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Secretariat

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Basel Committee on Banking Supervision
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Re – Consultative Document – "Margin Requirements for Non Centrally Cleared Derivatives"

Barclays appreciates the opportunity to provide comments on the above Consultative Document issued by the Working Group on Margining Requirements of the Basel Committee on Banking Supervision and the International Organization of Securities Commissioners (the "Working Group") in July 2012.

We set out below our comments.

Policy Objectives

The policy benefits that are intended to result from the imposition of a margin requirement on uncleared swaps are expressed to be

(a) the reduction of systemic risk, and
(b) the promotion of central clearing

Reduction of Systemic Risk

We support the widespread use of variation margin to offset current exposure between all participants in the market – with the exception of those not subject to the clearing mandate. Our support presumes that the cost of such variation margin is mitigated by there being no need to segregate the margin and allowing rehypothecation of margin received. Although the use of variation margin is already widespread among larger participants in the market, we believe mandating the requirement to deliver variation margin will further reduce systemic risk.

In relation to intial margin however, the issue is more complex. The systemic risk concern is that there exists too much credit risk between entities in the market and that, for major participants at least, this risk is interconnected.

The initial margin issue is more complex because of its relationship to capital, which is an alternative mechanism for addressing the systemic concerns. Capital is intended to cover unexpected losses at a given confidence interval. Arguably, initial margin is intended to achieve the same, protecting not

against the expected exposure (variation margin accomplishes this) but the potential unexpected exposures also at a particular confidence interval.

In order to reduce the systemic risk that excessive credit risk generates, one could introduce a strict initial margin regime with confidence intervals that would create a very high expectation that actual losses would not exceed the prescribed sums set aside as margin. This is represented by the base case assumptions of 10 day 99% confidence interval set out in the Consultancy Document. Such a regime places a huge liquidity cost on the market but significantly reduces the need for capital cost to be incurred since the credit risk is almost eliminated by the provision of margin.

The liquidity cost is also disproportionate to the capital cost reduction. The funding cost of margin can be assumed to be linear, but the benefits of initial margin in risk mitigation are weighted towards the first dollar posted being more "valuable" in defeasing risk than the last dollar. In any intial margin regime the chance an entity needs to resort to the first dollar is theoretically 50%, because the market is as likely to move in favor as against the entity's position. At very high confidence intervals (99%) the chances an entity needs to resort to the last dollar of initial margin is only one in one hundred, even if the market moves against it. But the funding cost of the first dollar provided is the same as the last. That is why we question whether in practice the use of thresholds for initial margin has merit.

At the other end of the spectrum would be a regime where there was minimal use of initial margin. Each participant relies solely on its own capital to support the credit risk taken. The entire cost in this case is in the form of capital cost.

Neither approach is optimal. A reliance on protecting the system entirely through liquidity cost introduces significant new risks –which may themselves be systemic in nature – ie the need to fund large sums of margin, periodically to roll this funding of margin and to fund increases in the amounts required to be delivered in times of stress.

A sole reliance on capital alone is also prohibitively expensive.

We believe the Basel III capital regime produces the appropriate inducements to strike the right balance between these two costs - an entity incurring a capital cost when it holds credit risk or incurring a liquidity cost (thereby reducing the corresponding capital cost) through the provision of initial margin. Each entity has its own optimal balance point between its capital and liquidity costs, which will vary by entity depending on its access to and cost of funding additional margin relative to its cost of funding additional capital or paying a premium for the transactions it executes. For this reason we do not believe it is necessary to introduce a mandated initial margin regime. Given the rigor of the Basel Capital standards each participant will find the optimal balance between the use of capital and margin. Since this balance is not the same for all entities, mandating an initial margin regime removes the flexibility that would otherwise allow an entity to arrive at the point of intersect that optimally balances these two costs and therefore may make it difficult for entities appropriately to protect themselves against credit risk at the cheapest overall cost.

