CP17/23 – Capitalisation of foreign exchange positions for market risk

Consultation paper 17/23

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Responses are requested by Wednesday 31 January 2024.

Consent to publication

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Responses can be sent by email to: **CP17_23@bankofengland.co.uk.**

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1: Overview

1.1 This consultation paper (CP) sets out the Prudential Regulation Authority's (PRA's) proposed clarifications and amendments when capitalising foreign exchange exposures under the market risk capital framework. It also sets out the process for seeking permission to exclude Structural Foreign Exchange (SFX) positions from this capital calculation. The PRA has proposed in CP16/22 – **Implementation of the Basel 3.1 standards** that the existing regulation from the onshored Capital Requirements Regulation (CRR) Article 352 will be moved with amendments to Article 325 in the proposed Market Risk: General Provisions (CRR) Part of the PRA Rulebook.

1.2 The proposals in this CP relate to the post-Basel 3.1 PRA proposed implementation described in CP16/22, and would result in changes to:

- the proposed Article 325 (Approaches for Calculating the Own Funds Requirements for Market Risk) in the proposed Market Risk: General Provisions (CRR) Part of the PRA Rulebook (Appendix 1);[1]

- the proposed supervisory statement (SS) 13/13 – Market Risk from CP16/22 (Appendix 2); [2] and
- the CRR Permission 352(2) supplementary application form (Appendix 3).

1.3 This CP also:

- clarifies that items held on the balance sheet at historical exchange rates (FX) are not to be included as a risk position for the purposes of calculating Pillar 1 capital requirements; [3]
- sets out the types of positions eligible for the SFX permission – currently available under Article 352(2) CRR and proposed to be available under Article 325 of the Market Risk: General Provisions (CRR) Part consulted on in CP16/22, together with SS13/13 (the 'SFX Permission');
- sets out expectations on the calculation of the maximum net FX risk position and the overall net FX position for the own funds calculation in SS13/13;[4] and
- updates the supplementary application form.

1.4 The current CRR Article 352(2) contains broadly analogous requirements for SFX to the proposed Article 325 of the PRA Rulebook. The PRA has been reviewing and granting permissions under CRR Article 352(2) of the current framework, in conjunction with the expectations set in the SS13/13 – Market Risk, and the supplementary application form for SFX. While not formally part of the Basel 3.1 amendments and proposals as set out in CP16/22, the PRA is of the view that it is appropriate to harmonise and be transparent on the SFX treatment in the UK. For convenience, certainty, and ease of implementation, the PRA proposes to align the timing of implementation of the proposals in this CP with implementation of the proposals in CP16/22.

1.5 The PRA considers it is prudent and proportionate to clarify Pillar 1 minimum requirements for FX market risk calculations and the SFX permission as set out in the proposed Article 325 of the Market Risk: General Provisions (CRR) Part of the PRA Rulebook, and propose minimum guidance in SS13/13. The proposals aim to set minimum prudential standards, while providing firms with the flexibility to adapt their approach to best fit their business model.

1.6 The CP is relevant to PRA-authorised UK banks, building societies, and PRA-designated UK investment firms that hold FX positions or items held at historical FX rates.

1.7 The PRA does not expect firms to incur material additional costs as a direct result of these proposals. Costs for the PRA and for the firms in implementing these proposals are expected to be minor, as the new proposed mandatory requirements were either already expected to be met by firms or are not expected to be material.

1.8 The PRA has a statutory duty to consult when changing rules (FSMA s138J). When not making rules, the PRA has a public law duty to consult widely where it would be fair to do so.

1.9 In carrying out its policymaking functions, the PRA is required to comply with several legal obligations. The analysis in this CP explains how the proposals have had regard to the most significant matters, including an explanation of the ways in which having regard to these matters has affected the proposals.

