ESRB
European Systemic Risk Board
European System of Financial Supervision

23 August 2013

Response from the ESRB to the EBA Consultation Paper on Draft Guidelines on Capital Measures for Foreign Currency Lending to Unhedged Borrowers under the Supervisory Review and Evaluation Process

Introduction

In September 2011, the European Systemic Risk Board (ESRB) issued a Recommendation on lending in foreign currencies (ESRB/2011/1) to address the systemic risk originated by excessive FX lending. In particular, the adopted text on lending in foreign currencies included seven Recommendations, one of which (Recommendation E) advisedthe EBA to address guidelines to national supervisory authorities on Pillar II. In particular, this concerns the need for institutions to hold adequate capital to cover risks associated with foreign currency lending, and notably the risks stemming from the non-linear relation between credit and market risks.Against this background, the EBA issueda Consultation Paper on a proposeddraft guidelinesto competent supervisory authorities. This Consultation Paper is subject to public comments until 23 August 2013. In response to this Consultation, the ESRB wishes to raise the following issues.

The ESRB welcomes the EBA consultation paper on “Draft Guidelines on Capital Measures for Foreign Currency Lending to Unhedged borrowers, under the Supervisory Review and Evaluation Process (SREP)”, as it responds to the ESRB recommendation and the analysis for imposing such capital measures is comprehensive.

As a positive contribution, the ESRB identified the following points on 5 specific areas. It agrees with the publication of the ESRB’s response by EBA and intends to make it public also in its own website.

1 - On the presumed identification of the share of unhedged lending in the overall foreign currency lending

The ESRB Recommendation aims at reducing risks affecting unhedged borrowers only. This is a crucial criterion of economic proportionality to avoid any unintended consequences on the activities of those market players which are either naturally hedged or are able to enter into hedging agreements. It is therefore crucial to have effective procedures to identify which borrowers are hedged and which borrowers are *not* hedged. This information is however often not available to authorities.

The EBA proposes (§ 4) that "wherever data on FX lending to unhedged borrowers is unavailable from an institution, competent authorities should use FX lending to households as a proxy for FX lending to unhedged borrowers."

The following comments concern the concept of FX lending to so-called "households and non-profit institutions"[1]as a valuable*proxy* for overall FX lending to unhedged borrowers. The proxy aims at making sure that the effective exposure of credit institutions to unhedged borrowers is not underestimated, in those cases where effective information is missing. However, there is a residual risk of underestimation, as it may be expected that also a portion of lending to non-financial corporations (e.g. small and medium sized companies; local municipalities) may triggersizeable exchange rate risks, due to a lack of hedging.

While it is acceptable that institutions use FX lending to households as a first proxy to determine their overall unhedgedlending activity to all categories of borrowers, the EBA guidelines should embed a system of incentives to make sure that credit institutions rely less and less on such a proxy concept, and increasingly collect real information on their overall level of lending to unhedged borrowers. Accordingly, the EBA guidelines should emphasise that institutions adequately reflect material risks stemming from FX lending to unhedged borrowers in their ICAAP.

[1]As defined in Regulation (EC) No 25/2009 of the European Central Bank of 19 December 2008concerning the balance sheet of the monetary financial institutions sector (Recast) (ECB/2008/32)

2 - On the impact of the FX exchange regime on the supervisory assessment

The EBA suggests (§ 10) that the definition of the exchange rate regime would have an impact on the assessment to be taken by competent authorities. The latter should also ensure that credit institutions fully understand the impact of the foreign exchange regime on effective real exchange risk.

To clarify the text it is suggested that it would be interpreted in the sense that the classification of the exchange rate regime should not unduly bias the assessment by competent authorities on potential exchange rate risks. Relying only on a definition of public policies might have the following effects:

- First, it is notorious that the *de jure* classification of exchange rate regimes may be substantially different from *de facto* exchange rate developments. A pure consideration of *de jure* categorisation should be avoided.
- Second, in cases where exchange rate exposures are very significant, tail risk events (like the possible 'break' of a fixed exchange rate regime, including 'hard pegs') may have material implications of first order, i.e. affecting the debt servicing capacity of unhedged borrowers and consequently having a material impact on credit risk. Tail risks should therefore not be ignored in the assessment by supervisory authorities.

3 - On the assessment of whether capital levels are adequate

The thrust of the recommendation E is to make sure supervisors assess whether the level of capital institutions hold is commensurate to the risks stemming from the risks they bear on the specific case of foreign exchange loans. It is noted, in particular that foreign exchange loans compound market risks (foreign exchange rate risk) and credit counterparty risks in anon-linear fashion. As EBA suggests (§15), this must be supported bythe credit institutions' capacity to identify the factors affecting their capital position, and be further enhanced by their readiness to accommodate higher capital needs, if need be.

The comments refer to the need to strengthen this assessment.

- The language of paragraph 15 should be strengthened by stressing that one of the main tasks of supervisors is to assess whether institutions cover these risks within their ICAAP and whether institutions provide a reasoned assessment of capital levels. Furthermore, another key task of supervisors isto ensure that the supervisory assessment leads to supervisory measuresif capital levels are deemed insufficient (which are then covered in the following section "III.3 Application of supervisory measures").

4 - On the capital add-on being calculated as part of the SREP

According to the consultation paper, the suggested FX-lending specific additional capital add-on is to be based on the risk score derived from the SREP assessment. The SREP assessment risk scores constitute a figure ranging from 1 to 4 and the higher the score, the higher the capital add-on. That is to say, depending on the SREP risk score, the so-called “additional own funds requirement multiplier” varies from 0% to over 100%(§24).

The comment below refers to using Pillar II as a tool applicable across the board and not only dependent on institution-specific risks.

- Having the capital add-on being *only* dependent on the institution-specific SREPcould limit the ability of a supervisor to react in a way they find appropriate for the whole system, in case Pillar II would be chosen as the appropriate “macro-prudential” tool to address systemic risks in the FX loans portfolio. In this context, the following could be added as a last paragraph in section “II.3 Application of supervisory measures”:

  “*The approach of defining the capital add-on based on the SREP is appropriate for calculating institution-specific capital add-ons. This approach should however be without prejudice of competent or designated authorities using Pillar II in the context of Articles 103 and 104 of Directive 2013/36/EU, namely in what concerns institutions with similar risk profiles or which might be exposed to similar risks or pose similar risks to the financial system, which may warrant higher levels of capital add-ons implemented throughout the system.*”