

Consultation Paper

Draft Guidelines

On Capital measures for foreign currency lending to unhedged borrowers under the Supervisory Review and Evaluation Process (SREP)

Under the Recommendation E of the European Systemic Risk Board Report of 21 September 2011 on lending in foreign currencies (ESRB/2011/1). Published on 22 November 2011 (Official Journal C 342)



Consultation Paper on Draft Guidelines on capital measures for foreign currency lending to unhedged borrowers under the Supervisory Review and Evaluation Process (SREP) under Recommendation E of the European Systemic Risk Board (ESRB) Report of 21 September 2011 on lending in foreign currencies (ESRB/2011/1).

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1. Responding to this Consultation

The EBA invites comments on all proposals put forward in this paper.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Please send your comments to the EBA by email to EBA-CP-2013-20@eba.europa.eu by 23.08.2013, indicating the reference 'EBA/CP/2013/20' in the subject field. Please note that comments submitted after the deadline, or sent to another e-mail address will not be processed.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please indicate clearly and prominently in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an e-mail message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.eba.europa.eu under the heading 'Legal Notice'.

2. Executive Summary

These Guidelines on capital measures for foreign currency lending (FX lending) to unhedged borrowers under the Supervisory Review and Evaluation Process (SREP) provide guidance to national competent authorities on how to deal with the specific risk of FX lending to unhedged borrowers as part of the SREP.

In 2011, the European Systemic Risk Board (ESRB) published its report on lending in foreign currencies¹ highlighting that excessive FX lending can lead to systemic risks for national economies and can create conditions for negative cross-border spill-over effects, adversely impacting financial stability within and across member states. The ESRB subsequently issued seven recommendations, one of which mandated the EBA to draft and address guidelines to national competent authorities regarding capital requirements under Pillar 2 to address risk related to FX lending to unhedged borrowers.

Title I of the guidelines covers the subject matter, scope and definitions and sets out the process to be followed in the guidelines. As the focus of the SREP should be on the risks which are material to an institution, Title I includes a materiality threshold whereby if FX lending risk to unhedged borrowers surpasses the threshold specified in the guidelines, competent authorities should expect institutions to include FX lending risks in their internal capital adequacy assessment processes ('ICAAP') and, also, to adequately account for FX lending risks in their governance arrangements which competent authorities will review as part of the SREP. Title II then gives guidance on both the supervisory review of FX lending governance arrangements and of capital adequacy. These Sections are in accordance with Article 92 CRD IV, which specifies that competent authorities shall review the arrangements, strategies, processes and mechanisms implemented by the institutions and evaluate the risks to which institutions are, or might be, exposed. Title II subsequently gives guidance to supervisors on how to calculate the capital add-on, where applicable, as a result of the SREP.

These guidelines are closely related to other technical standards and guidelines drafted by the EBA, focusing on the specificities of FX lending and they complement existing guidelines, in particular on the subject of the supervisory review process, internal governance, concentration risk, stress testing and home-host supervisory cooperation. These guidelines will form a part of the suite of EBA guidelines setting out common procedures and methodologies for the supervisory review and evaluation process ('SREP') being developed pursuant to Article 102(3) of the proposed CRD. These guidelines are subject to the finalisation of the SREP guidelines and may therefore be revised in due course.

In accordance with the mandate set out in the ESRB Recommendation of 21 September 2011 on Foreign Currency Lending, the Guidelines will apply from 1 January 2014.

¹ Recommendation of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (ESRB/2011/1). Published on 22 November 2011 (Official Journal C 342)

3. Background and rationale

Exchange rate movements, essentially a market risk driver, in the case of loans denominated in foreign currencies, can strongly influence borrowers' debt-servicing capacity, thus impacting credit risk. Additionally, an institution may have significant credit risk concentrations if a material part of an institution's lending portfolio is denominated in the same foreign currency or highly correlated foreign currencies. Lastly, FX lending may cause higher residual risk in the case that the value of the collateral (e.g. mortgage value) does not change in line with FX movements.

FX lending risk is characterised by a non-linear relation between market risk and credit risk where exchange rates (market risk) can have a more than proportional impact on the credit risk of an institution's FX loans portfolio. As a result of this relationship it is challenging to adequately include the impact of potential exchange rate movements when assessing credit risk. This means that FX lending can influence an institutions' overall risk profile via several unobvious channels which must be taken into account by addressing FX lending risk. This non-linear relation needs to be adequately captured by the risk measurement framework meaning that the exchange rate effects on credit risk and market risk must not necessarily be simply added, but instead they require an integrated measurement of this market risk driver on credit risk components in an institutions' credit portfolio.

Beyond this micro-prudential dimension, justifying the need for competent authorities to take FX lending risk into account in their review and evaluation of individual institutions, there is a macro-prudential dimension to FX lending risk also identified by the European Systemic Risk Board (ESRB) in September 2011. Given a high dependency of many institutions on a common risk factor (i.e. certain predominant exchange rates) the ESRB concluded that excessive FX lending may produce significant systemic risks for national economies and may create conditions for negative cross-border spill-over effects, thus threatening financial stability within and across Member States.

The ESRB issued seven Recommendations on FX lending in September 2011². One of these Recommendations (Recommendation E) recommends that the EBA drafts and addresses guidelines to competent authorities regarding capital requirements under Pillar 2 to address risks related to FX lending to unhedged borrowers. The ESRB recommends that competent authorities should assess institutions' capital adequacy in this regard as part of their SREP. Furthermore, it recommends a two-stage approach towards the treatment of FX lending risks for cross-border institutions based on home / host cooperation.