Background

1.10 As part of Pillar 1 capital requirements, firms are required to maintain capital against positions exposed to FX risks. FX risk can occur, among other things, when positions revalue due to changes in the value of a currency (rather than changes in the value of the underlying asset or liability). The CRR is ambiguous on the treatment of positions that are denominated in a foreign currency, but do not revalue in line with current exchange rates – ie where positions are valued at historical foreign exchange rates. Such positions are not subject to daily FX risk, but typically retain residual FX risks under certain circumstances. This CP proposes to clarify that items held at historical FX rates, which only re-value in certain circumstances, are not included in Pillar 1 FX risk requirements as their sensitivity to FX rates is generally zero.

1.11 Separately, the Structural FX Permission allows firms, with the permission of the PRA, to exclude any positions from Pillar 1 FX risk requirements which an institution has deliberately taken in order to hedge against the adverse effect of the exchange rate on its capital ratios in accordance with Article 92(1).

1.12 Structural FX risk refers to the risk that a firm is exposed to when its assets, liabilities, or capital resources are denominated in a currency that is different to its reporting currency. When these positions are translated into the reporting currency at the prevailing exchange rate, the firm can experience a gain or loss depending on how the exchange rate has moved, regardless of whether the value of the underlying position has changed. This approach introduces capital ratio volatility, even if the underlying position value remains unchanged.

1.13 Consistent with the current Basel Committee on Banking Supervision (BCBS) market risk framework, the CRR currently permits the PRA to exclude certain positions from the calculation of FX risk where these positions mitigate SFX risk, subject to the conditions stipulated in CRR Article 352(2). To aid assessment of applications, the PRA published a **supplementary form** allowing firms to apply to exclude positions under the SFX exemption. Additional details were added in the BCBS Market Risk Framework.[5] PRA Rules reflecting these additional details were consulted on in CP16/22, and are currently subject to consideration pending final confirmation of the policy.[6] Nevertheless, there remain a number of ambiguities regarding positions eligible for the exemption which have not been clarified in the current or proposed future framework.

1.14 Recognising that the BCBS framework remains largely unchanged, and the importance of maintaining a transparent approach across firms, this CP proposes to:

- set minimum requirements on the treatment of positions held at historical FX rates and the segregation of SFX positions from other trading activity for the SFX permission;
- update SS13/13 to revise existing expectations on the calculation of the net FX and maximum risk positions, inclusion of non-credit risk-weighted assets (RWAs) and the location of the positions that hedge the SFX risk; and
- update the existing CRR Permission 352(2) supplementary application form to reflect these changes and to include more quantitative detail.

Implementation

1.15 The PRA proposes that the implementation date for the changes resulting from this CP would coincide with the PRA's implementation of the Basel 3.1 standards, currently set for Wednesday 1 January 2025.

Responses and next steps

1.16 This consultation closes on Wednesday 31 January 2024. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to **CP17_23@bankofengland.co.uk**. Please indicate in your response if you believe any of the proposals in this CP are likely to impact persons who share protected characteristics under the Equality Act 2010, and if so, please explain which groups and what the impact on such groups might be.

2: The PRA's proposals

Treatment of items held at historical FX rates in the Pillar 1 Market Risk calculation

2.1 Firms may hold assets, liabilities, or capital resources in currencies other than the reporting currency of the institution. Subject to certain accounting requirements, these positions may be held on the balance sheet, valued using the exchange rate at the time of acquisition (so-called historical cost, or historical FX rates). The accounting value of such positions would generally not be updated frequently, and the FX risk arises in a different way, under different circumstances, than when positions revalue more frequently.[7]

2.2 The PRA proposes to clarify that positions held at historical FX rates in accordance with the relevant accounting principles are not to be included in the net risk position calculated under the proposed Article 325 of the PRA Rulebook.

