

Including a statement that competent authorities (e.g. the JST) may provide a phasing in on a case by case basis, depending on the impact and complexity of the changes necessary, to be compliant with the new EBA GL, and that competent authorities may set individual timelines for banks to prepare the exemption application, needs to be considered and should be included in the final EBA GL.

The currently proposed application date beginning 2021 is not realistic. The draft EBA GL are still in consultation and will probably not be finalized before Q2 2020. Institutions will then have to file permission requests already in 2020 and competent authorities need to handle several requests in parallel within a very short timeframe. In addition, there are critical points that are left open in the draft EBA GL. Assuming that these points will not be clarified in the final version and remain subject to the discretion of the competent authorities the timing with an application beginning 2021 becomes even more challenging and unrealistic.

In addition, technical implementation has to be ensured by institutions to fulfill the on-going monitoring requirements at consolidated and solo level. Such an implementation can only be initiated based on the final GL and after alignment with the competent authority.

Finally, we would like to emphasize again the adverse economic effects and unintended consequences of the general inclusion of Structural FX positions into the Pillar 1 framework (which is assumed in the EBA GL). First, it punishes well and over capitalized subsidiaries that might lead to capital reductions in order to reduce hedging costs and P&L volatility. Second, the GL may lead to intensified and concentrated hedging in CEE currencies within a short time period, with possible effects on the national currencies & national banks' reserves. In general, market liquidity in CEE currencies might not be sufficient for the required size of hedging transactions.

Impact on Business Model:
Eurozone cross-border institutions owning subsidiaries outside the monetary union will have to re-assess their business model due to the potential negative impacts stemming from the new guidelines. Institutions deliberately took the decision to invest in non-Eurozone subsidiaries taking into consideration all positive and negative impacts from such investments. Both the business and capital plans factor in the volatility in the profit and loss account and in the other comprehensive income as institutions have internal management buffers and macro-hedge strategies in place to properly handle the volatility.

In order to minimize the impact from the guidelines, institutions would need to take the following measures which are in our view very contradicting:

- Reduce the overcapitalization in the subsidiaries to an absolute minimum, having very limited internal management buffers.
- Engage in fully financed business activities in local currency in order to reduce the maximum open position eligible for exemption from the guidelines.

Relation to capital buffer regime:
We see a possible overlap between EBA GL and systemic risk buffer and O-SII buffer that would lead to double coverage of the same risks.

In our view, the risks associated with cross-border business and the CESEE cluster risk (such as vulnerability vis-a-vis CESEE) are reduced by the new EBA GL. These risks should therefore not be taken into account again by the competent authorities in the individual Member States when introducing a systemic risk buffer.

Further comments on specific topics in the consultation paper that are not covered by received questions:
On page 60 it would be helpful to include an illustrative example for the interpretation of the following sentence in paragraph 3: "Accordingly, the size of the range depends on which strategy the institution performs; in other words, the size of the range is relatively small for under-hedges, and gets larger moving from under-hedges to overhedges".

Since the treatment of non-monetary items at historical costs as described in this and abovementioned paragraphs has also an (indirect) impact on consolidated level, the paragraph 110 on page 29 has to be amended, we would suggest that the last sentence of this paragraph should be deleted.

Consultation's questions:

Question 1: 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.

Institutions should be free to decide which capital ratio they choose. Despite the banks' internal strategy and the composition of the balance sheet, the targeted ratio defines also the amount of maximum position to be exempted and consequently the size and hedging strategy for remaining open positions. Choosing CET1 Ratio gives the smallest amount for MaxOp and therefore the highest amount of remaining Open Position to be hedged. Hedging strategy and size of hedges will be influenced by market liquidity, cost of hedging (negative carry) and risk estimation in the respective currency.

Question 3: 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?

