BARCLAYS

Secretariat of the Basel Committee on Banking Supervision ("BCBS")
Bank for International Settlements
CH-4002
Basel
Switzerland

10th September 2010

Barclays response to BCBS CP 164 "Countercyclical capital buffer proposal"

Dear Sirs,

Barclays Bank PLC ("Barclays") welcomes the opportunity to respond to BCBS consultation paper 164 "Countercyclical capital buffer ("CCCB") proposal." We have also contributed to the IIF, BBA and joint ISDA/AFME trade association responses and broadly endorse the industry comments raised therein. In particular, we draw the Committee's attention to the proposals regarding a Single Variable Capital Buffer Framework as set out in the BBA response (we comment further on these proposals in the Appendices to this letter).

We recognise the regulatory objectives to protect the banking sector from periods of excess credit growth with a view to maintaining the flow of lending in a downturn. We also understand the desire to reduce excessive pro-cyclicality in the existing capital regime. However we believe that CCCB should:

- be considered as part of the overall calibration of new regulatory capital requirements and against the backdrop of proposals for enhanced micro and macro prudential regulation;
- form part of a Single Variable Capital Buffer, the size of which could be adjusted through the cycle, to take account of firm specific risk and stress testing outcomes;
- be applied on a firm specific basis under Pillar 2, following confidential discussion between firms and regulators;
- be applied at the level of the consolidated group.

If the CCCB requirement is to be implemented as set out in CP164, we believe that there is significant further work required to develop a clear and consistent international framework for the proposed buffer. This should specifically recognise:

- Importance of consistent global implementation and the level playing field;
- Need for a mechanism to resolve home/host conflicts;
- Risk of negative market signalling:
    - transparent approach required for triggering the CCCB requirement, so that it does not become a systemic event ;
    - CCCB must not become the new minimum and firms must be able to draw down in times of stress; and
- Outstanding questions regarding formulation of the CCCB requirement.

Further details on these key elements of our response can be found in the Appendices to this letter. We would be happy to discuss the CCCB proposal, or any other aspects of the current regulatory debate, at your convenience.

Yours sincerely,

Jon Stone,
Group Treasurer

APPENDIX 1

1. Calibration Issues

We remain concerned that there is no clear concept of how the various proposals to (i) enhance minimum capital and liquidity requirements (ii) improve the quality of macro and micro prudential supervision across the globe and (iii) deal with the problems associated with bank recovery and resolution, will come together to form a comprehensive, robust and workable regulatory framework for the future.

1.1 Double Counting of Risk

We understand the regulatory goal of protecting the banking sector from periods of excess credit growth and the desire to maintain the flow of lending to the real economy in a downturn. However we believe that supervisors already have Pillar 1 and Pillar 2 tools to deliver this objective and that the proposed CCCB will result in double counting of risk in the system.

Pillar 1: Through the Cycle ("TTC") versus Point in Time ("PIT") credit models

In line with the advanced risk-adjusted methodologies prescribed under Basel II, Barclays calculates credit risk RWAs for certain credit portfolios using TTC credit modelling that reflects long run average default patterns. Properly calibrated TTC models normalise lending patterns, acting as a brake in an upturn and a release in a downturn.

Applying an additional CCCB requirement during an upswing in the cycle would penalise firms using TTC approaches relative to firms using PIT methodologies. Overall, firms would be dis-incentivised from building fully compliant AIRB models, contrary to Basel II requirements.

Pillar 2 and Stress-testing

The consultation paper is unclear as to how the proposed CCCB will be integrated into the Pillar 2 framework and how it will interact with stress-testing.

We support the increasingly prominent role that stress testing plays in the regulatory toolkit and note the positive impact that stress tests in the UK, US and Europe have had on market sentiment at key stages of the recent crisis. In our view, stress-testing permits home regulators to assess, and tailor a response to, institution specific concerns arising from a variety of factors, including over-reliance on a particular business line or geography or over-exposure to potential credit bubbles.

A properly constructed stress-testing regime enables macro-prudential authorities to work with home and host regulators to set changing parameters for the relevant stress scenarios and to monitor the build up of system wide risks. Capital adequacy levels that take account of these stresses are already considered as part of the ICAAP and Pillar 2 processes.

We believe that the proposed CCCB is a blunt tool for delivering results that can be better managed through the existing Pillar 2 and stress-testing frameworks. Not only does Pillar 2 take account of the idiosyncratic risk profile of a given institution but it also permits a degree of confidentiality which we believe can be useful to firms and regulators in certain scenarios (see further at 1.2 below).

