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Secretariat of the Basel Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basel
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Dear Sirs

CAPITALISATION OF BANK EXPOSURES TO CENTRAL COUNTERPARTIES

Barclays Capital welcomes the Basel Committee's consultation paper "Capitalisation of bank exposures to central counterparties" (CCPs) and we acknowledge the importance of the issues raised therein. We have contributed to the joint ISDA, AFME, BBA and IIF response and are broadly supportive of the messages in that document. We would also like to raise certain points below in our own response.

It is in our interest to continue to provide products to the market which are appropriately risk managed and associated with the right amount of capital, as a result the level of capital required may increase from current levels. However, the proposed calibration is likely to result in a number of unintended consequences and may penalise clearing firms for following the increasing regulatory pressure to clear OTC business. As a result, derivative trading may be driven out of the regulated sector towards bilateral trades in the unregulated sector. The Committee should work with CPSS-IOSCO to ensure that there is a) compatibility between the requirements on CCPs and those on the banks facing CCPs and b) appropriate incentives at all stages in the clearing process.

We recognise that the Committee and CPSS-IOSCO are seeking increased central clearing as a means of increasing transparency in the derivatives market. At the same time the Committee is seeking to ensure that the level of capital held in and against CCPs is calibrated appropriately for this greater role. While we are appreciative of this objective, ensuring the correct alignment of incentives to clear remains critical and we would be very supportive of a more detailed cost benefit analysis in this area before making material amendments to capital regulation.

The introduction of changes to the regulatory capitalisation of these exposures is likely to influence the quantum of Initial Margin (IM) and guarantee fund required by clearing houses. This influence needs to be understood and aligned with the desired risk management. This is difficult to achieve if the measurement of this capital requirement is not appropriately risk sensitive and uses approximately calibrated calculations.

Exchange traded and cleared OTC trades potentially have very different risk profiles, particularly around liquidity, but the two are not appropriately distinguished in this paper. We would support maintaining the existing exchange traded treatment, although the liquidity aspects are likely to need further consideration to ensure that they are distinguishable from cleared OTC trades.

Under these proposals there may be circumstances where there is a positive disincentive to clear trades under the revised capital regime. The Credit Value Adjustment (CVA) capital charges may be less onerous on an OTC trade with another bank rather than the various charges associated with clearing on a CCP. Furthermore CVA charges can be managed (to some extent) with hedges, whereas the capital requirement associated with the default fund can not be.

As an example, we are very concerned about the treatment of client trades where they are accessing the CCP through a clearing member. The client treatment set out in the CP is for the client to treat the trade as cleared if all margin is in a bankruptcy remote account etc. However, there is a lack of clarity around how the clearing member should treat trades with the end client. In the existing UK FSA regime, such trades are deemed exchange backed and treated as akin to exchange traded. The bank is at risk to the client only for margin not received. The CP is unclear on this subject.

If the client leg is treated as OTC with the attendant stress EEPE and CVA charges there is very little incentive to be a clearing member. In particular, if we clear a trade for a client where we are also counterparty to the trade, these proposals would cause us to have two charges for the identical trade (one with the client on the clearing side and one with the CCP on the execution side), even though our economic exposure is one sided (e.g., if the client does not pay, then we do not get paid on the derivative).

We provide more detail on the points above in the annex to this letter. Please do not hesitate to contact me on the number below if you have any questions or comments on any of the issues raised in this response. Furthermore, we would be happy to participate in any fora (either at a BCBS or FSA level) to discuss the issues presented in this paper in more depth.

Yours sincerely,

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General comments

Incentives to clear

1. One of the originally stated aims of Basel 3 was to encourage a switch from OTC trading to central clearing by increasing the capital requirements on the former and offering beneficial treatment for the latter. This was congruent with requirements in the EU and US to mandate clearing for much of the historic OTC business. The subsequent changes to the Basel 3 treatment have significantly eroded the incentives to provide clearing services to our clients. It is hard to envisage an OTC clearing business achieving its hurdle return on regulatory capital without charging significantly more.

   Furthermore, the CP implies that the scope of this treatment will extend to existing exchange based business (also confirmed by the QIS instructions) calling into question the viability of exchange broking businesses. As a result, the Committee's proposals may result in increasing the risk in the financial sector by decreasing the number of financial institutions involved in clearing, and thereby not achieving the desired result of diversifying clearing risk.