Corporates provide a simple example of how this balance differs by market participant type. A corporate typically has a strong preference against incurring a liquidity cost. Corporates are reluctant to post margin, and, in lieu, pay a higher price for the transaction to cover the additional capital costs the

dealers would incur. It is unlikely, however, that the corporate would be contributing materially to systemic risk. Dealers by contrast will, in the course of their risk management, have a preference to incur some liquidity cost over capital cost up to the point of equilibrium and are, therefore, willing to post initial margin in a bilateral agreement, rather than incur the larger capital costs. Therefore, we expect the Basel III rules will naturally result in widespread use of initial margin on a timetable market participants can bear. The Basel capital framework effectively operates as a proxy for a mandated initial margin regime. The incentives in Basel III – including the CVA charge and the provisions of BCBS227 - strongly favor prudentially regulated banks incurring a degree of liquidity cost to balance the capital cost. Based on these considerations, we think it unnecessary to introduce a mandated initial margin regime.

Recognizing that the Dodd Frank Act may impose a requirement to offset credit risk with margin with the objective of reducing systemic risk, we urge the regulators to have particular regard to changes that the implementation of a margin regime may have on the propensity within the Basel III framework to reduce systemic risk arising from credit risk at the lowest cost by allowing market participants to incur capital cost and liquidity cost in their optimal relationship.

The promotion of central clearing

The second policy objective – the promotion of central clearing – is stated to be the basis for the need to have the base level confidence intervals for initial margin be at the high levels proposed in the Consultative Document. The proposition is that by imposing materially higher margin levels for uncleared swaps than the equivalent risk held in cleared swaps, the market will be motivated to migrate products to clearing. While we do not dispute the stimulus that this "stick" could generate, we do not believe that it is necessary to achieve an appropriate and expeditious move of products to clearing. The proposed Basel III framework contains such significant capital incentives to encourage the use of central clearing that no other incentive is required.

In the same way that the capital inducements under Basel III induce an appropriate use of initial margin, these capital provisions also create very strong motivation to clear swaps. The capital that needs to be set aside for a transaction that is cleared receives a 2% risk weight, whereas an uncleared swap with a corporate receives a much higher risk weight (for instance, 100% under standardized tables). It is worth noting that the CVA charge effectively multiplies this differential between cleared and uncleared risk by, on average, three, (since the CVA charge is intended to be calibrated at twice the default risk). We believe that the Basel III framework provides adequate motivation.

In addition to the strong Basel III capital incentives to clear we note also that other incentives also favor moving swaps to clearing -

(i) *Transactions with a single client / Single client portfolio risk*

Every market participant has the incentive to unify their derivatives counterparty risk by moving uncleared swaps to clearing at a single CCP (or limited number of CCPs) and not fragmenting their portfolio between cleared and uncleared swaps. The market is already actively engaged with the CCPs and other stakeholders under the auspices of the ODSG to address issues that may exist and sequentially and with targeted prioritization move swaps

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not yet capable of clearing to clearing as soon as prudently practicable. As an illustration, the inducement is particularly strong in the case of commonly traded "pairs of swaps" – for example where an option not as yet capable of being cleared is hedged with a delta swap hedge that is subject to the clearing mandate. Absent exempting the delta swap hedge from the clearing requirement, the cost of holding these trades in margin terms is multiples higher when one swap type clears but the other does not than if both types clear.

(ii) Transactions across multiple clients / Cross client portfolio risk

Where a participant has a series of counterparties with whom it has portfolios of uncleared swaps with fractionized risk across all its counterparties, the overall credit risk of the set of portfolios will be higher than if these were moved to clearing, which results in the entire risk being netted together. This may be so even if on an individual basis the initial margin attached to any particularsingle trade is *lower* than if that discrete trade were cleared or attracts no margin at all. Dealers have strong incentives to integrate these risks into a single cleared portfolio.

We believe in fact that no additional inducement is required beyond those that already exist to motivate clearing of swaps that do not currently clear and that accordingly this is not intrinsically a necessary reason to introduce a mandated initial margin regime to meet the policy objective. Although uncleared swaps likely do have more risk than cleared swaps since these risks are less liquid, raising confidence intervals beyond what is appropriate given the risk so as to "artificially" motivate a move to clearing is not necessary.

We urge the regulators to take these considerations into account in the assessment of the need for and, where necessary, the framework of any margin regime adopted.

We would be pleased to respond to any questions you may have.

Respectfully yours,

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