European Banking Federation

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EBF response to EBA consultation paper (EBA-CP-2020-01) Draft Regulatory Technical Standards on the treatment of non-trading book positions subject to foreign-exchange risk or commodity risk under Article 325(9) of Regulation (EU) No 575/2013 (Capital Requirements Regulation 2 - CRR2)

Q1. Do you agree with the approach in relation to the use of the accounting value and alternatively the fair value as a basis for computing the own funds requirements for foreign exchange risk, or do you think that institutions should be requested to use e.g. only the accounting value? Please elaborate.

The EBF agrees that institutions should be granted the possibility to use accounting values or alternatively fair values as a basis for computing the own funds requirements for foreign exchange risk.

The CRR framework relies on the classification of each exposure either in the trading book or in the banking book (i.e. non-trading positions) to determine appropriate capital requirements. Positions classified in the banking book are not held with a trading intent or in order to hedge a position with a trading intent. While a fair value basis is relevant for positions managed with a trading intent, banking book positions in general are not fair valued, as also recognized in the consultation paper.

Therefore, we are generally in favour of using the accounting value as a basis for computing the own funds requirements for foreign exchange risk stemming from non-trading book positions.

Furthermore, the CRR requires using the applicable accounting framework for the evaluation of assets and liabilities (cf. article 24). The accounting value stems from the business model and positions in a business model, which is a key driver in understanding the way cash flows are generated and will be generated in the future. Accordingly, it makes sense to rely on accounting values as a basis for computing the own funds requirements for foreign exchange risk, consistently with the level 1 text. However, most banks take actions to mitigate or offset these risks, including FX risks that arise from their business-as-usual activities using hedging strategies usually involving derivatives. In order to represent and measure those risks correctly (and to avoid creating mismatches and duplications due only to a different accounting valuation) the EBF therefore suggests that the regulation gives leeway to institutions to match the risk components hedged under different accounting valuation regimes.

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For example, when using derivatives to hedge foreign currency denominated cash flows of an amortised item, by establishing a cash flow hedge relationship, the FX exposure will be completely closed. However, asymmetries in the account value by currency will appear. Furthermore, the article 33 of the CRR indicates that valuations of cash flow hedges are not considered subject to capital requirements when hedging amortised cost items.

Q2. Do you agree that institutions should be requested to update on a daily basis only the foreign-exchange risk component of banking book instruments? Please elaborate.

The EBF appreciates the proposal to have institutions revaluate only the FX component as this is in line with common industry practice.

However, we do not agree with the request to perform this revaluation on a daily basis as this is not common industry practice and will therefore be challenging for some institutions, even if the compromise proposed by the EBA consisting on valuing only the FX component may ease the burden. The EBF does not see a sufficient added value of requiring daily valuation of positions in the banking book for the FX component, under the standardised approach.

In our opinion, capital requirements calculation for own funds requirements for foreign exchange risk of instruments in the banking book are only required on a monthly basis and reporting is set on a quarterly basis in the Capital Requirements Regulation 2019/876 ("CRR2") (cf. article 430b and EBA related Implementing Technical Standards).

The CRR framework relies on the classification of each exposure either in the trading book or in the banking book (i.e. non-trading book positions) to determine appropriate capital requirements. In the trading book, capital requirements measure mainly price or value volatility risk due to the variation of market factors (interest rate, foreign exchange rate, credit spread, indexes, etc.) which requires daily calculations, consistently with the risk management of these positions held with a trading intent.

Positions in non-trading book are not held for trading. Accordingly, reporting and data requirements for banking book instruments should be consistent with applicable accounting reporting, e.g. with frequency and remittance derived from financial statement reporting ones.

The bank should have the flexibility to define the frequency at which they value the FX component of non-trading book positions, according to the way the banks manage these non-trading book positions.

Q3. Could you please describe the current risk-management practices that institutions use for managing the foreign-exchange risk stemming from banking book positions, e.g. whether the accounting or the fair-value is used as a basis for determining the exposure in a currency, the frequency at which banking book positions are fully revalued, the frequency at which the foreign-exchange component is updated?

The question is bank specific. It will be answered on an individual basis.

Generally, FX risk for banking and trading book positions are measures according to accounting rules. This means that monetary assets / liabilities are revaluated daily using fixing rate through profit and loss, non-monetary assets/liabilities are revaluated at historical costs or at the revaluation date. Additionally, an entity shall assess at the end of each reporting period whether there is any indication that a non – monetary asset may be

impaired. If any such indication exists, the entity shall estimate the recoverable amount of the non-monetary asset, which includes fair value decrease and foreign-exchange impact.

Q4. Do you agree with the proposed methodology for capturing the foreign-exchange risk stemming from non-monetary items at historical cost under the standardised approach? Do you have any other proposal for capturing the foreign-exchange risk stemming from non-monetary items at historical cost that would be prudentially sound while fitting within the standardised approach framework? Please elaborate.

EBF recognises the importance of the appropriate treatment of non-trading book positions subject to foreign-exchange risk or commodity risk and would be pleased to contribute to the development of a more simple, effective and meaningful regulatory framework. However, the regulatory framework set out by the CRR does not provide a clear definition of non-monetary items and refers to accounting standards for a general description. This could be misleading as there are deviations across the accounting standards, jurisdictions and legal entity structures as well as different interpretations among banks.

Therefore, the EBA should consider those deviations by providing a better definition of non-monetary items or clarifying and detailing non-monetary items for prudential purposes to ensure a common ground (level playing field). We do believe that giving a detailed description of non-monetary items can become more productive and meaningful when it is comparable across jurisdictions and avoiding any unnecessary regulatory fragmentation.