Timing

2. Whilst the Committee should recognise the need to finalise these proposals to enable banks to assess whether they should be a clearing member for client business and which CCPs they should use. We are keen to avoid either these proposals resulting in a hiatus and loss of momentum in the drive by central counterparties and clearing members to implement the US and EU requirements on clearing OTC trades, or rushing rules in which dis-incentivise clearing of OTC trades from a capital perspective.

Harmonisation

3. A harmonised timetable and applicability across jurisdictions are essential. With the proposed capital treatment of CCPs, it is essential that banks are able to make rational decisions on which CCPs to use. For example, if the Committee is to penalise banks for being exposed to collateral that is not bankruptcy remote from the CCP it would be unhelpful if CPSS-IOSCO were to dis-incentivise CCPs from holding such collateral in this manner. Furthermore, at present, little of this collateral is bankruptcy remote as it offers sources of liquidity and income to the CCPs. Otherwise the CCPs are likely to increase their fees which would be a further disincentive to clearing trades.

Scope

4. We are keen to receive clarification of the scope of the proposals. The document refers to the clearing of derivatives and repo-type trades, which could indicate that security exchanges as out of scope. Furthermore, the exposure measures suggested are not relevant for exposures related to such products.

5. A distinction should be made in capitalization rules depending on whether a clearing member bank clears client trades as a principal or as an agent. The proposed rules, as currently drafted, could be seen as including a perverse incentive to conduct more business as principal. Under the agency model, the member bank acts as an

intermediary between the client and the CCP, facilitating margin payments and receipts between the client and the CCP. In the event of the CCP's default, the clearing member does not have a legal obligation to cover the client's losses. However, in the event of client's default, the clearing member is legally responsible to continue payments to the CCP. Under the principal model, the clearing member bank steps in between the client and the CCP as a principal. In the event of the default of the CCP or client, the clearing member has a legal obligation to continue making payments to the other counterparty.

6. There is a potentially significant cliff effect if a CCP loses its qualifying status that should be managed and there should be allowances made for clearing members on that exchange to:

    a) Avoid retrospective capital reporting problems, i.e. the bank is told in January that the CCP qualifying status is revoked as of 31 December and hence the year-end position has materially changed the clearing member should not be penalised for that fact; and
    b) Allow a period of transition for the clearing member to move trades to qualifying CCP and hence avoid a spike in their capital requirements. (There is no incentive to use non-qualifying CCPs and a movement to other CCPs would naturally happen as one is disqualified).

7. Given the potential increase in centrally-cleared trading, it is legitimate for policymakers to question the level of capital required by the CCPs themselves. However, it is not appropriate to estimate this using the crudest approaches under the banking framework and then requiring bank clearing members to hold this capital by proxy. The questions in the CP regarding who should calculate the CCP's hypothetical requirement given data sourcing and quality obstacles speak to the practical difficulties of trying to assess CCP capital needs indirectly, but such difficulties should not result in clearing members bearing this burden. Furthermore, achieving consistency of implementation across jurisdictions will be critical in this area.

Risk sensitivity

8. Regarding central counterparties themselves, the costs of funding and regulatory capital will influence the quantum of initial margin and the default funds. The exchanges are likely to factor the revised default fund requirements into the amount of initial margin required as they balance between these two risk mitigants. It is important, therefore, that the Basel calculation methodology is appropriately risk-sensitive to ensure that this influence enhances risk management, rather than distorting the relative initial margin between two products of varying riskiness but equal capital requirement according to these proposals.

Specific comments

Risk weighting

9. The 26 July 2010 press release by the Group of Governors and Heads of Supervision included the following note on the potential Basel 3 approach.

"Banks' mark-to-market and collateral exposures to a central counterparty (CCP) should be subject to a modest risk weight, for example in the 1-3% range, so that banks remain cognisant that CCP exposures are not risk free."

As a result, the 2% risk weighting for trade exposures was not a surprise to readers of the CP. However, although we acknowledge that the calibration of this risk weight will be tested during 2011, the rationale for this range has not been articulated and therefore 1% should not be presumed to be the lower bound. Compared with the IRB risk weightings for institutions, the implied default probability of even 1% is relatively high given the collateralisation and short maturity of the exposures.

