



Barclays response

Basel Committee on Banking Supervision

Consultative document Global systemically important banks: Assessment methodology and the additional loss absorbency requirement

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1 Executive Summary

- 1.1 Barclays welcomes the opportunity to comment on the proposals for Global Systemically Important Banks (**“G-SIB”**).
- 1.2 We agree with the Basel Committee on Banking Supervision’s (the **“BCBS”**) proposition that a menu of approaches is required to address the negative externalities associated with firms that are currently viewed as too big to fail and that higher levels of loss absorbency is an appropriate way of reducing both the probability and impact of default of such firms. However, we believe that the proposals in the BCBS consultation paper (the **“G-SIB Paper”**), if enacted in their current form, will place a significant cost on the economy without a commensurate benefit and will not provide the right incentives for banks to reduce systemic risk.
- 1.3 In order to meet the objectives of the Committee, we consider that any G-SIB buffer should meet the following key requirements:
- Economic cost of meeting the G-SIB requirements should be kept to a minimum, given the diminishing value of ever increasing capital buffers as a tool for reducing financial instability/systemic risk. The means to achieve this is by use of Contingent Capital Instruments (**“CoCos”**) rather than Common Equity Tier 1 (**“CET 1”**);
 - Systemically important firms should be identified using a transparent risk based methodology that explicitly incentivises banks to take action to reduce, and penalises banks for increasing their systemic risk.
 - Implementation should be delayed beyond the transition period for the conservations buffer.

Minimising Economic Cost

- 1.4 We are in firm agreement that the suite of regulatory reforms already implemented (or in train), listed in paragraph 2 of the G-SIB Paper. Those reforms have had a significant positive impact on the resilience of all banks and systemic banks in particular. These changes, coupled with the proposals put forward by the Financial Stability Board (the **“FSB”**) with respect to the effective resolution of G-SIBs, should effectively address the negative externalities and any potential moral hazard issues at an acceptable cost to the economy.
- 1.5 We recognise that avoiding resolution is preferable to testing the efficacy of resolution plans in practice. We also acknowledge that increased levels of going concern loss absorbing capital will further reduce the probability of default and, for gone-concern instruments, the impact of default. However, this benefit diminishes in value for each marginal increase in capital requirements and must be assessed against the impact on the economy.
- 1.6 We therefore recommend that the cost/benefit analysis to be performed by the Macroeconomic Assessment Group (**“MAG”**) considers this marginal reward against the full economic cost.
- 1.7 We have estimated that the population of G-SIB banks will require additional capital of €271bn to meet the existing Basel 3 changes plus the

new G-SIB proposal. We are concerned that the equity market capacity for this level of capital will be insufficient, requiring banks to retain more profits and/or reduce lending with knock on impact on economic growth and credit pricing. Introducing alternative debt investors would raise the capacity to meet the G-SIB requirement.

- 1.8 We believe that CET 1 has no discernable loss absorbing benefit over appropriately designed CoCos in a stress whereas the cost differentiation is material, with or without tax relief (see section 3). As a result any incremental cost to the economy of using CET 1 rather than CoCos to meet a G-SIB buffer is too high. We strongly urge the Committee and FSB to instruct the MAG to include the relative merits of these two forms of loss absorbing capital in their impact analysis as a matter of urgency and to reconsider their recommendations accordingly.
- 1.9 By our analysis, using CoCos instead of CET 1 would translate into £275bn of additional SME lending capacity in the UK alone over a ten year period without diluting going concern loss absorbency in a stress.

Identifying and Measuring G-SIBs

- 1.10 BCBS has identified a list of 28 banks to be included within the G-SIB framework, but the population of these banks and the entry criteria used to select them are unclear.
- 1.11 There should also be a very explicit and demonstrable positive incentive to improve resolvability or reduce systemic risk. Neither exists in the current formulation.
- 1.12 The use of relative indicators further diminishes the incentive for banks to reduce their systemic activity as, rationally; all banks will attempt the same corrective actions, resulting in no net relative change to their position. Collective bank action on this scale could have a significant negative impact the real economy.
- 1.13 We believe the objectives of the BCBS will be best served if the indicators are absolute, measured on a risk adjusted basis and applied, over time, to all banks. Benchmarks should be set to define the population of systemic banks with provision for appropriate levels of national supervisory judgement and global peer review by BCBS.
- 1.14 We agree with the BCBS's view that there should be scope to penalise banks further if they fail to become more resolvable (if their Recovery and Resolution Plans ("RRPs") are not deemed satisfactory, for example) or otherwise increase their systemic importance. Higher capital requirements could achieve this although any such increase should be well flagged by the regulator with the bank in question.