From our perspective, using only 3 material currencies as a starting point is too restrictive; we consider CZK, RON, HUF, HRK and RSD to be material for many banks operating cross-border. We expect that 4-5 currencies will be in scope of a request for permission. Thus, we would suggest changing the wording in para 19 accordingly and generally extend the scope to five currencies.

Question 5: Do you deem the provision included in paragraph 25 clear or do you think it could lead to a different interpretation than the one outlined in the text above included in the box? Please elaborate.

In our view paragraph 25 seems to be reasonably clear.

Question 8: 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.

We agree.

Question 10: 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.

We agree that positions that are non-eligible should be exempted from the sensitivity calculation.

Question 12: Do you agree with the definition of the range in paragraph 27(d)? Do you think that 0.05 is an appropriate value?

We think that 0.05 is too small. This leads to very tight boundaries and results in an overly sensitive measure where minor variations in the exchange rate, RWA or Equity composition can lead to a breach of the boundaries and henceforth need frequent actions. We think that wider boundaries are consistent with the overall target of Art 353 (2), the institutions hedging strategy and the structural nature of the exposures.

Limit on upper thresholds, i.e. adverse sensitivity development: Art 352 (2) states "… to hedge against the adverse effect of exchange rate on its ratios …". In our view, this implies that the institutions ratio sensitivity should remain below the upper boundary but on the other hand, a lower sensitivity (reducing the adverse effect) does not need to be limited.

Metric for sensitivity boundary: We propose that boundaries are set in relation to the overall sensitivity in currencies where exemption is approved.

Level of threshold: The efficiency threshold for the target boundary should be set on the overall target range using a multiplier of 25% instead of 5% in alignment with similar thresholds (e. g. threshold of hedge efficiency in hedge accounting).

<u>Question 14</u>: 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?

Several issues are related to the application of the framework in the internal market risk model:
- Treatment of exposures from entities which are not included in the internal model;
- Requirements for actual and hypothetical back-testing are not clear;
- Determination and application of the multiplier: back-testing overshootings resulting from Structural-FX positions will impact the capital requirement for trading book. As exposure from Structural-FX positions cannot be managed (reduced or closed) like a trading position the connection should be avoided;
- Identification of positions and changes in the data process require time for implementation;
- Diversification effects between trading book capital charge and capital charge for Structural FX are not stable.

In order to foster a level playing field across institutions we proposed that all calculation for MaxOP and Sensitivities should be based on standardized approach methodology (current STA or FRTB-STA).

<u>Question 15</u>: What is the size of non-monetary items that are held at historical costs with respect to the size of institution's balance sheet?

For some of our members, on a consolidated level the items in FX held at historical costs are not material. On solo level participations in subsidiaries held at historical costs are material (between 5-10% of solo balance sheet).

We propose to explicitly foresee full exemptions of items held at historical costs for the calculation of the net open position. Hedging requirements from consolidated structural positions may be not fully matching the book values on the solo level.

<u>Question 16</u>: 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.

We believe the formulas in paragraph 31 are appropriate.

<u>Question 17</u>: Do you think that is operationally feasible to compute the maximum open position and the sensitivity on a monthly basis?

Due to the structural nature of the position we think that a quarterly process should be sufficient. We think that the reporting frequency should be aligned with regular reporting dates (i.e. quarterly). Due to the structural nature of position are not expected to change frequently.

The current version of the CP requires inclusion of all FX-sensitive RWAs. This implies high operational effort for some parts (e.g. CVA) although the contribution may be immaterial.

We therefore propose to include a paragraph that banks need to include all material contribution. Materiality can be assessed as part of the waiver application and regularly (e.g. yearly) in the validation process.

<u>**Question 21**</u>**: 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.**

We don’t think so.

About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 21 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 900 banks, which together employ more than 650,000 people driven to innovate at roughly 50,000 outlets. ESBG members have total assets of €5.3 trillion, provide €1 trillion in corporate loans (including to SMEs), and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking. Our transparency ID is 8765978796-80.

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