If the CCCB is to be implemented in its current form we would appreciate greater clarity on how it is intended to operate alongside the existing Pillar 2 and stress testing framework. If, for example a home regulator has already imposed a Pillar 2 add-on to address the build up of risk in a given portfolio and, soon after, a host regulator invokes a CCCB requirement that impacts the same portfolio, how will the firm be protected from holding additional capital against the same risk? This potential for building "buffers on buffers" will create a dis-jointed and ineffective global capital framework that could, we believe, be better managed through consistent application of Pillar 2 measures by national regulators, with appropriate oversight from the BCBS Standards Implementation Group.

1.2 Market-signalling

Without clear signposting of intent, we believe that the levels of capital required by international regulators are becoming increasingly opaque to the market and that there is a real risk of additional buffer requirements becoming the new minima. Furthermore, it is customary for banks to maintain internal buffers over and above the regulatory minima to ensure (i) that regulatory ratios are not breached and (ii) to comfort the market that the bank remains robust and can continue to operate independently, without risk of regulatory intervention. Given the increasingly high public buffer requirements, and the proposal to implement on a "one size fits all" basis, we believe that banks could be forced to hold levels of capital well in excess of that required to support the risk in their books. The additional cost of raising this capital will have to be absorbed, either through increased lending costs or reduced returns on equity, each of which could impact economic growth.

We are also concerned that the imposition of a CCCB should not, in itself, become a systemic event. Public announcement of a CCCB requirement by regulatory authorities is a highly visible and blunt indicator that the economy could be over-heating; imposition of the buffer requirement will deliver a negative message to bank stakeholders and to the wider market that new lending will be increasingly risky as the system moves into a downturn. This could undermine one of the key objectives of the CCCB proposal, i.e. maintaining the flow of credit to the real economy through the downturn. Given the challenges facing authorities in publicly calling a point in the economic cycle we believe there is significant further work required, on a national and supra-national basis, to ensure that the CCCB requirement does not generate such negative outcomes.

We believe that some of these unintended consequences could be mitigated if the buffer requirement could be set through bilateral and confidential

discussions between the bank and its regulators. As we have stated above, we believe that the Pillar 2 regime already allows for such bi-lateral communications and could easily be adapted to deliver the appropriate risk-adjusted regulatory response to the issues which the CCCB seeks to address. The stress-testing framework could be used (in co-ordination with national macro-prudential authorities) to more subtly communicate approaching macro stress to the market through the publication of revised stress-testing parameters which take the changing economic environment into account.

We acknowledge the protections that the BCBS has built into the CCCB proposal to address some of the market signalling concerns (e.g. 12 month "grace period" to build capital to required levels following announcement of a CCCB) and we note that the CCCB is likely to be invoked only on rare occasions (maybe once in every 10 - 20 years) thereby reducing the likelihood that this would become the new minimum. However, calibration of the final buffer range and the sliding scale of restrictions on distributions applicable to the combined CCCB and capital conservation buffer, remain important outstanding issues on which we are unable to comment until final overall calibration of the new requirements is complete.

1.3 Single Variable Capital Buffer Framework

We believe that many of the unintended consequences of the CCCB proposal, outlined in sections 1.1 and 1.2 above, could be mitigated by introducing a Single Variable Capital Buffer Framework as part of the Pillar 2 regime.

Proposed guiding principles to the Single Variable Capital Buffer Framework are set out in Appendix 2 to this letter.

2. Implementation Issues

If a formal, mechanistic CCCB is imposed firms will require greater clarity on the calculations required to operate the buffer.

2.1 Exposure Measures

CCCBs should be based on the weighted average of RWAs, not unweighted credit exposures. The consultation paper is unclear on this issue and we have heard that some regulators are considering using unweighted data, prepared independently of the regulatory balance sheet.

We consider that the firm's Pillar 1 banking book regulatory balance sheet would be the most appropriate starting point for any CCCB exposure calculation:

- Method of calculation is already agreed by, and subject to oversight from, international regulators;
- Firms have the systems and controls in place to calculate such exposures, using methods which comply with the use test;
- The proposal suggests that CCCB calculations should be run “with at least the same frequency as …Pillar 1” which strongly suggests that the two exposure measures should be aligned;
- Unclear whether trading book exposures are relevant to the calculation and thus whether they should carry an additional CCCB charge.

2.2 Location of Exposure

The proposal is also unclear as to how the location of an exposure should be determined. This is an important question given the potential for both home and host regulators to impose a CCCB requirement based on credit exposures in a given geography. International banks, servicing multinational clients, across geographic borders use different means to assess location of risk: e.g. domicile or location of borrower; head office or local subsidiary of borrower; booking entity used by lender. BCBS should be clear on its intended measure to avoid creating opportunities for regulatory arbitrage.