Timing of Implementation

- 1.15 We believe that a combination of the volume of capital required to meet a G-SIB buffer, the cost to the economy in terms of potential credit transmission foregone and the weak global economic backdrop, warrant a delayed implementation of any G-SIB requirement beyond the current Basel III transition period.

2 Introduction

- 2.1** Barclays welcomes the consultation by the BCBS regarding additional capital requirements for global systemically important banks G-SIBs and the opportunity to provide comments.
- 2.2** Barclays fully supports the need for regulatory reform, including enhanced capital standards, to make the global financial system more stable through improved supervision and better regulation. Identifying and understanding the risks that G-SIBs pose to the financial system is an important element of this.
- 2.3** There are certain banks that have systemic importance, either because they provide essential infrastructure services to the economy (e.g., payments) or because their failure would have a significant impact on counterparties and markets. The interconnectedness of financial markets and banking systems has increased dramatically in recent decades driven by the needs of customers and clients to compete in an increasingly globalised economy. Consequently, global, interconnected, systemic banks are a necessary feature of the modern economy.
- 2.4** Given the critical role that G-SIBs perform in the global economy, it is, therefore, necessary to ensure that any additional risks that those banks pose to global and domestic economies are identified and can be managed without damaging their ability to support the economy.
- 2.5** Mitigating the risk that G-SIBs pose inherently means reducing both the probability and impact of their failure. Barclays supports achievement of these aims through the full use of the global regulatory toolkit in development: cross-border Recovery and Resolution plans for all institutions; operational subsidiarisation; and the use of bail-in debt all form integral parts of addressing and reducing systemic risk; as well as increased supervision.
- 2.6** We understand the split between this BCBS G-SIB surcharge paper and the Financial Stability Board (the “FSB”) effective resolution paper, but we believe there should be further efforts to link the two workstreams and for the final recommendations to explicitly complement each other.
- 2.7** Given the improvements already implemented and in the pipeline, we are of the view that an additional G-SIB capital requirement in excess of that already required under the Basel III minimum capital standards would be counter-productive to the global economy on a cost/benefit basis. If, however, it is ultimately determined that it is necessary, then we believe such a buffer can be met in a more cost efficient way without reducing the anticipated benefit.

2.8 The rest of this response is divided into three sections:

- **A section on ‘capital levels’ which addresses scale of capital raising required to meet the higher capital ratios implied by the consultation paper and the benefits of including CoCos in the G-SIB buffer;**
- **A section on ‘methodology’ which focuses on ways in which the indicators could be made more effective including using risk based measures and incentivising reductions in systemic risk; and**
- **Observations on timing of implementation.**

3 Capital Levels

- 3.1 We fully recognise that the proposed G-SIB extension to the capital conservation buffer is one of a menu of approaches to address the risks posed by systemic firms, but the cumulative impact of measures already in place or underway since the financial crisis should be fully considered when testing its merits.
- 3.2 Barclays has analysed the impact of the proposed G-SIB surcharge on the aggregated published accounts and reports¹ for a set of banks that we believe are likely to be included within the initial group of G-SIBs (according to a number of external sources²).
- 3.3 Based on this data, the population of G-SIBs will be required to raise approximately €271bn of equity capital to meet the new Basel III and G-SIB requirements, in addition to capital already raised since 2008:
- G-SIBs already hold €500bn of additional CET 1 capital compared to pre-crisis levels
 - G-SIBs will need an estimated additional €74bn of CET 1 capital to meet Basel III minimum standards
 - G-SIBs will require an estimated additional €197bn of CET 1 to meet their G-SIB buffer requirements.
- 3.4 Given the current under-performance of bank stocks (in part as a result of the uncertain regulatory backdrop), it is unclear whether there is market capacity for new equity issuance to meet these requirements. G-SIBs will therefore need to meet these additional capital requirements through retained earnings, and reduced availability of credit to fund a return to economic growth.
- 3.5 The cost/benefit analysis to be undertaken for the purposes of determining the requirement and calibration of a G-SIB buffer should allow for the ever diminishing positive enhancements to financial stability that the incremental G-SIB buffer will bring. A means to improve the cost/benefit analysis would be to widen the current scope to encompass alternative capital securities. We urge the BCBS and the FSB to ensure that this is considered by the MAG in their impact analysis.

