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Dear Mr. Farkas

***Deutsche Bank's response to the European Banking Authority's Consultation Paper 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)***

Deutsche Bank (DB) welcomes the opportunity to comment on the EBA's consultation paper on foreign currency lending to unhedged borrowers. We support the European Systemic Risk Board (ESRB) initiative to address systemic risks associated with foreign currency lending to retail clients through developing EU-wide policy recommendations. Having a common approach at the EU level for identifying and addressing these risks is of paramount importance and we welcome the EBA's work in developing these draft Guidelines for national authorities.

In our response, we recommend the following: a clearer definition of unhedged borrowers; a more precise definition of FX lending and; a simpler way to test whether the Guidelines apply to a financial institution.

### **General comments**

We understand that the ESRB recommendations on FX lending were adopted in a response to increased foreign currency borrowing to the non-financial private sector in Central and Eastern Europe (CEE) and Austria which lead to currency mismatches and subsequently, reduced ability for households to repay the loans.

We note that the risks stemming from foreign currency lending are already addressed through credit risk and market risk measures and are reflected in risk adjusted capital requirements under Capital Requirements Directive (CRD4). DB believes, therefore, that the Guidelines should address only those risks not already covered by the capital adequacy assessment processes on credit risk (Article 79 of CRD4) and market risk (Article 83 of CRD4).

### **1. Definition of unhedged borrower and natural and financial hedges**

The EBA Consultation paper defines "unhedged borrowers" as "*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*" (page 8 of the Consultation). We believe a more precise definition of both hedged and unhedged borrowers should be provided as neither of term is currently defined by regulation.



The proposed definition of unhedged borrower lacks necessary clarity, leaving industry and national supervisors with uncertainty. The necessary precision is not provided by the proposal 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*” (page 8 of the Consultation). A clear definition of ‘unhedged’ is also necessary in the context of transaction criteria with hedged transactions, excluded from the scope of the Guidelines.

As we understand it, these Guidelines are intended address the risk of FX lending that results from hard currency lending in a very specific retail segment as identified in the ESRB recommendations. Foreign currency lending to retail clients, is materially different from the foreign currency lending to businesses, professional clients and eligible counterparties as defined by MiFID (Markets in Financial Instruments Directive). For example, the guidelines are directed at an individual who lives in Poland, receives income in Polish Zloty, and takes the unsecured household loan denominated in CHF or EUR currency other than for investment purposes. In contrast for example, a German or US business located in London and receives income in GBP but takes out a loan in USD or JPY to finance its business operations in Asia, shout not be but is in fact covered by the wide definitions used in the Guidelines. The Guidelines should clearly distinguish between foreign currency lending to individual retail clients and foreign currency lending to corporate clients. We would therefore recommend narrowing the scope of the definition of unhedged borrowers to individual retail clients as defined by MiFID and to further refine coverage by reference to the purpose of the foreign currency loan. In particular, we believe that the Guidelines should further differentiate foreign currency lending for investment or speculative purposes from lending that is not for investment or speculative purposes. The Guidelines should therefore apply to retail clients as defined by MiFID that do not engage in FX lending for investment purposes.

## **2. Definition of foreign currency lending**

The EBA consultation paper defines the FX lending as ‘*all foreign currency lending in currencies other than the legal tender of the relevant jurisdiction*’ (page 8 of the Consultation). We believe that this definition of FX lending is too broad and that FX lending should be more precisely defined by differentiating secured from unsecured lending, as well as making a distinction between lending for investment purposes and lending for non investment purposes. For the purpose of these Guidelines, we propose excluding secured lending as well as lending for investment purposes from the definition of FX lending.

In our view, the aim of the Guideline is to require financial institutions to hold adequate capital to cover risks associated with unsecured foreign currency lending to retail clients (as defined by MiFID). In order to address this risk, excluding secured lending from the scope of the Guidelines would further refine the target business and provide for a collateral based process where lending is unsecured. In cases where the institution is providing an unsecured foreign currency loan to MiFID retail client, we would suggest including a requirement for a financial institution to present sensitivity analysis relating to currency movements to the client associated with the unsecured loan as well as the value of the loan restated in the base currency of the client in. We believe this approach would provide adequate answer to the client of the risks.

## **3. Testing whether threshold criteria are passed**

DB agrees with the proposed principle that institutions where FX risk has not been sufficiently addressed through Pillar 1 capital adequacy requirements should make additional capital provisions in Pillar 2. To test whether these additional provisions are necessary, as the first step in the process the EBA proposes that ‘*(i) competent authorities should require institutions to identify their FX lending risk to unhedged borrowers, if necessary by using the proxy (paragraph 4 above)*’ (page 9 of the Consultation). As pointed out in the consultation paper (page 9 of the Consultation)



the guidelines would apply wherever the following threshold of materiality is met: *‘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.’*

DB believes that testing whether the institution meets the threshold criteria should be procedurally simple and without the need for extensive data analysis. However, without the precise definitions of FX lending and unhedged borrowers, it will be difficult for institutions and national regulators to identify whether institutions pass threshold criteria and whether these guidelines apply to them.

In FX lending, the loans in different currencies are usually not hedged on an individual portfolio basis, but rather bundled together and risks hedged through a structured credit loan book where the risk is captured by counterparty rating on portfolio basis. In practice, it is hard to segregate the FX hedging effect of lending products from a client’s overall portfolio FX risk if the client is a more sophisticated client. Whilst it may be possible to capture that data on retail clients, capturing such data for corporate clients would be challenging due to the complexity of revenue streams employed by corporate clients. We believe the lack of data on unhedged borrowers already noted in the impact assessment is a reflection of the fact that it is challenging to capture this data in practice (page 19 of the Consultation).

The compliance cost of testing whether the institution passes the threshold would be high for both institutions and national regulators and could be avoided by introducing a more precise definition of unhedged borrowers and foreign currency lending.

#### **4. Other issues**

The consultation proposes that the competent authorities should review the impact of FX lending risk on institutions’ reputational and legal risks (page 11 of the Consultation). In our view, the reputational and legal risks are already extensively considered in the internal capital adequacy assessment process and subject to comprehensive reviews by competent authorities, hence no new requirements are proposed by the Guidelines. We therefore propose to delete this sentence from the Guidelines.

#### **Conclusion**

In DB’s view, focusing the scope of application of these Guidelines individual retail clients as defined by MiFID, who take an unsecured FX loan for a purpose other than investment purpose, would appropriately capture the intended target group of these Guidelines. We believe this in turn would more appropriately address the ESRB concerns and ensure easy implementation of these rules by national regulators.

We would be happy to discuss further any of the points in our response.

Yours sincerely,

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