Banks understand that EBA is proposing to treat non-monetary items that are measured in terms of historical cost that are subject to the risk of impairment due to movements in the exchange rate between a foreign currency and the reporting currency, as denominated in that foreign currency for computing the own funds requirements for foreign-exchange risk.

Banks disagree with such an approach which overrides the level 1 text (namely the CRR article 24 which requires the valuation of assets and liabilities to be effected in accordance with the applicable accounting framework) and interacts with the previous consultation of EBA draft Guidelines on the treatment of structural FX under 352(2) of the CRR of October 2019 (EBA/CP/2019/11), all the more if it were to be applied to investment in subsidiaries that are in general held at historical cost notably at the parent entity level.

In its draft Guidelines, EBA clarifies that non-monetary items held at historical costs are in the scope of positions to be included in the calculation of the open position and that in the context of the structural FX treatment, they are not taken into consideration when comparing the value of the net open position stemming from positions that are eligible to be structural against the threshold set by the guidelines.

However, the calculation of the net open position is 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).

Items at historic costs are denominated in the functional currency of the entity in which they are accounted for per IFRS. Accordingly, based on the level 1 text, those items do not affect the net open position.

In general, the losses incurred due to foreign exchange are contingent by nature and cannot be deemed to be a permanent impairment in value. This aspect is particularly

relevant for items at historical cost, which are not managed with a trading intent nor with the purpose of being sold. They are subject to an impairment loss if and only if there is an indication of impairment in which case the impairment loss amounts to the difference between the net realisable value or recoverable amount and the carrying amount (cf. IAS 21 The Effects of Changes in Foreign Exchange Rates §25). However, while a foreign exchange depreciation may cause an impairment, it is not the only factor which is considered to determine whether there is an indication of impairment.

Accordingly, and as any impairment is anyway recognised in P&L, we see no legal reason to consider that these instruments are denominated in foreign currency for the determination of the net open position and the determination of own funds requirements for foreign exchange risk.

At least, this question of foreign-exchange risk stemming from non-monetary items at historical cost is closely linked with the scope of the structural FX provisions and EBA previous consultation on draft Guidelines on the treatment of structural FX under 352(2) of the CRR.

The EBF would like to point out that the role of CRR Article 352(2) enables institutions to exempt positions that would otherwise be subject to Pillar 1 capital requirement due to their foreign exchange components, when they have been “deliberately taken in order to hedge against adverse effect of the exchange rate on its ratios”.

Moreover, under 352(2) of the CRR investments in subsidiaries or branches are usually not done for the purpose of hedging prudential ratio, and the impacts of foreign exchange rates on those investments do not affect profit and loss (P&L) statement. This applies both at consolidated level and at individual level.

In CRR and in the Basel framework, there is no example of a Pillar 1 capital charge that would not relate to an impact on P&L. Both reasons evidence that the proposal to subject investments in subsidiaries at historical cost (at individual level) to Pillar 1 capital requirement (bar granting of an exemption) would go beyond regulatory requirement. Such a framework would be so inconsistent that, by default (i.e. bar granting of an exemption), it would lead to a capital requirement due to foreign exchange for having well capitalized a subsidiary in a different currency which cannot make sense.

EBF therefore disagrees with the proposed methodology for capturing the foreign-exchange risk stemming from non-monetary items at historical cost under the standardised approach as it would lead to an undue Pillar 1 capital charge to investment in subsidiaries at solo level (if no waiver granted).

Q5. How are you currently treating, from a prudential perspective, non-monetary items at historical cost that may be subject to an impairment due to a sharp movement in the foreign-exchange rate? In which currency are those items treated from an accounting perspective?

This question is bank specific.

Q6. Could you please provide an estimate of the materiality of non-monetary items that are held at historical cost for your institution (e.g. size of the non-monetary items at historical cost with respect to the institution’s balance sheet)? Please elaborate.

The question is bank specific. It will be answered on an individual basis.

Q7. Do you think there are any exceptional cases where institutions are not able to meet the requirement to daily fair-value commodity positions? Would these exceptional cases occur only for commodity positions held in the banking book or also for commodity positions held in the trading book?

No comments

Q8. Do you agree that, with respect to the valuation of foreign-exchange and commodity positions held in the banking book, the provisions applicable in the context of the alternative standardised approach (Article 1 paragraphs 1 and 2) should also apply in the context of the alternative internal model approach (Article 3 paragraphs 1 and 2)? Please elaborate.

As a general principle, banks should be allowed to use internal models when enough data are available.

All previous considerations done related to standard approach would apply to internal models as well.

Q9. Do you agree with the provision requiring institutions to model the risk that non-monetary items at historical cost are impaired due to changes in the relevant exchange rate or do you think that the RTS should be more prescribing in this respect? Please elaborate.

Any attempt to model impairment risk as a consequence of exclusively FX movement seems artificial. FX movement would be one of different elements that lead to an impairment, not the cause of the impairment.

There is a high risk of creating an overlap with credit risk on the balance sheet.

Q10.How institutions would capture the risk of an impairment in their risk-measurement model? Would the definition of impairment used in the internal model be identical to the one proposed in the accounting standards? Please elaborate.

No comments

Q11. Do you think that the requirement to capture the impairment risk in the risk-measurement model for institutions using the internal model approach is less or more conservative than the requirement proposed for institutions using the standardised approach? Please elaborate.

We consider it is not clear about how such assessment should be estimated as it depends on how banks would implement such a modelling requirement.

Q12. Do you agree with the definitions of hypothetical and actual changes in the portfolio's value deriving from non-trading book positions that have been included in the proposed draft RTS?

No comments

About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.1 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

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