¹ Accounts and Reports – H1 2011 Nordea, Q1 2011 HSBC, Santander, Commerzbank, BBVA and Mizuho. YE 2010 all others

² "Impact of draft rules on the 28 globally systemic banks" Morgan Stanley, 21st July 2011. "Guidelines to identify globally systemically important banks are credit positive" Moody's, 25th July 2011

3.6 The analysis has to measure:

- (a) The relative benefits of CET 1 as going concern loss absorbent capital over CoCos in a long tail risk scenario; against
- (b) The relative cost to the global economy of selecting CET 1 over CoCos in terms of credit transmission and economic growth.

Contingent Capital

- 3.7** Given the volume of capital required to meet the new requirements and the likely cost of raising new CET 1, we believe that CoCos would be (by far) the most suitable instruments to meet this requirement.
- 3.8** We believe that CoCos offer the same going concern loss absorbent capital benefits as CET 1 in the long tail risk scenarios that we believe the G-SIB buffer is seeking to address. CoCos fully convert into CET 1 post trigger and consequently there is little additional benefit to be derived from selecting the latter over the former in a tail risk scenario – a fact acknowledged in paragraph 85 of the G-SIB Paper. Whilst we understand that loss absorbency in a stress scenario is not the sole qualitative attribute to consider in this comparison, it is certainly the most significant and should be the yard-stick against which the respective costs are measured.
- 3.9** The cost to the economy of requiring the use of CET 1 in any G-SIB buffer in lieu of CoCo will be significant. Assuming a G-SIB requirement for Barclays of 2.5% RWAs, a cost of equity of 11.5% and a pre-tax contingent capital coupon of 7.875% (the recent Credit Suisse Co-Co clearing coupon), we calculate that the present value of retained earnings generated by using contingent capital (on a tax adjusted basis) for the G-SIB buffer instead of CET 1 over the next 10 years is €5.3bn. This translates into €55bn of RWAs or (more significantly) €79bn of SME lending (using current average risk weight of 70%).
- 3.10** Running similar scenarios for our UK peer banks generates an aggregate present value of retained earnings over the next 10 years of €18bn, which translates into €192bn of RWAs and €275bn of SME lending. It can be safely assumed that extrapolating this analysis across the entire spectrum of SIFI banks on a pan-European and global basis would result in a significant multiple of the UK numbers. This exercise should be an intrinsic part of the scope of work undertaken by MAG. As the loss absorbency benefits of CoCo are equal to those of CET 1 in a stress scenario, cost should be the rational determining characteristic for inclusion in the G-SIB buffer. Viewed from this perspective, using CoCo in lieu of CET 1 becomes axiomatic.

- 3.11 Jurisdictional discrepancies in the tax treatment for CoCos have been cited as an impediment to their general global application. We welcome recent initiatives from HMRC and the IRS to consider the domestic tax treatment of potential Basel III compliant capital instruments. Clearly a global level playing field (though challenging to achieve given different legal, tax and accounting regimes) is to be preferred on this important issue.
- 3.12 However, the cost benefit of CoCos over CET 1 absent tax-deductibility is still compelling. For example, in respect of the UK banks cited above it would still amount to €50bn of SME lending for Barclays and €161bn for aggregate UK banks.
- 3.13 There has been considerable debate regarding other qualitative aspects of CoCo and its suitability to function as efficiently as CET 1. The Committee considers these in its “pros” and “cons” list set out in paragraphs 86 and 87 of the Paper respectively. Seeing as the conclusive preference for CET 1 over CoCo is derived from a balancing of these factors against each other, they warrant detailed consideration.
- 3.14 While we agree with most of the observations made in paragraph 86, we would make the following additional observations:
- With respect to paragraph (a) “*Agency problems*” – we believe the discipline brought to bear on management through the use of CoCos instead of CET 1 is often understated in this regard. There are two inter-connected points that create a virtuous circle: (1) the introduction of a more “lumpy” bi-lateral relationship with a fixed income community defeats the agency problem of equity from a granularity and accountability perspective, (2) the enhanced accountability is to an investor class that has a lower risk appetite than traditional CET 1 investors. There is no “upside” to a CoCo holder should management take on additional risk. In this respect a G-SIB buffer that comprised CoCos as opposed to CET 1 has a naturally prophylactic effect that the latter lacks.
 - With respect to paragraphs (b) “*Shareholder discipline*” and (c) “*Contingent capital holder discipline*”, we agree that CoCo triggers would provide a new “floor” capital requirement above regulatory minimum levels in the minds of management; incentivising protective capital cushions, more conservative risk management and, where appropriate, pre-emptive management actions (including pre-emptive equity raising). However, we do not think that the ‘conversion rate’ has a bearing on this – these positive pressures would exist irrespective of the selection of write-down or equity conversion features in CoCos.