Although these guidelines address FX lending to unhedged borrowers they focus on prudential requirements and not on the consumer protection elements of FX lending. In this context, there are two further Recommendations published by the ESRB in 2011 and addressed to competent authorities for treating concerns related to consumers. These Guidelines therefore contribute indirectly to consumer protection by avoiding bubble-like FX lending behaviour, by making FX

² Recommendation of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (ESRB/2011/1). Published on 22 November 2011 (Official Journal C 342)

lending more costly in terms of capital and hence FX lending rates are more likely to reflect actual risks, and therefore potentially reduce the likelihood of unaffordable borrowing in the system.

The EBA has developed these draft guidelines on the basis of the ESRB Report on FX lending taking account of the legislative text for the CRD agreed by the European Parliament and the Council in April 2013^[1]. The EBA will review the draft guidelines to ensure that they take account of any changes made in the final text of the CRD, as well as to take account of any changes arising out of the consultation process.

^[1] The CRD/CRR text as agreed by the Council can be found at
<http://register.consilium.europa.eu/pdf/en/13/st07/st07746.en13.pdf> /
<http://register.consilium.europa.eu/pdf/en/13/st07/st07747.en13.pdf>

4. Draft EBA Guidelines on capital measures for foreign currency lending to unhedged borrowers under the Supervisory Review and Evaluation Process ('SREP')

Status of these Guidelines

This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC ('the EBA Regulation'). In accordance with Article 16(3) of the EBA Regulation, competent authorities must make every effort to comply with the guidelines.

Guidelines set out the EBA's view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. The EBA therefore expects all competent authorities to whom these guidelines are addressed to comply with guidelines. Competent authorities to whom guidelines apply should comply by incorporating them into their supervisory practices as appropriate (e.g. by amending their legal framework or their supervisory processes).

Reporting Requirements

According to Article 16(3) of the EBA Regulation, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by 28 February 2014. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form provided at Section 5 to compliance@eba.europa.eu with the reference 'EBA/GL/201x/xx'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities.

Notifications will be published on the EBA website, in line with Article 16(3).

Title I - Subject matter, scope and definitions

1. These guidelines deal with capital measures for foreign currency lending (FX lending) to unhedged borrowers under the supervisory review and evaluation process ('SREP') under Article 92 of the CRD.

2. For the purposes of these Guidelines, the following definitions apply:

'FX' means any currency other than the legal tender of the Member State in which the borrower is domiciled;

'FX lending' means all foreign currency lending in currencies other than the legal tender of the relevant jurisdiction;

'unhedged borrowers' means borrowers without a natural or financial hedge which are exposed to a currency mismatch risk. Natural hedges include, in particular cases where borrowers receive income in foreign currency (e.g. remittances/export receipts) while financial hedges normally presume a contract with a financial institution.

'non-linear relation between credit and market risk' means where changes in the exchange rate, the market risk driver, may cause disproportionate effects on the overall level of credit risk. In this context fluctuations in the exchange rate can impact borrowers' debt-servicing capacity, potentially the exposure at default and the value of collaterals, thus resulting in large changes to credit risk.

3. The guidelines are addressed to competent authorities. They focus on the SREP to ensure that institutions have adequate arrangements, strategies, processes and mechanisms to identify, quantify and manage FX lending risk, and that they have adequate amounts, types and distribution of internal capital with respect to FX lending risk. If, as a result of the process, competent authorities identify deficiencies in risk management arrangements, strategies, processes and mechanisms and concludes that capital held by an institution is inadequate, the guidelines set out how competent authorities should require institutions to manage their FX lending risk more effectively and cover these risks with an adequate level of capital as appropriate thus increasing the resilience of the institution to exchange rate changes.

4. The guidelines are concerned with FX lending to unhedged borrowers, noting that wherever data on FX lending to unhedged borrowers is unavailable from an institution, competent authorities should use FX lending to households³ as a proxy for FX lending to unhedged borrowers.

5. These guidelines apply on an institution-by-institution basis wherever the following threshold of materiality is met:

³ FX lending to households and non-profit institutions as defined in Regulation (EC) No 25/2009 of the European Central Bank of 19 December 2008 concerning the balance sheet of the monetary financial institutions sector (Recast) (*ECB/2008/32*)

Loans denominated in foreign currency to unhedged borrowers constitute at least 10% of an institution's total loan book (total loans to non-financial corporations and households), where such total loan book constitutes at least 25% of the institution's total assets.

Competent authorities should also apply the guidelines where an institution does not meet the threshold set out above but the FX lending risk to unhedged borrowers is nevertheless considered by them to be material.

6. The guidelines should be applied on a consolidated, solo, and where applicable, sub-consolidated level, and in accordance with the SREP level of application of the CRD (Article 105).
7. The process established by the guidelines is as follows:
 - (i) competent authorities should require institutions to identify their FX lending risk to unhedged borrowers, if necessary by using the proxy (paragraph 4 above);
 - (ii) competent authorities should determine whether this risk is material either because it meets the threshold or because they have nevertheless deemed it to be material;
 - (iii) wherever FX lending risk is material in line with paragraph 5 above, then competent authorities should expect the institutions to reflect the risk in their ICAAP;
 - (iv) competent authorities should review the treatment of FX lending risk in the ICAAP as part of the SREP (Section II.1 and Section II.2 below);
 - (v) if the arrangements, strategies, processes and mechanisms to identify, quantify and manage FX lending risk are considered to be inadequate and existing levels of capital are considered to be insufficient to cover FX lending risk to unhedged borrowers, then competent authorities should impose appropriate measures under Article 100 CRD IV to address these deficiencies, including requiring an institution to hold additional capital (Section II.3);
 - (vi) if the institution is part of a cross-border group, the outcomes of the assessment of FX lending risk will feed into the joint decision process, as specified in Article 108(1).
8. These guidelines provide for an institution-specific assessment and application of a capital add-on. They complement other supervisory measures, including macro prudential measures, implemented by competent authorities with respect to FX lending, for example higher minimum regulatory capital requirements. Competent authorities should, under the SREP, continue to assess the overall adequacy of all such measures.