2.3 Notwithstanding that such positions are not exposed to regular or daily FX risks, positions held at historical FX rates have contingent FX risk, which materialise in limited circumstances. The PRA considers that firms should take account of, and where necessary capitalise, the contingent FX risk arising from these positions in the Internal Capital Adequacy Assessment Process (ICAAP) Pillar 2 calculations under the Internal Capital Adequacy Assessment (ICAA) Part of the PRA Rulebook.[8]

2.4 To this end, the PRA proposes to explicitly mention that positions held at historical FX rates should not be included in the Pillar 1 calculations by amending the proposed Article 325 of the Market Risk: General Provisions (CRR) Part of the PRA Rulebook consulted on in CP16/22. This approach is proposed to apply to all market risk calculation approaches, including the proposed Simplified standardised approach (SSA), the Advanced standardised approach (ASA) and the Internal model approach (IMA).[9]

2.5 The PRA assesses that the proposal to not capture the FX risk associated with these positions in Pillar 1 market risk capital requirements is prudent and proportionate. Positions held at historical FX rates do not typically affect capital ratios. Thus introducing them in the Pillar 1 FX risk calculations could distort firms' hedging incentives, leading to potentially higher capital volatility. Several of the proposed new market risk methodologies use a sensitivity-based approach to risk calculation. Applying a sensitivity-based approach to positions which do not revalue frequently, and hence are not sensitive to movement in FX rates, may lead to a gap between the risk faced by firms, and the risk estimation in the capital framework. The PRA considers it is proportionate and transparent to provide clarity on risk estimation for positions that do not revalue frequently.

The Pillar 1 Structural FX treatment

2.6 This section sets outs the PRA's proposals to:

- amend the minimum requirements for the SFX Permission by requiring firms to segregate their SFX positions from other trading activities; and
- clarify the PRA's expectations on the calculation of the risk position eligible for the SFX Permission, the consolidation level which hedges the SFX risk, and the treatment of credit risk and non-credit risk RWAs in the Pillar 1 FX risk calculation.

Structural FX

2.7 SFX risk arises when firms have assets, liabilities, and capital resources that are denominated in a currency that is different to their reporting currency – generally due to having overseas operations. Positions held in currencies other than the reporting currency of the institution can lead to capital ratio volatility when firms translate all of their RWAs and capital resources into the reporting currency, as exchange rates change. Capital ratios are

key regulatory metrics and performance indicators for investors, and they can be affected by changes in exchange rates due to the FX translation even when the risks of the underlying assets have not changed.[10]

2.8 SFX risk is managed by firms maintaining FX risk positions calibrated to stabilise capital ratios.[11] The size of the risk positions is determined so that the increase (decrease) in the value of foreign currency RWAs due to a movement in the FX rate is matched by a proportionate increase (decrease) in the value of the risk positions such that the values broadly offset.

2.9 A risk (or open) FX position generally implies FX risk, which attracts a market risk capital requirement. The Basel 3.1 framework permits, with the permission of the supervisor, capital requirement exemptions for risk positions that stabilise capital adequacy ratios. In effect, a firm could reduce the potential capital ratio volatility arising from FX rate movements by using risk positions without maintaining extra capital. The PRA is proposing to retain this possibility in the proposed Article 325 of the PRA Rulebook.

2.10 The PRA is of the view that firms' management and reduction of capital volatility is prudent and desirable in the context of SFX positions. However, by retaining a risk position, there are scenarios in which such positions will result in losses. Running a short net risk position can protect the capital ratio when the reporting currency depreciates, but it can lead to losses if the reporting currency appreciates.[12] There are also risks from overstating the positions eligible for exemption, by including items that are not of a structural nature. The PRA proposes to further clarify the minimum requirements and expectations with respect to the SFX Permission, in order to minimise the risk associated with potential losses, and harmonise application across firms.

2.11 The current requirements for the SFX Permission can be found in the onshored CRR Article 352(2). Firms may apply to the PRA for a permission to not include such positions meant to hedge a capital adequacy ratio. However, the provisions have been subject to numerous interpretations by regulated firms in the past. The proposals in this CP aim to clarify the general PRA approach for evaluating SFX Permissions, which meet the existing practice. At present, firms who want to apply for the SFX exemption permission must meet at a minimum the requirements from the current CRR Article 352(2), and are expected to meet the supervisory expectations set out in paragraph 3B of SS13/13.