3.15 We disagree with most of the observations made in paragraph 87. In particular:

- With respect to (a) “*Trigger failure*”, there should be no uncertainty around the trigger event. CoCos that have recently been issued in the market have used a CET 1 trigger with a “non-viability” back-stop. To question the efficacy of these triggers is to question the very fabric of bank capital adequacy measures. The CET 1 trigger is simply an elevated minimum capital requirement that crystallises an equity underwriting to maintain capital adequacy when all other management actions have failed. If the nominal trigger is deemed insufficient for the specific stress in question, or if it is a liquidity driven stress as opposed to an immediate threat to capital adequacy, the regulatory override in the “non-viability” backstop trigger will ensure that CoCos have the same intrinsic benefit as CET 1 at all times.
- With respect to (b) “*Cost effectiveness*”, it is clear that the coupon on CoCos is considerably lower than that on CET 1 irrespective of tax efficiencies (an irrelevant consideration from the investor’s perspective). The difference is simply explained through the certainty of a fixed income return to the investor and the probability of a trigger event occurring – as losses do not accrue until the latter does³. This does not prejudice the fact that coupon payments will be cancelled and losses will be incurred *pari passu* with equity if it does. Regarding roll-over risk, it is common practice to prohibit banks from calling/retiring capital instruments unless they can illustrate that they are sufficiently well capitalised to do so. There is absolutely nothing to prevent this from being a pre-requisite for retiring CoCos in the G-SIB buffer. Likewise, there should be no risk of financial engineering diluting loss absorbency – if it is made clear that trigger events must create CET 1 through an equity conversion or write off. This is as certain as the loss absorbency requirements for subordinated debt at the point of non-viability currently being implemented under CRD IV.
- With respect to (c) “*Complexity*”, the essentials are simple – a qualifying CRD IV compliant subordinated debt capital instrument that provides CET 1 through a stress by either share conversion or a write-off following a prescribed core tier 1 trigger event. Not dissimilar to the proposal in Annex 3 of the G-SIB paper. Whilst we believe that the market should be left to determine certain structural nuances of CoCo (e.g., degree of share conversion versus write-down, trigger points etc) we think the risk of complexity has been exaggerated by the lack of regulatory guidance in this space (fuelling endless speculation by market commentators). Given clearly defined parameters regarding the form the product should take, we do not believe there is any risk of overly complex products diluting the regulatory objective of creating a layer of pre-funded going concern CET 1 in a stress.
- With respect to (d) “*Death spiral*”, given the positive incentives referred to in above, management would have attempted a pre-emptive rights issue well in advance of a CoCo trigger being reached.

³ This stands in contrast to CET 1, where expectation of discretionary dividends for the basis of stock price valuations which are far more sensitive to fluctuations in earnings (impairments) generally.

If this was insufficient to stave off a trigger event, equity prices would already be under considerable stress and we do not believe that this would be greatly exaggerated by the presence of CoCos themselves. In actual fact, the presence of an ‘all else fails’, significantly sized, pre-funded equity buffer should engender confidence at this stage and help mitigate equity pressure to a degree – this would be even more likely in the context of write-off CoCos where the absolute share dilution is taken out of the structure.