Title II- Requirements regarding Capital Measures for FX lending to unhedged borrowers under the SREP

9. In line with Article 92 of the CRD, competent authorities should, under the SREP determine whether the arrangements, strategies, processes and mechanisms implemented by the institutions and the own funds held by them ensure a sound management and coverage of their FX lending risk. This clearly implies that competent authorities should review the adequacy of the ICAAP arrangements and internal capital calculation for FX lending risks.

II.1 Supervisory review of FX lending risk management

10. In relation to FX lending risk as part of the SREP, competent authorities should assess the following:

- The type of exchange rate regime:
 - Competent authorities should consider the extent of FX lending risk in the light of the currency regimes in which exposures to unhedged borrowers are denominated and should take particular account of where (i) the domestic and the foreign currency are closely linked (either by law or through the proximity of respective economies or monetary systems); (ii) currency board or pegged exchange rate regimes exist; and (iii) where there is a 'free floating' regime. The extent and pattern of potential future exchange rate changes generally depends on the currency and the currency regime;
 - Competent authorities should ensure that institutions have a sound understanding of the possible future trends and volatility of exchange rates on an ongoing basis, in line with the type of exchange rate regime. In particular, they should ensure that institutions undertake a regular assessment of exchange rates against the creditworthiness of borrowers since exchange rate movements pose a continuous risk irrespective of the exchange rate regime;
- Institutions' FX lending risk-related processes:
 - Competent authorities should ensure that institutions have FX lending policies in place, which include an explicit statement on FX lending risk tolerance, taking into account institutions' own risk bearing capacity, and determine absolute and relative limits for FX loan portfolios and currencies. Competent authorities should undertake reviews of institutions' risk management policies and processes on FX lending and assess whether, despite those policies and processes, material levels of FX lending risk are still not adequately addressed by these processes.
 - Competent authorities should ensure that the risk identification processes in institutions adequately cover FX lending risks;
 - Competent authorities should ensure that institutions have sound risk control methodologies in place to account for FX lending risk when scoring clients and underwriting FX loans e.g. by means of adequate risk pricing and collateral requirements. In particular competent authorities should ensure that institutions have incorporated the exchange rate risk driver into their risk assessment methods;
 - Competent authorities should ensure that institutions specifically include FX lending risk in their ongoing monitoring and therefore that they determine appropriate exposure-specific thresholds. Competent authorities should ensure that institutions' processes effectively stipulate prompt and adequate pre-emptive measures (e.g. request the provision of additional collateral etc.) whenever such thresholds are surpassed.
- The impact of exchange rate movements:

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- Competent authorities should ensure that institutions take adequate account of exchange rate movements on borrowers' credit rating/scoring and debt servicing capacity including in their internal risk pricing and capital allocation processes;
 - Competent authorities should ensure that institutions have adequate procedures in place for continuous monitoring of relevant exchange rate movements and assessing these potential effects on the outstanding debt and associated credit risks on both individual exposures and at portfolio level;
 - Additionally, competent authorities should ensure that institutions periodically review the hedging status of borrowers as this may vary over time and institutions should avoid incorrect classification of borrowers whose situation has changed. So far as legally possible such status monitoring should be included in the terms of the lending arrangements between institutions and borrowers;
 - Finally, competent authorities should review, as appropriate, the impact of FX lending risk on institutions' reputational and legal risks.

II.2 Supervisory review of capital adequacy

11. Competent authorities should ascertain that institutions adequately incorporate FX lending risk to unhedged borrowers into their risk measurement systems and ICAAP. In particular, competent authorities should ensure that:

- institutions' FX lending risk exposures do not exceed their risk bearing capacity nor risk appetite; and
- ICAAPs take proper and adequate account of FX lending risk, including risk concentration in one or some currencies.

12. Regardless of how institutions classify risks stemming from FX lending in terms of credit and market risk, competent authorities should investigate how the non-linear relation between credit risk and market risk has been addressed and should assess whether this treatment is adequate

13. Competent authorities should ensure that institutions:

- maintain an overall consistency of the whole risk measurement framework by ensuring that the underlying hypotheses (confidence level, holding period etc.) used to measure market and credit risk are defined in a consistent way;
- recognise that portfolios denominated in foreign and domestic currencies may exhibit markedly different default patterns and should therefore account for potential future credit losses as a result of exchange rate fluctuations separately for different currencies;
- account for the impact of exchange rate movements on default probabilities;
- account for the fact that they may become exposed to market risk through borrowers even if they hedge themselves against exchange rate movements in relation to their FX lending activities. (The market risk hedge may become ineffective when FX borrowers default,

especially if the loans were collateralised in local currency. In that case, institutions would suffer credit losses from borrowers' defaults and at the same time they would be exposed to market risk losses from the hedge which was broken up by the defaults).