2.12 In CP16/22, the PRA proposed to retain the existing SFX Permission requirements, and incorporate updates from the new BCBS standards on market risk.[13] In this CP, the PRA proposes further amendments to Article 325 in the Market Risk: General Provisions (CRR) Part proposed to be added to the PRA Rulebook. The new proposed Article 325.9 from CP16/22 reads:

Any risk positions which an institution uses to hedge against the adverse effect of foreign exchange rates on any of its capital ratios in accordance with Required Level of Own Funds (CRR) Part Article 92 may be excluded by an institution from the calculation of own funds requirements for foreign exchange risk set out in paragraph 1 of this Article, with the prior permission of the PRA to the extent and subject to any modifications set out in the permission if, on applying for such permission, an institute is able to demonstrate to the satisfaction of the PRA:

- the risk positions are deliberately taken or maintained for the purpose of hedging partially or totally against the potential that changes in foreign exchange rates could have an adverse effect on its capital ratios;
- the risk positions are of a non-dealing or structural nature;
- the amount of the risk position excluded is limited to the amount that neutralises the sensitivity of the capital ratio to movements in foreign exchange rates;
- the risk positions are excluded from the calculation of own funds requirements for at least six months;
- the risk positions excluded are established and managed in accordance with a clear risk management policy that the PRA has approved; and
- the risk positions excluded are documented and can be made available for the PRA – an institution that has been granted the permission set out in the first sub-paragraph shall comply with the requirements set out in that first sub-paragraph.

2.13 The PRA considers there is benefit in harmonising the requirements in the PRA Rulebook, the PRA's expectations set out in SS13/13, and the supplementary application form. This will provide clarity and transparency to firms, and reduce the burden for firms on the application and assessment of SFX permissions. The PRA proposes:

- amendments to the proposed minimum requirements for the SFX Permission; and
- amendments to the PRA's expectations on the Pillar 1 FX risk calculations and positions used to mitigate SFX risk.

Amendments to the proposed minimum market risk capital requirements for positions used to mitigate structural FX risk

2.14 The PRA proposes to supplement the proposed requirements for the SFX Permission by requiring that SFX positions be segregated from other trading activities. This is currently set as an expectation in SS13/13.

2.15 Given the longer-term and intrinsically different nature of SFX positions to trading book activities, it is prudent and transparent to maintain these separate from trading activities. Introducing this into rules would advance the PRA's primary objective of safety and soundness because it would require firms to consider the specific risk management

requirements of exempt SFX positions. Requiring all firms applying for the SFX Permission to segregate the structural positions from trading activities would ensure such positions are managed independent of trading activities of the firm. At the same time, the proposal is proportionate – this rule should not impose an additional burden on firms as these positions were already expected to be segregated.

Expectations on Pillar 1 FX risk calculations and positions used to mitigate structural FX risk

2.16 The PRA proposes to further clarify the expectations for the calculation of the net risk FX position, and the expectations for the SFX Permission by specifying:

- the consolidation level for booking the risk positions;
- the calculation of the overall risk FX position;
- a proposed formula for the calculation of the net maximum risk position per currency used for the SFX Permission;
- the treatment of credit risk and non-credit risk RWAs in the calculation of the net maximum risk position; and
- the removal of several expectations which are already incorporated or proposed as rules.

2.17 The PRA already expects firms to consider the effects of hedging capital adequacy ratios at both consolidated and solo levels. As the SFX Permission is granted at an entity level, the PRA proposes to clarify the expectation that firms will apply to exclude a position at the level(s) of consolidation for which the position actually hedges the ratios. The proposed option would ensure that the FX risks are adequately capitalised at the entity level. Applying to exclude a position outside the entity for which it provides a hedge would create un-capitalised risk at the entity which holds the hedge, while also increasing complexity when constructing and analysing the positions for both regulators and firms.