- With respect to (e) “*Adverse signalling*”, the inability of a bank to stave off a trigger event will not have been caused by the presence of CoCos, but the inability of management to convince the market they are an investible proposition at the prevailing share price. As CoCos are intrinsically cheaper than equity, it is even less likely that this determination would have been overturned by the use of CET 1 in the G-SIB buffer – which would have resulted in lower profitability and ROE (without alleviating management of the requirement to raise additional equity to stave off the consequences of falling short of the G-SIB buffer). Indeed at this stage, CoCos could have a positive signalling advantage over

CET 1: a defibrillator effect of boosting CET 1 in a time of stress.

- With respect to (f) “*Negative shareholder incentives*”, we re-iterate that CoCos better align management incentives with all stakeholders (CoCos and CET 1 holders alike). Given the restrictions on a bank’s business that arise as a result of breaching G-SIB buffers, it is difficult to see why the curtailment on RWAs or accelerated asset sales cited are more pronounced if the G-SIB buffer is comprised of CoCos over CET 1. As stated above, we believe that pre-emptive equity issues will have been attempted long in advance of a trigger event arising and the banks ability to convince equity holders of its feasibility is unlikely to be materially influenced by the presence or absence of CoCos in the capital structure.

3.16 Measuring the significant cost to the economy of including CET 1 over CoCos in the G-SIB buffer against the neutral benefit of doing so gives rise to a starkly one sided conclusion in favour of the former over the latter.

3.17 This conclusion is augmented when making the essential determination of capacity. The delineation between fixed income and equity investment funds over the last 20 years has become increasingly entrenched. During this period the fixed income community has contributed €742bn of subordinated debt capital to the European banking sector of which €436bn is currently in issue. If we are unable to design capital instruments that appeal to the fixed income community, it is likely that a large portion of this capital will be directed away from the banking sector altogether. It is by no means certain that equity investors would be willing or able to fill the gap – particularly given the downward pressure on Return on Equity that a front-loaded CET 1 G-SIB requirement would create. CoCos create a virtuous circle for bank capital and global financial stability – preserving the fixed income bid and augmenting the CET 1 bid without prejudicing the requirement for the highest quality of capital in a stress scenario.

4 Methodology for the Surcharge

- 4.1 We can understand the appeal of seemingly objective measures of bank size and systemic risk profile, but it is difficult to reduce something which is inherently complex to a few indicators. We note, for example, that analysis performed by Morgan Stanley and by Moody's Investor Services, based on the methodology embedded within the proposals, produced widely divergent outcomes. This may suggest that potentially very small changes to the parameters can make significant difference to the rankings of the banks.
- 4.2 If the G-SIB framework is to have real value it needs to promote behavioural change that is to the benefit of the financial system and the economy as a whole. In our view, the G-SIB framework needs to be shaped further to incorporate the following key attributes:
- Encouraging positive behaviour through rewarding or penalising a G-SIB's contribution to systemic risk.
 - Providing clear and transparent disclosure of the status, ranking, entry and exit criteria for the initial sample of banks selected as G-SIBs.
 - Providing for appropriate levels of judgement overlay on this very complex issue.

Encouraging positive behaviour through rewarding or penalising a G-SIB's contribution to systemic risk

- 4.3 The following paragraphs highlight how the current proposals fail to appropriately reward or penalise a G-SIB's contribution to the risk of the system as a whole, and suggest some potential improvements.
- 4.4 All banks contribute to systemic risk, not just those identified as G-SIBs – As the recent financial crisis taught us, even the failure of relatively small banks can have systemic implications. It is crucial that regulators understand risk at a firm-specific level and do not lapse into a 'one size fits all' approach that a G-SIB list could encourage.
- 4.5 Firms should be incentivised to benefit from reducing their relative contribution to systemic risk – The current focus on ranking and scale-based measures means that banks taking similar positive or risk-mitigating action would not realise any benefit individually, as relative rankings are likely to remain the same. Collective action would reduce individual firms' risk and risk in the system as a whole. This relative approach is likely to increase the cost of credit to consumers (if the capacity of the system reduces), move risks to other banks that are not part of the sample, or to the shadow banking system, where bubbles of risk created are less likely to be detected and controlled. We would suggest that the quantitative measures could be applied to a broader sample of banks in all G20 countries, with trigger points for instigating more comprehensive assessment, or that aggregate banking statistics for the system could be used.
- 4.6 Incentive to improve resolvability – The G-SIB framework should dovetail seamlessly with the rest of the regulatory framework (including the current FSB work on resolution). Incentives should be provided for firms who go

beyond minimum standards in respect of recovery and resolution planning. Similarly the G-SIB regime could be used to penalise firms who are lagging in their implementation or move off track from the requirements.