14. Additionally competent authorities should ensure that institutions quantify the capital needed to cover FX lending risk, including the concentration risk aspect, in a prudent and forward-looking manner, in particular focusing on concentrations due to the dominance of one (or some) currency(ies) (as the movements in exchange rates are a common risk factor simultaneously driving defaults of many borrowers).
15. Competent authorities should assess whether institutions hold adequate capital to cover risk associated with FX lending by assessing whether institutions are able to identify underlying causes of changes in their capital position and whether they adequately prepare for potential additional capital needs.
16. Competent authorities should ensure that institutions carry out capital planning thoroughly also to take into account stressed conditions and account for possible exchange rate movements. Competent authorities should ensure that institutions do this by focusing not only on the direct effect of nominal adjustments but also taking into account the indirect consequences on credit risk parameters.
17. For institutions with a cross-border presence, FX lending risk and its management should be assessed by competent authorities on a consolidated, sub-consolidated and solo level. This should also be reflected in the joint decisions required under Article 108 of the CRD and associated EBA technical standards. Consolidating supervisors should be promptly informed by host supervisors if FX lending risk is material at a subsidiary level.

II.2.1 Supervisory review of stress testing

18. In line with the EBA Guidelines for Stress testing (GL32) and to enable institutions to withstand severe exchange rate movements, competent authorities should ensure that institutions include FX-related shocks in their stress testing scenarios, both as a part of ICAAP stress tests used for capital planning purposes and separate portfolio-level stress tests.
19. Stress tests should, where appropriate, include shocks to the currency arrangements and resulting changes to borrowers' ability to repay for the whole portfolio and for each individual currency.
20. Competent authorities should review the stress tests carried out by institutions, including scenario selection, methodologies, infrastructure and the results of such stress tests and their use in risk management. Competent authorities should ensure that institutions' stress tests cover FX lending risk sufficiently and that institutions take appropriate mitigating measures to address the results of the stress tests.
21. Where stress tests are not carried out or the results of the review of institutions' stress testing programmes reveal that they are insufficient, competent authorities should request institutions to take remedial actions. In addition, competent authorities may do the following:

- recommend scenarios to institutions;
- undertake supervisory stress tests on an institution-specific basis;
- implement system-wide supervisory stress tests based on common scenarios.

II.3 Application of supervisory measures

22. Based on the outcome of the supervisory reviews outlined in Title II.1 and II.2 above, competent authorities assess that institutions' arrangements, strategies, processes and mechanisms and own funds to cover FX lending risks are adequate in which case there is no need for further supervisory measures. Where these are considered to be inadequate, competent authorities should apply the most appropriate measures to address specific deficiencies (such as requiring reinforcement of the relevant arrangements, processes, mechanisms and strategies, requiring additional provisioning and/or requesting improvements to the ICAAP methodologies, or other measures specified in Article 100 of CRD IV).

23. If competent authorities assess that institutions do not hold capital which adequately covers FX lending risk, they should require institutions to hold additional own funds in excess of the minimum regulatory capital requirements in line with Article 100(1) of CRD IV. Such capital add-ons for FX lending risk to unhedged borrowers can be imposed alone, or with other supervisory measures aimed at improving arrangements, strategies, processes and mechanisms implemented for FX lending risk management.

24. Additional capital add-ons should be calculated as part of the SREP cycle using the following method, whereby competent authorities should apply an FX lending-specific add-on, linked to the risk assessment framework and to the results of the SREP:

- Competent authorities should apply the additional capital add-on on top of the minimum regulatory capital requirement for credit risk in proportion to the share of FX loans to unhedged borrowers using the following formula:

*The percentage proportion of the stock of FX denominated loans to unhedged borrowers * Pillar 1 capital requirement for credit risk * additional own funds requirement multiplier based on the results of the SREP assessment of the FX lending risk,*

where:

- the 'additional own funds requirement multiplier' will be linked to the results of the SREP assessment of FX lending risk for an institution in line with GL39 and the Implementing Regulation on Article 108(1)(a)⁴ :
 - SREP risk scores of "1" (i.e. FX lending risk is assessed as "Low") would attract a capital add-on of between 0 - 25%:

⁴ Pending the finalisation of the Guidelines for "common procedure and methodologies for the supervisory review and evaluation process" under Article 102(3) CRD the reference and calibration is made based on the common scoring methodology in the GL39. Once the guidelines under Article 102(3) are finalised, this would be revised accordingly.

- SREP risk score of “2” – (i.e. FX lending risk is assessed as “Medium-Low”) would attract a capital add-on of between 25.1% - 50%,
 - for score “3” – (i.e. FX lending risk is assessed as “Medium-High”) would attract a capital add-on of between 50.1% - 75%, and
 - for score “4” – (i.e. FX lending risk is assessed as “High”) would attract a capital add-on of over 75.1% (this figure can be over 100%)
- When deciding on the capital add-on to be applied, competent authorities should take into account the level of concentration of institutions’ FX lending towards certain currencies, historic volatility of exchange rates for currencies where concentration is observed, exchange rate arrangements and any volatilities incorporated into such arrangements.
 - The method can also be applied on a portfolio by portfolio basis if the competent authorities use SREP scores for particular portfolios. In this case the formula for computing capital add-ons for individual portfolios is as follows:

*The percentage proportion of the stock of FX denominated loans to unhedged borrowers in a specific portfolio * Pillar 1 capital requirement for credit risk in a specific portfolio * additional own funds requirement multiplier based on the results of the SREP assessment of FX lending risk to unhedged borrowers in a specific portfolio*

25.If the institution is part of a cross-border banking group, the actual levels of capital add-on shall be agreed in the context of the joint decision process as required by Article 108(1) of the CRD.