2.18 In SS13/13, the SFX Permission is applicable when firms attempt to stabilise the capital adequacy ratio when the foreign currency depreciates against the reporting currency. Firms need to demonstrate that the relevant position eligible for exemption is only used for hedging the capital adequacy ratio. A position that is larger than required for hedging purposes only will not meet this requirement, and would increase capital ratio volatility. To this end, the position is limited to the point which neutralises the sensitivity of the capital ratio to changes in FX rates. This clarification was added in 2019 by the BCBS, and is included in the proposed rules for the PRA in CP16/22.

2.19 The PRA is of the view that further detail would assist in transparency and consistent application of this requirement. In practice, the maximum size of the risk positions eligible for exemption in each currency is calculated by comparing (a) the overall net FX risk position used in the calculation of own funds requirements for market risk of all trading and non-

trading book positions subject to FX risk, as stipulated in the proposed Article 325.1 with (b) the maximum risk position related to SFX items. The following paragraphs propose the PRA's expectations for the calculation of these two risk positions.

2.20 The overall net FX risk position of the firm includes all positions subject to FX risk of the firm, including the potential SFX positions. The PRA proposes to clarify that for the purposes of sizing the position relevant for the SFX Permission exemption, the net FX risk position in each currency should be determined by calculating the sensitivity to a change in the FX rate of the net risk position in each respective currency, where the risk position in each currency is as determined in accordance with the proposed methodologies consulted on in CP16/22 as in Article 325.1. The sensitivity is commonly referred to as the FX delta of the position.[14] However, firms may use an alternative measure for the purposes of the SFX Permission if they can demonstrate to the PRA that their proposed alternative captures more accurately the hedges of capital ratio volatility against FX movements. For that, the alternative measure should not omit any sources of FX risk that are of a non-trading or structural nature.

2.21 The PRA proposes to allow for alternative measures as the net delta FX position may be operationally complex to calculate for some firms, especially those who may have large transitory FX positions arising, for instance, from trading activities. The PRA considers its proposed approach provides enough flexibility to capture different business models, while remaining prudent and capturing the actual FX risk to the firm's capital ratio.

2.22 For the calculation of the maximum size of the eligible position to be exempted under the SFX Permission, the PRA proposes to introduce as an expectation the following formula per currency *i*:

$$\begin{gathered}\text{Maximum risk position in foreign currency i}\\ = \text{ Sum of the foreign currency i RWAs}\\ \times \text{current capital ratio of the entity hedging the risk}\end{gathered}$$

Minimising the sensitivity to the capital ratio is equivalent to finding the value for which a change in the FX rate will lead to no change in the capital ratio. Minimising the sensitivity of the capital ratio is equivalent to setting the partial derivative with respect to FX rates equal to zero:

$$\frac{\partial(\frac{\text{capital ratio}}{\text{RWA}})}{\partial \text{FX}} = 0$$

Solving for it will yield the formula above assuming that assets, liabilities, and RWAs are linear with respect to exchange rates. This proposed formula would provide the maximum risk position that minimises the sensitivity of the capital ratio to changes in exchange rates in

most cases: in particular where assets, liabilities, and RWAs change linearly with respect to exchange rates. If firms' capital ratios are volatile in a non-linear way in relation to movements in exchange rates, this formula would not capture those complex effects fully. The PRA assesses that those cases are likely to be rare, and, given that applying a formula that would take account of those non-linearities would be complex for many firms, judges it to be proportionate to expect firms to the approach set out above. However, firms could use more complex approaches to determine the maximum risk position if they can demonstrate to the PRA that their alternative approach better reflects the risk profile of the institution.

