A response to

PRA CP17/23

the capitalisation of foreign exchange positions for market risk

January 2024

Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 300 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

We are pleased to respond to the Prudential Regulatory Authority (PRA) consultation paper (CP) 17/23 on the Capitalisation of Foreign Exchange (FX) positions for market risk. We agree with the PRA that the current Capital Requirements Regulation (CRR) requirements contain some ambiguity which this consultation seeks to resolve.

We support the proposed aims and clarifications provided in the consultation but seek additional clarity on the following:

a) the treatment of FX risk at Group consolidated level that arises from subsidiary level items held at historical cost, but which are retranslated at Group level
b) the treatment of contingent FX risk arising from AT1 instruments
c) the treatment of Structural FX ('SFX') hedging that is undertaken on behalf of entities with SFX
d) waiver applications
e) the treatment of SFX inputs, beyond currency risk weighted assets (RWA), in the calculation of maximum amount exempted e.g., currency CET1 deductions/adjustments form a material component of a firm's SFX management practice, and
f) the level of application of SFX requirements (portfolio vs consolidated.

a) Items held at historic cost

Members broadly agree that assets and liabilities measured at 'historical cost' should not generate FX market risk charges. We note consistency with the solo entity level accounting treatment under IAS21 *The Effects of Changes in Foreign Exchange Reserves* paragraph 23(b) where non-monetary items measured at historical cost are translated using the exchange rate at the initial transaction date and therefore do not generate FX risk from re-translation at reporting periods. However, we are concerned that a blanket exclusion from the

calculation of net risk position could create a disconnect between RWA calculations and risk management practices, specifically where these positions do re-translate at a Group consolidated level as demonstrated in the example below.

Example: Property held in a subsidiary/foreign operation

In this example, the property is measured at historical cost in the subsidiary. On consolidation in the Group's results the property will be re-translated through the foreign exchange reserve with all the other foreign currency denominated assets and liabilities of the subsidiary/foreign operation.

It is assumed that the GBP subsidiary owns a property and is part of a group with a USD reporting currency. The property forms part of the net assets/equity of the GBP subsidiary and therefore impacts the SFX risk of the USD Group.

The impact of this is shown below, both including and excluding the property within the FX revaluation of the group's SFX risk and assuming the GBPUSD FX rate moves from 1.25 to 1.50.

If the property asset is excluded (as proposed in the consultation) from the calculation of net risk position, then as outlined in B below the Group's consolidated SFX risk position is not captured.

A. Property asset included in FX revaluation

	GBP (m)	FX Rate 1.25	USD (m)	FX Rate 1.50	USD (m)
Trading Assets	100		125		150
Loans & Advances to Cust.	100		125		150
Owned Property Plant & Equip	20		25		30
Total Assets	**220**		**275**		**330**
Customer Accounts	120		150		180
Trading Liabilities	80		100		120
Total Liabilities	**200**		**250**		**300**
Equity	**20**		**25**		**30**

B. Property asset excluded from FX revaluation

	GBP (m)	FX Rate 1.25	USD (m)	FX Rate 1.50	USD (m)
Trading Assets	100		125		150
Loans & Advances to Cust.	100		125		150
Owned Property Plant & Equip	20		0		0
Total Assets	**220**		**250**		**330**
Customer Accounts	120		150		180
Trading Liabilities	80		100		120
Total Liabilities	**200**		**250**		**300**
Equity	**20**		**0**		**0**

As can be seen, the property creates CET1 ratio FX volatility. Where firms seek to hedge this type of exposure, it is our view that it is imperative to ensure that sound FX risk management is not inadvertently penalised in the computation of net risk position and resulting RWAs.

We recommend that the calculation is afforded the appropriate flexibility to ensure that any hedging of CET1 ratio volatility associated with historical cost assets and liabilities does not result in market risk RWAs.

b) Additional Tier 1 instruments ('AT1')

UK banks issue callable AT1 instruments denominated in currencies other than their group reporting currency. The majority of these instruments are classified as equity instruments and measured at historical cost.

We are supportive of excluding AT1 instruments measured at historical cost from the "net risk position" on the basis that these instruments do not create CET1 ratio volatility due to re-translation at reporting dates. However, we would welcome clarity as to how contingent FX risk arising from AT1 instruments should be considered for Pillar 2 capital calculations as set out in 2.3 in the consultation.