II.4 Interaction with macro-prudential measures

26.In order to avoid duplication of capital add-ons to address this risk, competent authorities should also take into account, when applying the method above, any macro-prudential measures or other policy measures imposed by relevant authorities (i.e. macro-prudential authorities) that require institutions to hold additional capital for FX lending risk.

27.Where these measures are in place competent authorities should assess:

- (i) whether other institutions that have the risk or business profile targeted by the macro-prudential measure are omitted from the effects of the measure due to its design (for example, if the macro-prudential measure means that competent authorities address FX lending risk through increased risk weights applicable to FX denominated loans, the measure would only cover institutions applying the standardised approach to the calculation of minimum capital requirements for credit risk, and therefore institutions applying IRB approaches would not be directly impacted); and
- (ii) whether the macro-prudential measure adequately addresses the underlying level of FX lending risk of individual institutions.

28.Based on these assessments, competent authorities should:

- (i) in the case that the macro-prudential measure, due to its design specificities, does not capture a particular institution (as discussed in 27(i)), the competent authorities may consider extending the macro-prudential measure directly to institutions not captured, for example, by applying the same floor to risk weights for FX denominated loans used by IRB institutions in their risk models at the same level as the increased risk weights of the macro-prudential measure for similar exposures of institutions using the standardised approach. IRB institutions would then be expected to apply those floors in their risk models and the difference between the normal own funds requirement calculation (before the application of the floor) and the subsequent calculation would be considered as the capital add-on for FX lending risk. This can be illustrated by the following example:

	Bank using Standardised approach for credit risk capital requirement calculation	Bank using IRB approach for credit risk capital requirement calculation
Nominal amount of exposure in foreign currency	100	100
Risk weight (either regulatory or as coming from the IRB exposure)	35%	15.6%
Macro-prudential measure	70% risk weight for FX denominated exposures	
Extension of the macro-prudential measure (Pillar 2 capital add-on)		70% floor to IRB risk weights applied to FX denominated exposures
Capital add-on	$((100 \times 0.7) - (100 \times 0.35)) \times \text{min capital requirement}$	$((100 \times 0.7) - (100 \times 0.156)) \times \text{min capital requirement}$

- (ii) in the case that the SREP outcomes indicate that the macro-prudential measure does not adequately address the underlying level of FX lending risk of a particular institution (i.e. FX lending risk in institutions is higher than the average level targeted by the macro-prudential measure) then the measure should be supplemented with the institution-specific capital add-on using the method as described in Title II.3

Title III- Final Provisions and Implementation

29. The guidelines should be complied with by competent authorities by 30 June 2014.

5. Accompanying documents

5.1 Cost- Benefit Analysis / Impact Assessment

Introduction

30. In November 2011 the ESRB issued 7 Recommendations on foreign currency (FX) lending: among those, Recommendation E requests that the EBA draft Guidelines to competent authorities regarding capital requirements under the Supervisory Review and Evaluation Process (SREP) to mitigate risks related to FX lending to unhedged borrowers.
31. Article 16(1) of the EBA Regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council) requires that the draft Guidelines (GLs) be accompanied, when appropriate, with an impact assessment analysing the related potential costs and benefits.
32. Part of the information and views expressed in this impact assessment are based on qualitative and quantitative evidence (bank-level data) that the EBA collected from a subset of EU competent authorities, relating to bank-level FX lending exposures as well as to the current supervisory practices addressing FX lending risk.
33. In order to ensure proportionality and timeliness of the data collection exercise, only some Member States were selected based on the evidence already produced by the ESRB⁵ on the proportion of loans to households that is denominated in foreign currency, at the aggregate (national) level for a subset of EU Member States. The Member States selected for the data collection exercise supporting this impact assessment analysis are those that, according to ESRB data for year 2011, present a share of FX loans to households in the total loan portfolio broadly equal to or higher than 5%.⁶

Scope and nature of the problem

34. The measures set out in these Guidelines address the risks related to institutions' FX lending to unhedged borrowers. According to the ESRB recommendations, FX lending to unhedged borrowers poses risks to the financial system through several different channels. From a micro-prudential perspective, risks related to FX lending mainly stem from the interaction between movements in the foreign currency in which loans are denominated (market risk) and the debt servicing capacity of domestic unhedged borrowers (credit risk).
35. Adverse exchange rate movements (i.e. decreases in the value of the national currency against the currency(ies) in which the loans are denominated) translate into:

⁵ See Report on Lending in foreign currencies accompanying the Recommendations of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (ESRB/2011/1). Published on 22 November 2011 (Official Journal C 342).

⁶ The Member States involved by the EBA in the data collection exercise are: Austria, Bulgaria, Denmark, Croatia, Hungary, Lithuania, Latvia, Poland, Romania and Slovenia. Croatia is not covered by the ESRB report and was included in the data collection exercise to allow for data on its exposures in FX lending being collected for the first time.