10. The proposal to include a Potential Future Exposure (PFE) type of charge was not communicated prior to the CP and is a significant worsening of the treatment of cleared trades.

    We believe that the trade exposure to CCPs should not be based on the existing PFE metrics. The Current Accord requires 1-year horizon for PFE calculations. Cleared derivative transactions are marked on a daily basis and any net gains or losses from the previous day's mark is cash settled reducing the net exposure to zero on a daily basis. PFE for CCP exposures based on 1-year horizon would significantly overstate the CCP risk. Furthermore, in an extreme stress scenario where a CCP defaults, the outstanding trades are terminated at a value determined by the clearing member or clearing house as promptly as reasonably practicable, but in any case within 30 days of a bankruptcy event [1]. If the initial margin is considered insufficient to meet the potential movement, then this should be a key component of the decision as to whether a CCP is approved or not. This will then form part of the Bank's decision making process on trading with a specific CCP. This recognises the benefits of clearing (guarantee funds, daily variation margin, transparency etc) and the risk mitigation in the process through the use of initial margin to cover potential portfolio movement. A concern is that even on an IMM approach post Basel 3, large portfolios of centrally cleared trades are likely to trigger the requirement to use the longer 20 day margining period.

    However, these modelled approaches will be little comfort to clearing members without IMM approval and an alternative standardised approach giving a less penal outcome than a 1 year CEM should be considered.

11. The treatment of guarantee funds is disproportionately conservative compared to the risk of loss to the clearing firm. This degree of conservatism arises in two aspects:
    a) the concept of hypothetical capital requirements for CCPs; and
    b) the risk weights assigned to member banks' default fund contributions.

    These funds are not as risky as first loss securitisation exposures (the main asset class attracting such charges) and have not been called upon even during the failure of Enron and Lehman to bear losses. The losses were all covered by initial amount (IA) posted on the exchange. Furthermore the waterfall of losses would be, failed members' IA, failed members' default fund contribution and only then would losses be socialised to the other clearing members' default fund contributions.

[1] Based on CME rules. Other CCPs may have different timeframes.

To the extent that the clearing member's contribution represents less than 10% of the guarantee fund, it would seem odd that the exposure would be risk weighted as worse than any banking book equity exposure. We are also keen to understand why the default fund contributions to CCPs are assigned a risk weight equivalent of 1250% while the trade exposures to CCPs are risk weighted at 2%.

The Basel Committee introduced a concept of hypothetical capital requirement for CCP (KCCP). KCCP will serve as a benchmark for sufficient capitalization of the CCPs. KCCP will be calculated using the existing CEM which was originally designed to capture the potential exposure of banks' bilateral derivative transactions in a less risk sensitive Basel 1 environment. The CEM add-on factors were calibrated for a one-year horizon which is over long to represent the risk of potential exposures in a daily-settled environment. In addition, the CEM methodology recognizes only 60% of the netting benefits, which is extremely conservative for CCP operations where legal netting is a key risk mitigation tool. We strongly believe that the CEM will not yield a representative metric for CCP exposures and it will create an extremely conservative benchmark for sufficient capitalization of the CCPs. In addition to the punitive aspect of the hypothetical capital requirement methodology, there is also an operational challenge in relying on a third party to provide a key input to our capital calculations since no individual bank is likely to have access to all CCP trades to determine the KCCP.

Furthermore, whilst CVA may be hedged under the Basel 3 proposals, it is not clear how guarantee fund contributions could be hedged and hence it may prove (under certain circumstances) that the treatment of OTC is incentivised over acting as a clearing member.

Large exposures

12. The large exposures regime would be problematic on a CEM basis as exposures will become concentrated with a few counterparties and the CEM regime has marginal positive exposure for each additional trade whether or not there is perfect economic offset. Under the existing EU large exposure regime this will result in hard limits to the level of business that may be cleared unless either:
    a) Exposures to qualifying CCPs are excluded from the 25% LECB limit; or
    b) Exposure is redefined to exclude use of the CEM. This could be by either retaining a MtM vs margin approach, or by using an IMM approach (EEPE) with a 1 day time horizon as set out above.