AT1 instruments generally only give rise to limited capital risk over a 1-year ICAAP horizon, as firms will decide not to call an instrument were a material FX risk to be crystallised. So, we believe the capitalisation of contingent AT1 FX risk through Pillar 2 should be by exception, reflecting a bank's discretion to exercise call options on these instruments.

c) Dis-aggregation of SFX Risk and Hedging Transactions between Group, Solo entities and Hedging Locations

In practice, hedging transactions may not always be undertaken by the legal entity or sub-consolidation Group exposed to the SFX risk. Instead, mainly for operational reasons, the hedging transaction may be undertaken by another Group entity, which has the required FX desk structure, skills and market access to undertake it. Where this is the case a "back-to-back" model is utilised internally to move the risk position to the right entity location. Members would welcome confirmation that the SFX Permission should be applicable in the entity where the economic exposure exists, rather than in the entity executing the trade.

d) Waiver and governance

Member banks already have existing SFX Waivers in place and would wish to continue to rely on them rather than submitting new applications. Members recognise however that Waivers should be updated, and new permissions sought, only where there are material changes, such as a fundamental change to strategy or hedging approach.

e) SFX Calculation

The consultation notes that "the maximum size of the risk positions eligible for exemption in each currency is calculated by comparing (a) the overall net FX risk position as stipulated in Article 325.1 with (b) the maximum risk position related to SFX items". We understand this includes all positions subject to FX risk in a firm (Trading Book & Non-trading Book), including SFX positions, and calculated in reference to Article 352, which principally uses accounting values to arrive at the "FX position".

However, in respect of maximum "SFX items", the consultation references the formula in 2.22, which is specific to RWAs only. As such, we seek clarity as to how other SFX offsets/mitigants should be considered in these calculations, noting that derivative hedging, non-derivative hedging, and currency CET1 deductions/adjustments ordinarily form a material component of a firm's SFX management practices. We recommend the formula in 2.22 is updated to include these additional items, or that it is made clear that these items should be included when arriving at the net open FX position/FX delta as required by the he computation in Article 352. The example below demonstrates the impact deductions has on the calculation.

Example: GBP subsidiary is part of a group with a USD reporting currency

In this example, for simplicity, both the GBP subsidiary and USD group have a CET1 ratio of 10% and loans to customers are risk-weighted at 100%.

The GBP subsidiary has intangible assets (software) and an expected credit loss from the customer loans, which are deducted from capital when calculating both the subsidiary's and group's CET1.

Capital deductions in non-reporting currency have an FX impact on the group's CET1 ratio and should be included in calculations of SFX risk and maximum waiver amounts.

Balance Sheet	**GBP (m)**	FX Rate 1.25	**USD (m)**
Loans to Customers	100	→	125
Intangibles (Software)	20		25
Total Assets	**120**		**150**
Customer Accounts	80		100
Total Liabilities	**80**		**100**
Equity	**40**		**50**

CET1	**GBP (m)**	FX Rate 1.25	**USD (m)**
Equity	40	→	50
Intangibles (Software)	(20)		(25)
Excess Expected Loss (EL)	(10)		(12.5)
	10		**12.5**
RWA			
Loans to Cust (100% RW)	**100**		**125**

A. GBP Structural FX excluding CET1 deductions

If capital deductions are excluded from SFX calculations then it appears that the group is running a long GBP structural position.

SFX_{GBP} = $Equity_{GBP}$ – (RWA_{GBP} x Group CET1 Ratio)

SFX_{GBP} = 50 – (125 x 10%) = $37.5m (Amount requiring Pillar 1 charge)

Maximum Waiver Amount = (RWA_{GBP} x Group CET1 Ratio) = $12.5m

B. GBP Structural FX including CET1 deductions

GBP SFX exposure is NIL if capital deductions are included in the calculations and maximum waiver amount.

SFX_{GBP} = $Equity_{GBP}$ – $Deductions_{GBP}$ – (RWA_{GBP} x Group CET1 Ratio)

SFX_{GBP} = 50 – 37.5 – (125 x 10%) = 0 (Amount requiring Pillar 1 charge)

Maximum Waiver Amount = $Deductions_{GBP}$ + (RWA_{GBP} x Group CET1 Ratio) = 37.5 + 12.5 = $50m

f) Application of SFX Permission Requirements

SFX permission requirements are set out in 2.12 of the consultation and expand on existing PRA requirements detailed in SS13/13 *Market Risk*. In our view, it is unclear from the consultation the expectation for items such as currency RWAs and capital deductions with respect to the requirements outlined in 2.12, in particular the level of application (portfolio vs consolidated view). For example, we believe that applying these requirements to standalone RWA portfolios would be unnecessarily burdensome. As such, we recommend that the requirements should be assessed by firms dynamically and at the highest relevant level of consolidation for risk positions deliberately taken or transacted to manage Structural FX risk.

Implementation date

We note that the PRA plans to introduce the changes resulting from this CP contemporaneously with the introduction of Basel 3.1, currently being 1 July 2025.

Responsible Executive

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