2.23 The maximum risk position in the proposed formula above refers to foreign currency RWAs. The PRA proposes that firms are expected to include foreign currency credit risk RWAs at a minimum when calculating the foreign currency RWAs for the purpose of the maximum FX risk position. Non-credit RWAs, such as market risk RWAs or operational risk RWAs, can be, in principle, sensitive to movements in FX rates. However, in practice it can be complex to identify the sensitivity of non-credit RWAs to movements in FX, as it can be hard to assess their sensitivity to each currency specifically.[15] Firms can choose to include non-credit risk RWAs in their calculation, after their proposed methodology has been reviewed and agreed by the PRA. The PRA considers that permitting both options is proportionate, since it allows a simple approach for firms that wish to use it, while providing the option to apply to use more accurate, but more complex approaches for firms that may have larger non-credit RWAs and may want to hedge their capital ratio with greater precision.

2.24 Note; however, that the maximum risk position is a maximum limit, and does not imply that all positions up to this limit are eligible to be exempt under the SFX Permission. Any position that is proposed to be exempt must meet all the requirements set out in the PRA Rulebook.

2.25 The PRA is making consequential amendments to two expectations in SS13/13. First, the PRA proposed in CP16/22 to transition a SS expectation to minimum requirements in the proposed Article 325 of the Market Risk: General Provisions (CRR) Part of the PRA Rulebook. More specifically, the PRA proposed that all firms must demonstrate that the risk positions are deliberately taken or maintained for the purpose of SFX risk. Second, in paragraph 2.14 of this CP, the PRA proposed to introduce as minimum requirement that positions meant to hedge SFX risk should be segregated from other trading activities. The first amendment coincides with expectation 3B.3, and the second is currently found in 3B.7 in SS13/13. Hence, the PRA proposes the deletion of provisions 3B.3 and 3B.7 from the SS13/13, for avoidance of doubt of whether the provisions are rules or expectations.

Update of the PRA's supplementary application form for Structural FX Permission

2.26 Lastly, firms that apply for a SFX Permission currently submit to the PRA a CRR Permission 352(2) supplementary application form. The form requires firms to demonstrate that the conditions from the CRR are met, along with other risk management requirements. As part of firm's application for the SFX Permission, the PRA expects firms to provide a detailed quantitative account of the positions proposed to be excluded, and how they meet existing requirements and expectations. The PRA proposes to amend the supplementary application form to reflect the minimum standards for the SFX Permission proposed in this CP and the proposed Article 325 of the PRA Rulebook, and to detail the quantitative information required to be provided in support of the application. This will provide clarity and transparency to firms, and provide a more streamlined application process for firms.

PRA objectives analysis

2.27 This CP proposes to clarify the requirements and expectations based on the CP16/22 proposals on (i) the Pillar 1 capital treatment of the own funds FX risk calculation; and (ii) the permission to exclude positions meant to hedge SFX risk. Aligning the FX risk treatment with the general market risk framework, and clarifying the PRA minimum requirements and expectations around the SFX permissions promotes the safety and soundness of firms. The PRA considers that the proposed capital requirements and expectations are commensurate with the actual risks firms are facing.

2.28 On the Pillar 1 capital treatment, the PRA proposes to clarify that items held at historical FX costs may not be included in the calculation of the risk position. Detailing the risks and capitalisation requirements of items that do not revalue often with changes in exchange rates more closely aligns the risks faced by firms with the measurement of those risks in the capital framework. The approach also recognises that these positions hold contingent FX risk which should adequately be reflected in Pillar 2, maintaining prudential standards in proportion to the burden faced by firms.

2.29 The PRA proposes to add a new expectation to SS13/13 that firms include credit risk RWAs as a minimum in a SFX Permission. The PRA also proposes to insert as a rule the separation of the SFX positions from the trading book, and set expectations on the calculation of own funds requirements and maximum risk position eligible for exclusion. These proposals aim to promote the safety and soundness of firms by clarifying the requirements, and promoting transparency and unified standards. The PRA considered specifying that non-credit RWAs have to be excluded from the calculation of the SFX position, but did not identify any prudential concern with their inclusion. Setting an

expectation on the calculation of the maximum risk position is meant to avoid firms exempting positions that are too large relative to the objective and to ensure exemptions meet with the policy intent.