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- a. an increase in both the outstanding value of debt and the flow of payments to service such debt, determining higher probability of borrowers' default, i.e. higher credit risk;
 - b. for FX denominated loans that are collateralised by assets denominated in domestic currency, increases in the value of outstanding debt imply worsening recovery rates, i.e. higher credit risk;
 - c. due to increased risks described under (a) and (b), above, a higher likelihood arises for credit institutions to incur losses and to face deteriorations of their capital positions.
36. In addition, concentration risk at the individual lender level is likely to amplify the impacts described under (a), (b) and (c) above. Whenever an individual lender concentrates their unhedged FX lending activity within a single foreign currency, or in a limited number of highly correlated foreign currencies, significant adverse movements in the exchange rates contemporaneously affect the riskiness of all the exposures within institutions' FX lending portfolios.
37. From a macroeconomic perspective, materially high levels of FX lending can lead to:
- a. the emergence of credit bubbles sustained by the availability of foreign bank funds, which are likely to feed asset price bubbles (e.g. housing booms), in turn contributing to encouraging further development of collateral-driven over-borrowing in the economy;
 - b. amplified impact of external shocks, whenever such shocks determine or are accompanied by a depreciation of the domestic currency. The increased value of the private sector's financial liabilities following a currency depreciation/devaluation turns into financial stress of the private sector, falling aggregate demand and demand-driven fall in output.

Objectives of the Guidelines

38. The ESRB Recommendations address the risks identified in relation to FX lending under several different regulatory perspectives. As documented in the impact assessment of the ESRB Recommendation E, FX lending-specific capital add-ons under the SREP and the harmonisation of those requirements within the Single Market, would address the risks of FX lending by ensuring the following objectives:
- a. institutions engaged in material volumes of FX lending are adequately resilient to unexpected losses arising from adverse movements in the exchange rates of the currencies in which the lending is denominated;
 - b. systemic risk is better tackled, and in particular the risk of contagion due to spill-over effects between highly correlated currencies in which FX loans portfolios are denominated;
 - c. regulatory arbitrage practices are avoided within the Single Market in the area of FX lending.
39. In addition, as an indirect consequence of enhanced risk-management practices and more adequate levels of regulatory capital against FX lending risk, institutions are expected to better

price in the risk arising from potential adverse exchange rate movements on foreign currency lending exposures. As the interest rate differentials are among the driving factors behind the increased demand for FX loans, a more risk-sensitive (improved) pricing of exchange rate risk could reduce the gap in the costs of domestic and foreign loans, therefore helping mitigate the risk that credit bubbles develop that are financed by foreign currency funds.

Baseline

40. Under the current CRD regime competent authorities review the arrangements, processes and strategies that institutions implement in order to evaluate and tackle all the risks to which they are or might become exposed. Among these risks, FX lending risk can already be part of the SREP process as well as it can be embedded in the ICAAPs and governance arrangements of the institutions.
41. However in the current regulatory framework there is no harmonisation of the SREP treatment of risks by supervisory authorities such as the one proposed in these Guidelines.
42. From the data and qualitative evidence collected from 10 competent authorities, it can be inferred that:
 - Only 3 out of 10 jurisdictions require institutions to explicitly assess the proportion of FX lending to unhedged borrowers. Such practice is not carried out on a regular basis, although it can be carried sporadically and/or be associated to on-site inspections. Regulatory reporting requirements are not normally applied in these cases.
 - Almost half of the consulted jurisdictions do not evaluate FX lending risks as a separate risk category within their SREPs. Only one jurisdiction requires evaluation of the FX lending risk as a standalone risk category and assigns institutions scores related to FX lending risk; in all the other jurisdictions, within our sample, where FX lending risk is evaluated, such an evaluation is part of either the one for credit risk (more frequent) or the one for market risk.
43. Besides the focus on unhedged borrowers and a harmonised implementation of potential capital add-ons for FX lending risk, these draft Guidelines indicate that competent authorities should ascertain that institutions for which FX lending risk is material implement a series of practices aimed at addressing FX lending risk, such as: i) assessing future trend and volatility of exchange rates of material currencies; ii) accounting for the impact of foreign currency movements on the borrower's debt servicing capacity and probability of default in the loan underwriting; iii) reviewing periodically the 'hedge' status of borrowers; iv) including bespoke foreign exchange rate movement scenarios in the ICAAP related stress-testing and developing FX lending risk specific stress-tests at the individual foreign currency portfolio level.
44. Detailed data at the individual jurisdiction level is not available to assess whether, and to what extent, each of those practices is part of the current regulatory and supervisory framework in the Single Market. There is limited evidence on some of those practices, e.g. FX lending ad-hoc stress tests, being currently adopted by some Member States.

Impacts on Markets, Institutions and Competent Authorities

FX lending exposures and scope of applicability

45. In order to assess the extent to which the proposed thresholds capture individual institutions, triggering applicability of the Guidelines, the EBA asked 10 competent authorities to provide bank-level data on FX lending exposures in their jurisdictions.⁷
46. The sample comprises 87 institutions, whose size in terms of total assets as of year 2011 varies substantially: total assets of the median institution equal approximately EUR 5 billion, with the smallest institution in the sample holding approximately EUR 200 million and the largest consolidated reported entities holding between approximately EUR 100 million and EUR 400 million.
47. Two alternative thresholds were considered in order to establish the level of exposure to FX lending which triggers applicability of the proposed Guidelines:
- **Threshold 1:** (Total FX Loans to Unhedged Borrowers) / (Total Loans) is equal or larger than **10%** and (Total Loans) / (Total Assets) is equal or larger than **25%**.
 - **Threshold 2:** (Total FX Loans to Unhedged Borrowers) / (Total Assets) is equal or larger than 10%.
48. As described in the 'Baseline' section of this Annex, only a very limited number of competent authorities report having available data on the portion of FX loans granted to unhedged borrowers, on an institution-by-institution basis. In addition, no data on such break-down was made available within the data collection exercise for this Impact Assessment exercise.
49. In order to compute the exposure metrics included in Threshold 1 and Threshold 2, above, the variable 'FX loans to households' was used as a proxy for 'FX loans to unhedged borrowers', households being considered the most relevant category of borrowers with neither a natural nor a financial hedge against foreign currency risk.
50. Charts 1 and 2 and the associated tables below, illustrate the exposure of individual institutions in the sample to FX lending to households, by reporting for increasing thresholds of exposure (5% - 10% - 20% - 30%):⁸
- 1) The percentage portion of institutions, in the sample, that would fall into (i.e. be captured by) each exposure threshold.
 - 2) The aggregate percentage portion of assets, in the sample, corresponding to all institutions falling into each exposure threshold.