4.7 Dis-incentives in some current indicators – Some of the indicators provide little incentive for positive behavioural change. For example:

- on “substitutability”, the metric could encourage firms to reduce the volume of payments sent through the system rather than taking measures to ring-fence this activity; and,
- on “complexity”, it assumes that non centrally-cleared OTC derivatives are uniformly complex. The metric also penalises trading book scale without differentiating between risk profile or market liquidity, e.g., a bank with a large trading book of sovereign debt positions or equity flow business is treated in the same way as a bank with a large trading book of CDO positions.

4.8 Supplement the current methodology with risk-based indicators – Using the indicators proposed by the BCBS, we have identified some risk-based metrics which we believe would enhance the methodology:

Category	Suggested Risk Based Indicators
Cross-Jurisdictional Activity	<ul style="list-style-type: none"> - Use net, risk adjusted exposures - Review RRP (which take into account actions to mitigate impact of failure) - Take into account existing legislative regimes in relevant jurisdictions (eg national resolution regimes; EU Winding Up Directive)
Size	- Consider both Basel 3 Leverage (non risk-adjusted) and Capital (risk-adjusted) Ratios
Interconnectedness	<ul style="list-style-type: none"> - Undertake further Network Analysis - Use net, risk adjusted exposures - Apply CCFs to undrawn commitments - Review material counterparties only (define materiality in line with Large Exposures regime - ie exposures > 10% of CET1) - Use NSFR instead of wholesale funding ratio
Substitutability	<ul style="list-style-type: none"> - Use net, risk adjusted exposures - Review RRP (which take into account risk management of critical functions)
Complexity	<ul style="list-style-type: none"> - Consider risk management of positions not gross accounting values of positions eg for OTCs use net MtM rather than notional measures

4.9 A risk-adjusted approach would require a change to the collections of data which will not be met by for example consolidated international banking statistics). Alternatively, a new reporting requirement could be incorporated within the EBA Common Reporting methodology as there is currently potential for differences to arise in submissions if banks are required to interpret the requirements and provide additional information that is outside the scope of its existing central bank and supervisor returns.

4.10 The frequency of the reporting should be taken into account as a number of the proposed indicators, by their very nature, could move significantly between reporting periods. The measurement approach should be flexibly designed to enable an up-to-date view of a banks footprint to be assessed without placing unduly burdensome reporting requirements on banks.

Clear and transparent disclosure of the status, ranking, entry, and exit criteria for the initial sample of banks selected as G-SIBs

4.11 We are unclear why the BCBS has chosen to use a sample of banks rather than aggregate banking statistics. However, the pool of data used is less

important than the need for transparency and clarity for the markets as well as the regulators.

- 4.12 The absolute targets should be defined and quantified and there should be comparability across firms and jurisdictions, taking account of accounting and reporting differences.
- 4.13 Steps should be taken to minimise the potential negative market reaction. Promotion/relegation to and from buckets will need to be announced, with detail and reasons, by the relevant regulator in the national jurisdiction and/or by the BCBS itself.
- 4.14 Some of the metrics within the indicators will change considerably and frequently (e.g., trading book value) rendering a point-in-time assessment flawed and inaccurate. If the current metrics are maintained, there should be scope for timely review to ensure that market developments are addressed. However, there clearly needs to be a balance, as overly frequent review could make capital planning impossible.
- 4.15 Critically, the G-SIB framework needs to be capable of responding to changes in the global banking market. There should be more clarity regarding the entry and exit criteria for G-SIB status and for determining the appropriate number of G-SIBs, in order to address potential mergers, de-mergers and financial sector growth in emerging economies.