2.30 The proposal on the location of SFX hedges promotes the safety and soundness relative to the alternative option, which would imply additional risk and incentives mis-alignment between optimal hedging and resolution.

2.31 The PRA has assessed whether the proposals in this CP facilitates effective competition. Publishing the PRA view on how firms should calculate the maximum risk position that can be exempted should support transparency and help smaller firms understand the approach to SFX. The proposals, while setting minimum standards and prudentially sound options, would give enough flexibility to firms with different business models and are not excessively prescriptive.

2.32 The PRA assessed the impact on the international competitiveness of the UK economy and its growth in the medium to long term. As the proposals are focused on positions held in different currencies than the reporting one, the PRA anticipates that the proposals do not have a direct impact on the UK economy. The adjustments proposed here are not expected to be material. However, due to the flexible, simpler, and fit for purpose approach, the proposals promote the UK as place to do business, which in turn could attract further investments in the banking sector.

Cost benefit analysis (CBA)

2.33 The PRA considers that the proposals would facilitate firms' understanding of the Pillar 1 treatment of items held at historical FX rates and that of SFX positions, and documentation needed for their SFX Permission applications. Streamlining the requirements and providing clear calculation formulas should diminish operational costs. The PRA does not expect firms to incur material additional costs as a direct result of this proposal.

2.34 The PRA considers that the proposals in the CP would not create material costs as the majority of the proposals are making transparent the PRA's existing practice for granting SFX Permissions, and firms broadly apply them in their calculation for own funds requirements for market risk. Existing SFX Permissions incorporate the proposals put forward, and the PRA does not expect them to incur additional costs from this CP. In terms of benefits, having transparent requirements should reduce the costs of firms when making their application for SFX Permissions.

'Have regards' analysis

2.35 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2022, and the additional 'have regards' applicable to CRR rules.

The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposal:

1. The principle that a burden or restriction which is imposed on a person should be proportionate to the benefits which are expected to result from the imposition of that burden (FSMA regulatory principles): In light of the principle that a burden or restriction should be proportionate to its benefits, the PRA considered the proposed approach provides greater transparency on the PRA's approach to granting SFX Permissions. The approach should simplify the applications and approvals process, consistent with the prudent risk management of SFX.

2. Growth (HMT recommendation letter) and sustainable growth (FSMA regulatory principles): The proposals clarify the PRA approach and would permit firms that will apply to SFX Permissions to adapt the permission in line with their business model (with appropriate risk management), facilitating growth.

3. Competitiveness (HMT recommendation letter): The proposals would ensure that UK firms can effectively and flexibly hedge their SFX risk while remaining prudent. The proposals would also increase the transparency of the PRA's analysis and judgements, in particular, with respect to the PRA SFX permissions. This should help maintain the UK as an attractive market for firms.

4. Transparency (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006): The PRA considers that providing clarifications on the SFX treatment will improve transparency and aid firms when submitting their applications. Adding further guidance that reflects the PRA's internal assessment process in the SS13/13 will help firms better understand the PRA's expectations.

5. Different business models (FSMA regulatory principles): The PRA considers that the proposal for firms to use alternative calculation methods of the maximum risk position and of the net FX position provides a range of alternatives for firms, depending on the sophistication level of their FX operations.

6. Efficient and economic use of PRA resources (FSMA regulatory principles): The PRA considers that the proposed approach focuses supervisory resource on the most relevant considerations for SFX permissions.

2.36 The PRA has had regard to other factors as required. Where analysis has not been provided against a 'have regard' for this proposal, it is because the PRA considers that 'have regard' to not be a significant factor for this proposal.

Impact on mutuals

2.37 The PRA considers that the impact of the proposed rule changes on mutuals is expected to be no different from the impact on other firms subject to the CRR.

