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FRENCH BANKING FEDERATION RESPONSE TO EBA DISCUSSION PAPER ON THE TREATMENT OF STRUCTURAL FX UNDER ARTICLE 352(2) OF THE CRR

I- General comments

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The FBF welcomes the opportunity to comment on the EBA's Discussion Paper on the treatment of structural FX under article 352(2) of the Capital Requirement Regulation (CRR).

The current CRR wording of article 352(2) could be interpreted through various manners. We support the fact that EBA brings precisions on this topic. Nevertheless, we hope that those precisions would not lead to less flexibility in comparison with the current situation.

Summary of key comments:

- ✓ Hedging the ratios sensitivity should be construed as 'reducing' the FX-sensitivity not as fully neutralising the FX sensitivity. Structural net assets (or net assets equivalent positions in derivatives) that are taken or maintained with a view to reduce this sensitivity must be considered an acceptable strategy;
- ✓ The approach for the calculation of FX own funds requirements has no impact on the way the net FX position as well as the structural FX exclusion are determined;
- ✓ All FX positions should be considered in the net FX position, whether managed in the trading book or in the banking book and irrespective of the booking (in a branch, in a subsidiary, at operating level or at holding level) or the accounting or the underlying instruments. Only the structural FX position (i.e. the durable position in a given currency) is excluded;
- ✓ The structural open FX position depends on a management choice. It is a long term choice with the objective to reduce the sensitivity of the ratio to FX variations, it must be possible to hedge the ratios both with cash instrument and with derivatives. Management board should be free to choose the most adequate hedging strategy;
- ✓ The maximum size of the structural position should be determined in reference to the actual or target capital ratios, in order to fulfil the objective of reducing the ratios to FX movements;
- ✓ The article 325c of CRR2 is much more restrictive than the current article 352(2) of CRR and is unduly prescriptive

Please find below our main comments and our detailed feedback within our answers to the EBA's questions.

II- Answers to questions related to the discussion paper

a) Interactions between the accounting and prudential treatments of FX risk

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?

From the French banking sector's point of view, the accounting treatment doesn't impact the Foreign Exchange (FX) non-monetary items' treatment, especially the capacity to exclude them from FX positions pursuant to article 352 of the CRR.

Foreign exchange (FX) non-monetary positions held at historic cost should be included in the overall net foreign exchange position and computed at the last FX rate for each quarterly revaluation.

Question 2. Do you share 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?

It is worth reminding that the FX position that is subject to a capital requirement may arise from banking book positions (e.g. accrued income or provisions in currencies that are not the base currency) as well as positions resulting from a trading intent.

Only the positions that are of a "non-trading or structural" nature are excluded. 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 portfolios embedding the positions are from a trading or banking nature or from whether the standardized approach or an advanced method is used

However, we disagree on the relevance of computing net FX positions, as defined in article 352, for books managed under IMA (internal model approach). The IMA positions are subject to specific methodologies for globally computing the various risk factors (including FX risk) and calculating corresponding own funds' requirements.

b) Considerations around the structural FX position exclusion

<u>Question 3.</u> 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 only be acceptable for long FX positions? If you consider that it should be allowed for short positions, please provide rationale and examples.

Structural FX positions depend on long term choices with the objective to reduce the sensitivity of own funds to FX variations. Indeed, 'durable' and 'non-trading' (as a reference to the intent, not the capital treatment) are more adequate terms to describe such positions.

We share EBA's view that the potential exclusion should only be acceptable for net long FX positions.

Cf. more details regarding "positions" in question 5.

<u>Question 4.</u> 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?

FBF members believe that FX positions taken in order to hedge the ratio do not only result from hedging derivatives but cover a much larger scope. As such, FX 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'.

Furthermore, regulators should be aware that the ratio's neutralization against FX movements depends on (i) the consolidation level and (ii) the ratio (CET1 or Tier 1) considered. A FX position taken in order to hedge the local Tier 1 ratio could increase the ratio's FX sensitivity at the group (ie. consolidated) level for example. As such, the Management must decide how to allocate the hedging positions across the various relevant entities.

Such hedging positions are mainly stemming from subsidiaries/branches, tangible & intangible assets, capital operations. However, hedging positions may also include long net positions taken in an operating entity that cannot isolate in dedicated branches or subsidiaries its business denominated in currencies other than its base currency or even positions taken to tackle specific situations such as tax drag (notably with respect to the revaluation of participations or branches).

<u>Question 5.</u> 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".

It should be possible to hedge the capital ratio in both directions i.e. benefit from potential gains or protect the ratio from potential losses. Therefore, both types of derivatives (FX forward as well as options) could be traded.
The Management should be free to choose the most adequate hedging strategy.

However, from a management perspective, it could make sense to choose to renounce to potential gains to protect the ratio from potential losses.

<u>Question 6.</u> 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.)?

For "Structural FX", please see our answer to Questions n°3 & 5.

At least annually, the sensitivity of own funds to FX variations may be estimated and presented to the Management of the credit institution. FX risk policy is described in the Risk Appetite Statement approved by the Management. It mentions the ratio-hedging strategy.

FX risk position is internally reported to the Management through financial committees. Externally this is reported to the regulators. In the annual report, the CET1 sensitivity to major currencies (e.g USD, GBP) is disclosed.