Providing for appropriate levels of judgement overlay on this very complex issue

- 4.16 The supplementary use of judgement and qualitative indicators to assess G-SIBs need not impede transparency or consistency. Examples of good and bad practice in banks could be published. The home supervisor's initial assessment could be reviewed by the broader college and, ideally, persons not directly involved in the supervision of the institution such as the BCBS through the Standards Implementation Group (the "SIG").
- 4.17 Banks should be able to expect consistent and fair treatment and we recommend that the SIG should set out terms of reference by which the individual jurisdictions should be expected to comply with appropriate accountability, to ensure consistency, at the global level.
- 4.18 Finally, it seems inequitable that firms should be penalised where they may breach boundaries in response to specific direction from national authorities to help stabilise financial markets, for example through merger or acquisition.

5 Timing of Introduction

- 5.1** The Basel III transitional rules apply material increases in capital levels out to 2019. The logic behind the transition was to avoid unnecessary pressure on economic recovery. Applying the G-SIB buffer transition in parallel to the existing Basel III buffers will potentially undermine the original objective. We note that market comment is beginning to move in this direction as well (e.g., speech from A Haldane 18/8/2011), as the global economic recovery is looking less assured by the day.
- 5.2** Consequently, we believe that any G-SIB surcharge should appropriately be implemented after the Basel III conservation buffer.
- 5.3** It should also be recognised that whilst the transition in arrangements for the new standards may be reasonable, once announced the market will expect affected banks to respond with additional capital on a much shorter timescale. This is likely to exacerbate any negative impacts on the economy, especially if the surcharge is expected to consist of CET 1.
- 5.4** As well as addressing the economic consequences of higher capital levels in banks, the transitional arrangements are particularly important when considering the means available to Banks to increase their capital ratios. This falls into three main approaches, issuing new equity; retaining earnings; or shrinking balance sheets. The advantages and disadvantages of each approach needs to be considered by each bank carefully (especially when global economic growth remains weak and investor confidence is fragile). Appendix 1 summarises further some of the potential effects of raising capital ratios.

6 Conclusion

- 6.1 Barclays believes that it is critical that any capital surcharge is designed in the most cost effective way and creates the right incentives for banks to take actions that will reduce systemic risk.
- 6.2 Cost effectiveness can be achieved through addressing the nature of the surcharge. Using CoCos instead of CET 1 in the surcharge would introduce a wider investor base and realise significant cost savings to the economy. Given that the loss absorbency benefits of CoCos are equal to those of CET 1 in a stress scenario, there is little additional benefit in choosing the latter over the former.
- 6.3 The proposed methodology will not, at present, create the right incentives for banks to reduce their systemic risk. In fact, it might lead to perverse unintended consequences by setting the wrong incentives. Furthermore, the simplified, purely numerical analysis erroneously suggests a precision and level of accuracy that does not reflect the true systemic risk of a financial institution, particularly since its resolvability is not taken into account within the framework at all.
- 6.4 The indicators should be absolute, measured on a risk adjusted basis, and applied to all banks. An overlay of appropriate levels of national supervisory judgement with global peer review by the BCBS can then help to make the methodology more risk based. There should be certainty and clarity to enable banks to manage their contribution to systemic risk in isolation from their peers.
- 6.5 Ensuring that no bank is 'too big to fail' can then be achieved through incentivising banks to produce credible RRP that are thoroughly evaluated and approved, as well as to take steps beyond basic RRP to improve resolvability (such as structural changes). RRP will provide regulators with the information and tools needed to truly understand the potential impact of failure and provide a roadmap to mitigate that impact.
- 6.6 A penalty capital surcharge could then be applied to banks if their recovery and resolution framework was not sufficient.
- 6.7 The timing of introduction of a G-SIB buffer needs to factor in the other capital and non-capital changes that are already impacting bank profitability and capital levels whilst the global economy still remains weak. Consequently Barclays believes a delayed implementation beyond the current transitional arrangements for the conservation buffer is appropriate.
- 6.8 We would be delighted to provide further information or guidance on any of the issues discussed in this paper if that would be of use.