Equality and diversity

2.38 The PRA has assessed whether the proposal gives rise to equality and diversity implications, and considers that, given the nature of the changes proposed, there is no impact.

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1. Throughout the CP, the 'proposed Article 325 of the PRA Rulebook' refers to Article 325 of the Market Risk: General Provisions (CRR) Part of the PRA Rulebook consulted on in CP16/22.
2. This CP proposes changes to the section 3B from the proposed SS13/13 in CP16/22. The section from the proposed SS13/13 is broadly consistent with the current SS13/13, dated November 2020.
3. The net risk (or open) position in each currency is as determined in accordance with onshored CRR Article 352, and under the proposed methodologies consulted on in CP16/22 as Article 325.1 of the Market Risk: General Provisions (CRR) Part of the PRA Rulebook.
4. The Calculation for the Own Funds Requirements for Market Risk measures the minimum required Pillar 1 capital for market risk.
5. See paragraph 11.3 of the **BCBC Minimum capital requirements for market risk**
6. The additional details are listed in Chapter 6 – Market Risk, paragraph 6.14 of CP16/22: (i) the size of the exempt position should not be greater than the size of position that neutralises a firm's capital ratio sensitivity; and (ii) the exempted positions should be exempted for at least six months.
7. For these purposes, an item held at historical FX rates is an item where all of the following conditions are met: (i) the item is not measured at fair value; (ii) the item is subject to the risk of impairment due to foreign exchange risk; and (iii) the item's accounting value is not updated at each reporting date to reflect the changes in the exchange rate between the foreign currency and the reporting currency of the institution recognising the item in its financial statement.
8. Items held at historical FX rates hold contingent FX risk, which needs to be addressed in Pillar 2 calculations as described in Article 12.4 of the **Internal Capital Adequacy Assessment of the PRA Rulebook**
9. For a detailed description on the new proposed market risk approaches, please see paragraph 6.1 under Chapter 6 – Market Risk of CP16/22.
10. The overall capital ratio changes when the ratio of foreign currency capital resources to foreign currency RWAs differs from a firm's overall capital ratio. For example, a stylised way to think about the firm's overall capital ratio for a firm with overseas operations, is as a weighted average of the capital ratios in each country. So as the FX rate moves, the weighting of different countries' capital ratios changes, affecting the overall capital ratio.
11. A risk (or open) position arising from not having a perfect match between the value of assets and liabilities in the foreign currency.
12. Having a short risk position in a foreign currency implies that the asset value is smaller than the liabilities value in that currency. If the foreign currency appreciates with respect to the reporting currency, the Common Equity Tier 1 (CET1) capital will decrease as the assets have a lower marginal increase than the liabilities. At the same time, the RWA value

would increase. This would imply that a capital ratio, such as the CET1 ratio, will necessarily decrease, as the numerator decreases while the denominator increases.

13. Since the initial set of market risk requirements, the BCBS introduced in 2019 the latest framework for market risk in the Basel 3.1 standards. In the calculation of RWAs for market risk chapter (MAR11) – Definitions and application of market risk, paragraph 11.3 the framework introduced two additions to the structural FX permission. The changes do not materially impact the substance of the provision, but add further limitations in order to minimise risk and more accurately capture the SFX positions.

14. The sensitivity to a change in exchange rate is calculated as the relative change of the FX rate between a given foreign currency and the domestic currency.

15. Eg market risk RWAs are calculated with diversification and hedging benefit across different currencies. Operational risk RWAs may similarly be hard to attribute to a specific foreign currency.

Appendices

Appendix 1: Draft amendments to the proposed Article 325 of the Market Risk: General Provisions (CRR) Part of the PRA Rulebook (PDF)

Appendix 2: Draft amendments to supervisory statement 13/13 – Market risk (PDF)

Appendix 3: Draft amendments to the CRR Permission 352(2) supplementary application form (PDF)

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