⁷ See the Introduction to the IA annex.

⁸ The values reported in the charts and tables represent averages over 2009-2011 data. Identical (non-reported) computations were carried out on pre-crisis data, covering years 2006-2007, leading to broadly similar results.

3) The distribution of institutions by size⁹ within each exposure threshold.

Chart 1: Threshold 1

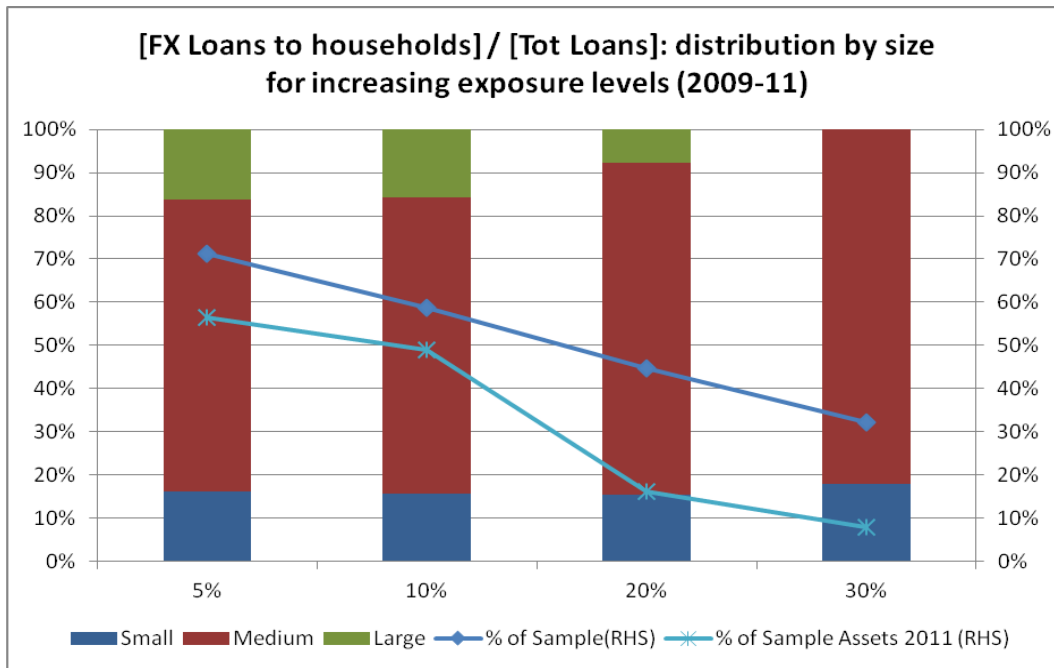


Table 1

	FX Loans to Households / Total Loans (2009-2011)			
	5%	10%	20%	30%
% of institutions in the scope:	70%	60%	45%	30%
% of total assets in the scope:	56%	49%	16%	8%
Break down by size:				
Small Institutions	16%	16%	15%	18%
Medium Institutions	81%	80%	85%	82%
Large Institutions	3%	4%	0%	0%

⁹ Institutions are classified as Small Medium and Large where: Total Assets smaller or equal than 1.8 Eur bn define Small Institutions, Total Assets between 1.8 and 30 Eur Bn identify Medium Institutions and Total Assets larger than 30 Eur Bn identify Large Institutions.