2.3 Location of Buffer

The CCCB proposal gives regulators considerable flexibility to negotiate location of the buffer requirement: “host authorities would have the right to demand that the CCCB be held at the individual legal entity level or consolidated level within their jurisdiction. If they do not exercise that right, the home authorities of the consolidated parent must ensure the buffer is held at the consolidated parent level.”

We strongly believe that any buffer should be held at the group consolidated level with global standards developed to govern home/host collaboration on this issue and a framework developed (perhaps through the Basel Standard Implementation Group?)to resolve disputes and to enforce regulatory decisions on this issue. We are concerned that the approach outlined in the proposal could result in cross-border banks like Barclays holding multiple buffers across the group.

2.4 Isolating “More Risky” Lending

The CCCB exposure calculation captures the stock of lending, including that put on in periods of low risk, as well as the flow of “more risky” current lending. There is also no apparent distinction between lending to different sectors of the economy: the exposure calculation applies to all lending irrespective of type of counterparty/industry segment or whether a sector is in boom or bust. In our view this creates a very blunt instrument for a nuanced problem. We believe that Pillar 2 and stress-testing could deliver the regulatory objectives in a more risk-sensitive and targeted manner.

2.5 Definition of “Distributions”

If banks are unable to raise capital to the required levels within the 12 month "grace period" following announcement of a CCCB requirement then we understand that restrictions on distributions to shareholders and employees will apply. The definition of restricted distributions (especially as regards employee incentive schemes) is unclear. We believe that only those distributions that have an immediate capital impact (e.g. cash bonuses rather than long terms share awards or long term awards with performance conditions and claw-back) should be included.

As noted in section 1.2 above, we cannot comment on the precise impact of the restrictions on distributions until we have a full understanding of the final buffer calibration and the sliding scale of restrictions that will be applied in the event of breach.

2.6 Use of Credit/GDP guide and regulatory judgement

Whilst we welcome the BCBS proposal to identify a common reference point in the Credit/GDP guide, we do not believe that the calculation of a buffer-add on can or should be purely mechanistic. It is therefore important that there is transparency over the decision making process to ensure, insofar as possible (i) a level international playing field and (ii) a culture of "no surprises." We would suggest that each jurisdiction establish, at a minimum:

- Clear framework of who is charged with making the decision and what their objectives are;
- Outline of how home/host regulators will interact;
- Transparent process for decision making - this goes beyond merely publishing the decision to impose a CCCB requirement and should include:
    - Minutes of regular meetings of the authorities charged with making the decision (such mechanism has proved useful, for example, in connection with interest rate policy decisions of the UK MPC; minutes of a similar macro-prudential authority could give the market some warning of an impending CCCB decision);
    - Full public disclosure of how and when a buffer decision has been reached, with detail of any disagreement between regulators (especially important where home overrides host);
    - Ex-post review of the buffer decision by an independent review body within at least 6 months (this in addition to the on-going discussion over when to release the CCCB).

3. Impact Issues

Whilst we support the aim of addressing excess pro-cylicality and of ensuring that the banking system is adequately capitalised heading into a downturn, we believe that there would be significant market based "side effects" to any decision to either impose or release a CCCB requirement. Authorities should be aware of the potential for such market impacts to undermine the regulatory goals.

3.1 Imposition of a CCCB Requirement

We welcome the 12 month "grace period" for building required capital to meet a newly imposed CCCB requirement. However if all banks (either globally or in a particular jurisdiction, depending on where the credit brake is being applied) seek to raise new capital during this period there could be a significant impact on both the supply and cost of bank capital. Even in normal market conditions there is a limited universe of bank investors and capital markets can quickly become saturated with financial supply as available credit lines are used up; the capital and funding environment would become even more challenging following public announcement of a CCCB requirement, indicating a regulatory expectation of imminent downturn.

If firms are unable to raise capital to the required levels and limits on distributions are applied, non payment of dividends will make it even harder to attract new investment and limits on compensation will increase flight risk of key personnel, potentially accelerating the demise of a stressed institution. This may mean that some banks are unable to raise the required capital and could be forced to exit the market at precisely the point at which national authorities are trying to protect the flow of lending to the consumer.

We believe that banks should instead be encouraged to gradually build levels of capital through retained earnings in the upturn. This could be effectively supervised through the existing Pillar 2 regime and would not have the effect of saturating capital markets with supply on the brink of a downturn.

We understand that some members of the BCBS have suggested that additional CCCB capital requirements could effectively be "pre-funded" by issuing contingent capital instruments which convert on the announcement of a CCCB requirement. We have strong doubts that an investor base exists for such a product (investors are effectively being asked to support macro risk in the economy) and would encourage the Committee to engage further with the investor community before making any formal proposal of this nature.