7 Appendix 1 – Raising Capital

- 7.1 Raising new equity, at the levels outlined in 3.9, would be challenging due to the nature and depth of equity investor markets. Both shareholdings and dividends risk being diluted if rights issues are not successful and new strategic investors are required.
- 7.2 Raising capital across the industry will depend on the careful cultivation of support of the investor community. To do this will require the banks improving their returns on equity.
- 7.3 The ability to retain earnings is limited by the fact that investors compare each bank to alternative companies, industries and countries (with possible consequences for the availability of capital in the UK economy). Investors expect to see some capital returned in the form of dividends. Generating additional capital through retained earnings could take a long time as a result.
- 7.4 Banks might reduce their balance sheets to a level supported by the existing capital at the new ratio. At the extreme end, this could represent a reduction of c. €2.7trn in risk weighted assets, seriously impacting banks' ability to lend in the real economy. Most likely, the management actions adopted by banks will comprise a combination of these solutions to transition to a new capital regime.

Shadow banking

- 7.5 One possible consequence of introducing the G-SIB buffer ahead of any wider G-SIFI requirement would potentially leave the shadow banking sector outside the regulatory perimeter and could lead to credit intermediation shifting to shadow banks. This would potentially raise system risk through maturity or liquidity transformation as well as potentially leveraged and flawed credit risk transfer. The risk to taxpayers of directly bailing out banks that fail might have been reduced, but the much larger systemic risk from a sudden withdrawal of credit in the economy would not be eliminated. We believe the potential for systemic risk as a result of uneven application of new and more restrictive regulation is material.

Impact on returns

- 7.6 In addition, significantly higher capital requirements are likely to drive a material fall in banks' Return on Equity (RoE). Assuming a hypothetical industry return in the range of the current cost of equity (about 12%), other things being equal, the RoE of European and US banks that might be part of a G-SIB list would fall from 11.5% to 9.0% when the surcharge is added.
- 7.7 This would in turn require a corresponding drop in the cost of equity to allow banks to continue to operate without destroying shareholder value. If that were not the case, shareholders would require banks to shrink and return capital to them so that they might deploy it in other sectors or countries. But the evidence does not point to such a reduction in the cost of equity. A simple analysis failed to find a consistent correlation between leverage and cost of equity for large banks (represented by beta as the main driver of the

cost of equity), across a range of markets. In some cases, it works in the opposite direction.⁴

- 7.8 It is also unreasonable to assume that banks would operate at profitability levels below those of the safest industries in the world which have strong regulatory intervention. For example, the current average RoE of the S&P index for the UK utility industry is 29%.⁵
- 7.9 The scope, for mitigating such a drop in RoE in the form of lower costs of funds, reduced operating costs, and higher prices is limited. A material reduction in the weighted average cost of funding as a result of higher capital levels would be unlikely. Deposits – which represent a large share of banks' funding (a fact that is ignored by the Modigliani-Miller theorem) - are not priced based on institutional risk. Rather, an increase in deposit spreads, due to more competition for stable funding, can be expected. Moreover, wholesale funding costs might not decrease proportionally to the enhancement of capital ratios. We believe this reflects the fundamental asymmetry in investors' perceptions; returns are given greater weight as they are tangible and current, whilst risks of a bank are not fully transparent to creditors. Further, debt is not priced solely on the basis of risk, but also on other factors such as market liquidity. Achieving the RoE target through cost reductions would be implausible; the UK banks would need to take around 45% out of their existing 2010 cost base to reach a RoE of 12%.

Impact on customers

- 7.10 The alternative for banks would be to widen customer margins. A number of studies⁶ put the link between lending spreads and higher capital ratios at 10-20bps for each additional 1% of equity. Banks might, however, also consider reducing their exposures even further, cutting those portfolio elements where capital consumption is highest and the risk return relationship is the least favourable – mostly in lending portfolios (e.g., trade finance, SME lending).
- 7.11 SMEs are likely to be particularly affected as SME lending consumes a high amount of capital: a SME loan generates as much as 4-5x the RWAs of a mortgage of the same asset value. So, higher capital ratios would require disproportionately higher returns and price increases (or a relatively higher reduction of exposures). SMEs – contrary to large corporate clients, for example – will find it more difficult to access funding from other sources, be it banks in other countries, the shadow banking sector or capital markets.

⁴ We examined a large cross-sectional sample of banks across Europe and the US for a simple correlation between leverage and the cost of equity (represented by beta as the main driver of the cost of equity) using forward looking variables.

⁵ Source: FTSE All-Share Index Series Review

⁶ E.g. studies by the UK banks, the IIF or the analysis of the Basel Committee's Macro-economic Assessment Group