<u>Question 7.</u> Do you share the EBA's view that the maximum FX position that could be considered as structural should be the position that would ideally neutralise the sensitivity of the capital ratio to FX movements?
Alternatively, in 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?

The maximum FX position that can be considered as "structural" is the maximum FX position that would ideally neutralise the sensitivity of the current or target capital ratio to FX movements.

The use of a minimum capital ratio is not optimal in our sense as it would not enable to neutralise the sensitivity of the current (or target) capital ratio (CET 1 for instance). The use of a minimum capital ratio would fail the objective of neutralization of the own funds to FX movements. In addition, the minimum *required* capital ratio is generally much higher than the minimum Pillar 1 ratio due to the required various buffers (including Pillar 2 buffers).

c) <u>Elements to be considered in the assessment of the structural FX position</u>

<u>Question 8.</u> How do you assess the consolidated ratio?
How does your treatment differ between subsidiaries and branches?

FBF members consider that the assessment of the structural FX position should be the same between subsidiaries, branches, and more generally any operating entities (including those without branches or subsidiaries) since structural FX positions are appreciated at a consolidated level.

The structural FX positions are taken at any relevant level (mostly but not exclusively at consolidated level) with a view to reduce the sensitivity of the consolidated ratios and when possible the other relevant ratios (sub-consolidated or even solo).

d) Treatment of the structural FX under the CRR2

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?**

FBF members consider that article 325c of the CRR2 is much more restrictive than the current article 352(2) of CRR. The current wording raises several issues:

- The assessment of exclusions by the supervisor on a case by case basis would be impossible to manage for credit institutions (article 325c(2));
- Members do not understand why the exclusion should be limited to the maximum amount between investments in non-consolidated affiliated entities and investments in consolidated subsidiaries. Total amount of exclusions should take into account both kind of investments and even other entities (article 325c(1)(a));
- The current wording implies that a credit institution with no branch or subsidiary is not allowed to protect its ratios from FX movement with a FX position (article 325c(1)(a)) which can be extremely detrimental when a significant part of the business is carried in currencies other than the local currency;
- Members do not understand the economic rationale behind the 6 month time period (article 325c(1)(b));

More generally speaking, the evaluation of structural hedges of FX risk should be assessed through a flexible framework that allows credit institutions to adopt for the most appropriate general FX policy.

Proposed amendment to CRR2:

Article : 325c - Structural hedges of foreign exchange risk	
Original version	Text of the amendment
1. Any position which an institution has deliberately taken in order to hedge against the adverse effect of foreign exchange rates on its ratios referred to in Article 92(1) may, subject to permission of the competent authorities, be excluded from the calculation of own funds requirements for market risks, provided the following conditions are met:	1. Any position which an institution has deliberately taken in order to hedge against the adverse effect of ~~foreign~~ **the** exchange rates on its ratios **in accordance with** ~~referred to in~~ Article 92(1) may~~, subject to permission of the competent authorities,~~ be excluded from the calculation of **net open currency position** ~~own funds requirements for market risks, provided the following conditions are met~~:
(a) the exclusion is limited to the largest of the following amounts:	**Such position shall be of a non-trading or structural nature.**
(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.	**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.**

	~~(a) the exclusion is limited to the largest of the following amounts:~~
	~~(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.~~
(b) the exclusion from the calculation of own funds requirements for market risks is made for at least six months;	~~(b) the exclusion from the calculation of own funds requirements for market risks is made for at least six months;~~
(c) the institution has provided to the competent authorities the details of that position, has substantiated that that position has been entered into for the purpose of hedging partially or totally against the adverse effect of the exchange rate on its ratios defined in accordance with Article 92(1) and the amounts of that position that are excluded from the own funds requirements for market risk as referred to in point (a).	~~(c) the institution has provided to the competent authorities the details of that position, has substantiated that that position has been entered into for the purpose of hedging partially or totally against the adverse effect of the exchange rate on its ratios defined in accordance with Article 92(1) and the amounts of that position that are excluded from the own funds requirements for market risk as referred to in point (a).~~
2. Any exclusion of positions from the own funds requirements for market risks in accordance with paragraph 1 shall be applied consistently and remain in place for the life of the assets or other items.	~~2. Any exclusion of positions from the own funds requirements for market risks in accordance with paragraph 1 shall be applied consistently and remain in place for the life of the assets or other items.~~
3. Competent authorities shall approve any subsequent changes by the institution to the amounts that shall be excluded from the own funds requirements for market risks in accordance with paragraph 1.	~~3.~~ **2. The exclusion from the calculation of net open currency positions, as well as any variation of the terms of this exclusion, is subject to permission by the** competent authorities. **For that purpose, the institution must provide the competent authority with a substantial hedging policy**. ~~shall approve any subsequent changes by the institution to the amounts that shall be excluded from the own funds requirements for market risks in accordance with paragraph 1.~~

e) Annex 1 - Structural FX balance sheet examples

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:

- The actual level of the capital ratio
- The effect of items deducted from capital / subject to a 1.250% RWA / subject to a 0% RWA
- 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.

We believe that the simplified examples are useful and should be maintained but not binding as it is not reflecting every possible use case.

FBF members agree with the simplified examples although more complex situations need to be assessed such as:

- Fiscal issues related to the revaluation of retained earnings or reserves within subsidiaries;
- Issues related to minority interests denominated in foreign currencies.