1 Churchill Place
Canary Wharf
London E14 5HP
United Kingdom

Tel +44 (20) 7116 1000

barclays.com

20 June 2013

Secretariat of the Basel Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basel
Switzerland
baselcommittee@bis.org.

Dear Sirs

RECOGNISING THE COST OF CREDIT PROTECTION PURCHASED

Barclays welcomes the opportunity to comment on the Basel Committee's ("Committee") consultation on "Recognising the cost of credit protection purchased" (BCBS245) and we acknowledge the significant amount of work that has gone into the paper and the importance of the issues the paper seeks to address.

In this letter we outline our key messages on the proposals, while the specific questions posed in the consultation paper are answered in Appendix 1.

Aim of the proposals

The consultation document raises concern with "potential for capital arbitrage within the credit risk mitigation framework particularly when (i) there is a delay in recognising the cost of protection in earnings while (ii) the bank receives an immediate regulatory capital benefit in the form of a lower risk weight on an exposure on which it is nominally transferring risk. In such instances, there may be no meaningful transfer of risk." Further it states that the proposals are intended to ensure that 'the costs, as well as the benefits, of purchased credit protection are appropriately recognised in regulatory capital.

The difference between the timing of recognising capital relief and the timing of expenses being recognised in the income statement is a function of the interaction between the regulatory and accounting frameworks. In order to effectively address related regulatory concerns, we would urge the Committee to initiate an industry roundtable to explain the nature of the arbitrage trades that have come to supervisory attention. This would enable common features to be identified and an open discussion of appropriate measures to address the risk of those trades recurring. Such an event would also allow the industry to seek clarification on a number of points in the consultation document. Barclays participated in similar events during the development and consultation phase of the large exposures review and found them invaluable. Furthermore, we recommend that the Committee undertake impact analysis subsequent to industry discussion to quantify the associated costs of options identified. Barclays is keen to participate in such a roundtable and is willing to provide data to help identify the appropriate regulatory solution.

In order to help progress the debate, we have focused on what we believe to be the Committee's key concern, namely securitisation transactions that result in capital arbitrage.[1] As a result we have considered, in the Annex, the significant risk transfer requirements in light of high cost of protection. As regards non-securitisation transactions, however, the nature of the perceived abusive activity is less clear as single name and untranched portfolio transactions are materially different to securitisation transactions. We propose that such transactions are not included within the scope of the proposals until further clarity is provided on the nature of any related problems.

Issues concerning the current proposal

We acknowledge the Committee has concerns regarding abusive activity. However we believe that the current proposal risks capturing a broad range of transactions that are undertaken for risk management or other legitimate

---

[1] This is based on the consultation highlighting that "arbitrage opportunities are more likely to occur when credit risk mitigation techniques are used for securitisation transactions, where the difference in the risk weight before and after buying protection can be very large".

commercial purposes. In doing so, it may lead to unintended consequences, such as a reduction in lending to corporates because effective credit risk mitigation is too costly in regulatory capital terms, further complexity in transactions or ineffective risk management.

We believe that consideration of a Pillar 1 treatment to address the risks posed by high cost of protection for securitisation transactions is reasonable, as the current Pillar 2 guidance does not necessarily deliver a level playing field. However prior to taking a Pillar 1 approach, it is imperative that the objectives are clear, the treatment is well understood, subject to consistent application and commensurate with the risk it attempts to capture. As currently proposed:

1. The consultation document is unclear in a number of areas, for example 'meaningful transfer of risk'.
2. The scope should be narrowed to address only transactions with features that cause concern rather than capture legitimate risk management.
3. The level of regulatory discretion is such that it is likely to result in an unlevel playing field.
4. The proposal potentially imposes a disproportionate operational burden on banks.

Given the current lack of clarity on the issues that require resolution, we note that regulatory convergence could equally be achieved through additional supervisory guidance under Pillar 2 until the position is clarified. Such an approach would give sufficient flexibility to address only those transactions that cause concern, but also provide clarity on the consequences for such transactions.

Recommended changes to the proposal

Our over-arching recommendation is for the Committee to initiate an industry roundtable to discuss the proposals in more detail, and undertake impact analysis. Notwithstanding that point, we set out below a summary of the areas in which the consultation document and proposals therein could be improved.

i. Meaningful transfer of risk

It would be helpful if the Committee can provide greater clarity as to what is meant with reference to "meaningful transfer of risk". We have inferred from the consultation document that the intention is to consider whether Credit Risk Mitigation (CRM) transactions give risk to a commensurate transfer of risk and we agree that this should be the case. However we are concerned that, as drafted, the proposals will capture much hedging activity, including that with meaningful transfer of risk.

The Committee identifies the cost of protection and highly risk-weighted reference assets as the only factors to consider when assessing whether a meaningful transfer exists. Since the cost of protection reflects market perception at a given point in the credit cycle, we believe that it should not be considered in isolation. We suggest within our detailed response in Appendix 1 a number of factors that could be considered in addition to the cost of protection.

ii. Scope of application

We recommend that all single-name CDS/TRS, centrally cleared credit protection trades and credit value adjustment (CVA) hedges are exempt the scope of the proposals.