3.2 Release of CCCB Requirement

We welcome the BCBS proposal that release of the CCCB requirement should operate immediately following public announcement by the relevant regulator but the consultation is otherwise unclear on how the transition to lower levels of bank capital would be achieved. Further clarity is required to ensure:

- CCCB, once imposed, does not become the new minimum;
- Transparent discussion of how/when to release the buffer;
- No negative messaging to the market on release;
- Banks can re-start distributions and continue to operate with reduced levels of capital.

APPENDIX 2

Guiding Principles to the Single Variable Capital Buffer Framework

1. Regulatory capital buffers should be expressed for each institution as a single "Variable Capital Buffer" derived by the supervisor based on its review of the quality of the institution's governance and risk management practices, capital plans (including under stress) and associated management actions.

2. The methodology for deriving the Variable Capital Buffer should incorporate four principles:

    1. Firm-specific – the buffer should not be set as a "one size fits all" requirement, with the potential to penalise well managed banks and to reward those that are more risky; each firm's forward-looking plans should be stressed to assess the implications of stress events for its particular risk profile and capital needs

    2. Counter cyclicality – the size of the capital planning buffer should vary, building up in benign times and being utilised in adverse circumstances.

    3. Conservation – designed to allow capital conservation measures to be taken as firms draw down the buffer under stressed conditions after management actions.

    4. Avoid double-counting - supervisors must ensure that double-counting is eliminated in determining the buffer.

3. The level of buffer should be determined:

    - Through the Pillar 2 process for individual firms with no fixed amounts and according to international standards set by the Basel Committee;

    - Using supervisor-defined scenarios which capture macro-economic and system-wide stresses (see global methodology below);

    - Taking into account the impact of macro-prudential and other supervisory tools (such as loan-to-value limits) which are designed to reduce risks undertaken by banks and hence their capital requirements;

    - Implemented by firms themselves with robust review and challenge by regulators;

    - At Tier 1 level (on the basis that under the new definition of Tier 1 capital, it will be loss absorbing);

    - In addition to the Tier 1 component of the total capital add-on for specific Pillar 2 risks;

    - As an absolute amount which can, for presentation purposes, then be expressed as a Tier 1 percentage of Pillar 1 RWA.

4. Measurable criteria should be defined to determine when the buffer may be used, explicitly recognising that the buffer is designed to be utilised at the appropriate point in the economic cycle or in other adverse external circumstances. That is, the size of the buffer should vary over time to take into account the position in the economic cycle and firm-specific stress circumstances.

5. In setting the Tier 1 Variable Capital Buffer, supervisors will consider the strength of an institution's corporate governance, risk management practices, going–concern recovery plans and the implications of resolution for the institution. These qualitative assessments inform measurement of institution-specific risk and should influence the resultant

quantitative buffer sum. Existing RWA calculation practices should also be taken into account when setting the buffer (for example, with regard to the extent of through-the-cycle volatility of the Pillar 1 methodology).

6. The methodology and standards for setting the Variable Capital Buffer should be aligned internationally.

   - The Standards Implementation Group should be charged with setting global standards for the capital buffer methodology. While firm-specific buffers should remain confidential, the methodology used by supervisors should be agreed internationally, made public and, be applied consistently across jurisdictions.

   - International supervisors should work on improving standards and coordination of stress testing practices across markets.

   - The macro-economic component should be based on internationally consistent tools, frameworks and processes.

   - The determination and review of stress scenarios and the process of stress testing should be coordinated internationally through supervisory colleges. The nature of stress scenarios should be published to signal to the market the level of in-built counter-cyclicality and to create confidence in the methodology.

   - The methodology should include approaches which specifically prevent supervisors from requiring growth of capital buffers in stressed circumstances.

   - To avoid creating market distortions and arbitrage opportunities, national supervisors should avoid weakening or strengthening the local capital buffer methodology and capital buffer levels.

7. The Variable Capital Buffer should be established at the group consolidated level as determined by the consolidated lead supervisor in liaison with the national supervisors of the countries in which the institution operates. Global standards should be developed to: govern how home and host supervisors should collaborate to set buffers for parent and subsidiary companies within the same group; ensure that there is no double-counting of buffers within a group; and, resolve differences of view.

8. Trigger ratio principles (particularly, in relation to capital conservation actions) should be made public. Specific trigger levels above the minimum Tier 1 ratio should be set bilaterally between supervisors and firms and remain confidential as part of the Pillar 2 supervisory framework.

9. If a firm's Tier 1 capital falls below pre-determined firm-specific trigger levels, this should initiate a supervisory review through a Pillar 2 process to determine if and how capital levels need to be rebuilt:

   - Actions for consideration should be set out in advance within a confidential recovery plan, with specific types of actions attributed to each trigger point.

   - The range of actions should include reductions in the distribution of retained earnings, particularly: dividends, share buybacks and discretionary payments on Tier 1 instruments.