Chart 2 – Threshold 2

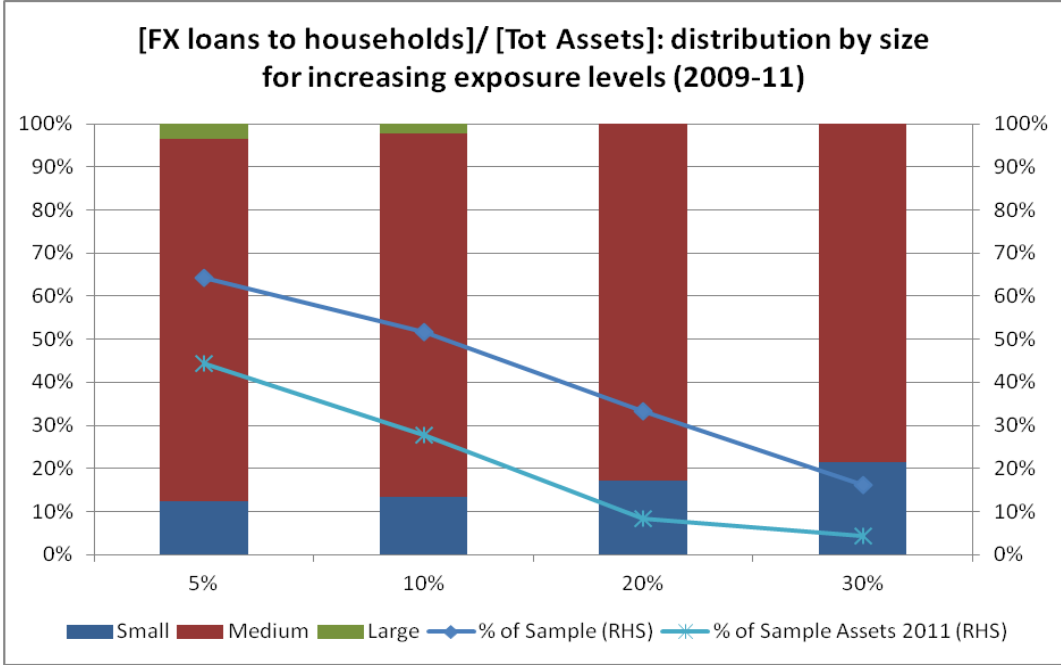


Table 2

	FX Loans to Households / Total Assets (2009-2011)			
	5%	10%	20%	30%
% of institutions within the threshold:	64%	52%	33%	16%
% of total assets within the threshold:	44%	28%	8%	4%
Break down by size:				
Small Institutions	13%	13%	17%	21%
Medium Institutions	84%	84%	83%	79%
Large Institutions	4%	2%	0%	0%

51. The ratio (Total Loans) / (Total Assets), which represents the importance of lending activities within the business model of the institution, takes on particularly large values for all institutions within the sample. On average data for years 2009-2011, only 1 in 86 institutions has a (Total Loans)/(Total Assets) value lower than 30%, with the lowest quartile of the sample being approximately between 30% and 53% and the median institution at 65%. This result implies that:

- 1) The (Total Loans) / (Total Assets) condition of Threshold 1 is always satisfied (i.e. always binds) for the institutions in the sample.
- 2) The scope of applicability resulting from Threshold 1, with respect to the sample, can be fully represented by the exposure levels as measured by the (Total FX Loans to Households) / (Total Loans) ratio.

-
52. The FX lending exposures, within the sample, as measured by both metrics in Threshold 1 and Threshold 2 are such that the proportion of small institutions falling within the thresholds slightly increases for increasing levels of exposure. This is because when the exposure is 30% or 20% in Threshold 1 and 2 respectively, there are no large, and mostly consolidated, entities in the sample meaning that for those levels of exposure, consolidated entities are no longer captured by the thresholds. However, the proportion of small institutions falling under each of the exposure levels appears to be relatively stable (between 15% and 18% under Threshold 1 and between 13% and 21% under Threshold 2), with no exposure 'bucket' being characterised by a particularly large or small presence of small institutions.
53. **Proposed Threshold:** The draft Guidelines propose identifying material FX lending risk exposures through Threshold 1. According to the data collection exercise carried out for the purposes of Impact Assessment, an exposure level measured by the $(\text{Total FX Loans to Unhedged Borrowers}) / (\text{Total Loans})$ ratio at least equal to 10% captures 60% of the institutions in the sample and brings under the applicability of the Guidelines approximately 50% of the total assets held by the institutions in the sample. The second condition within Threshold 1, ensuring that the $(\text{Total Loans}) / (\text{Total Assets})$ ratio be at least equal to 25% is proposed in order to ensure that those institutions that are characterised by a minor role of lending activities (business models) can be excluded from the applicability of the Guidelines even in cases where the loan books of those institutions featured high proportions of foreign currency denominated exposures.

Expected Costs and Benefits

54. The benefits associated to the proposed draft Guidelines relate to the materialisation of the regulatory objectives mentioned above in this Impact Assessment Annex (see 'Objectives of the Guidelines'). Such benefits cannot be quantified in this Impact Assessment analysis as they relate to forgone losses that would have been incurred, both at the level of the macro-economy and the individual institutions, were institutions not adequately risk-managed and protected by FX lending specific regulatory capital and were the formation of FX lending credit bubbles not addressed by micro-prudential regulation. The analysis presented by the ESRB¹⁰ on the potential consequences of exchange rate movements on mortgage borrowers' debt servicing capacity as well as on the relationship between exchange rate dynamics and the historical performance of FX lending in a set of EU Member States provided some quantitative evidence on the nature of the micro-prudential risks at stake.
55. As stated in the 'Baseline' section, there is no detailed data on the extent to which most of the risk management practices (e.g. FX risk assessment on borrower's profile at loan underwriting, ongoing monitoring of 'hedge status' of the borrower, FX specific stress-testing at portfolio level etc.) and governance practices proposed by the Guidelines are currently implemented in the supervisory practices of competent authorities. In order to comply with those practices, among those proposed in the Guidelines, which are not currently being

¹⁰ See Report on Lending in foreign currencies accompanying the Recommendations of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (ESRB/2011/1). Published on 22 November 2011 (Official Journal C 342).

required in their jurisdictions, institutions under the scope of FX lending specific supervision are expected to incur both one-off and on-going compliance costs. The overall level of such costs, however, is not expected to be comparable, in terms of magnitude, with the forgone losses associated with enhanced financial stability and reduced systemic risk.

56. The proposed Guidelines may result in increased capital requirements, for some of the institutions exposed to material levels of FX lending risk, to the extent that the current levels of regulatory capital held against FX lending risk are deemed insufficient, by the competent authorities, following the SREP for FX lending risk. Given the contingent nature of such capital compliance costs, the estimation of the latter is not an objective of this impact assessment analysis.