It is unclear whether the proposal is intended to capture protection transactions where the underlying positions are fair valued. We do not think it is appropriate to capture such transactions because the valuation changes prior to the purchase of protection will directly impact Core Tier 1. We request confirmation of our interpretation.

iii. Materiality threshold

We recommend that further analysis is undertaken to determine the appropriate scope of application, including consideration of other factors than risk weighting.

There are numerous factors to consider in assessing whether meaningful transfer of risk has occurred. We acknowledge that the Committee has taken a pragmatic approach to implementing the proposals, and in doing so has identified the 150% risk-weight threshold. However we consider the approach to be over-simplified and think that it creates a number of unintended consequences.

In particular, the proposed changes would create disincentive for banks to hedge highly risk-weighted exposures, and to manage their credit risk effectively. Furthermore, since some banks are permitted to use internal models to risk-weight their credit risk exposures, different banks may potentially allocate differing risk-weights to the same

reference asset. As a consequence similar protection trades are not captured by the materiality threshold, creating an unlevel playing field.

iv. Supervisory flexibility

We recommend that the supervisory flexibility in Pillar 1 is removed to improve comparability and transparency of the capital calculation, and that Pillar 2 is used to address any particular transaction specificities that cannot be captured adequately in Pillar 1.

The current proposed degree of flexibility given to supervisors is such that implementation of proposals is unlikely to result in consistent application, thereby undermining the Committee's aim in relation to transparency and comparability of RWA calculations. It is already incumbent on firms to address risks not appropriately dealt with in Pillar 1 in their Pillar 2 assessments and Supervisors have the ability to take action if the firm has not acted appropriately.

We provide examples of where we believe flexibility should be removed in Appendix 1.

v. Operational complexity and incremental cost

We recommend that impact analysis be undertaken to quantify the incremental RWA that would be held based on proposals prior to any final comment from the Committee.

The current proposals are likely to result in a disproportionate level of operational complexity and a significant increase in cost to resource the assessments that will be required. The burden will be a particular issue for non-securitisation transactions.

We have a number of other questions related to complexity and cost which we set out in Appendix 1.

I hope you find our comments helpful. Please do not hesitate to contact Roger Versluys on +44 (0)20 8773 2791 or email: roger.versluys@barclays.com if you have any questions or comments on any of the issues raised in this response.

Yours sincerely,

Peter Estlin
Co-Head of Finance, Barclays

Appendix 1: Response from Barclays to questions raised in the consultative document

1. In addition to the 150% risk-weight threshold, should additional exemptions for certain types of transactions be considered? In particular, the Committee welcomes feedback on (1) exposures guaranteed by governmental entities (including sovereigns and public sector entities) and (2) trade finance transactions with guarantees.

Exemptions

We acknowledge the Committee's pragmatism in proposing a 150% risk-weight threshold. However we recommend the Committee uses the proposed industry roundtable to identify and test other options for an exemption threshold or alternative definition of scope because we consider the 150% threshold to be over-simplified and to create a number of unintended consequences:

1. It creates disincentive for banks to manage their credit risk effectively.

2. Different banks that calculate risk-weights using internal models could feasibly risk-weight the same counterparty at risk-weights at either side of the threshold. Under the current proposals one bank would fall within scope of the proposal, while the other would not. This could lead to an unlevel playing field.

3. Unlevel playing fields may equally exist where banks use the standardised approach for credit risk-weighting. This is because banks may use different ratings agencies, each of which may apply a different credit rating.

4. The consultation document suggests that national supervisors may deem protection costs material even if the risk-weight on the underlying is less than 150%. This could lead to an unlevel playing field.

Guarantees

Barclays welcomes the proposed exemption on exposures guaranteed by governmental entities (including sovereigns and public sector entities) and trade finance transactions with guarantees. This is because we do not believe the intention of the proposal is to restrict legitimate hedging activity and because it is important to balance prudential requirements with support for economic growth.

2. The Committee welcomes feedback on all aspects of the proposed changes to the rules text and the supplementary technical guidance.

1. General comments

As noted above, our immediate recommendation is for the Committee to initiate an industry roundtable to identify example capital arbitrage trades and their common features, and discuss suitable measures to address the risk of those trades recurring. This will also allow the industry opportunity to seek clarification on a number of points in the consultation document. We also recommend that the Committee undertake impact analysis subsequent to those discussions to quantify the associated costs of proposals. Barclays is a willing participant in future discussion on this topic.

Barclays has participated in the development of industry association responses and supports many of the points therein. However, we have also chosen to submit our own response, as there are certain points that we would particularly like to highlight and others where we wish to draw out points that result in slightly different conclusions.

a) Scope of application

The consultation document raises concern with "potential for capital arbitrage within the credit risk mitigation framework particularly when (i) there is a delay in recognising the cost of protection in earnings while (ii) the bank receives an immediate regulatory capital benefit in the form of a lower risk weight on an exposure on which it is nominally transferring risk." Further it states that the proposals are intended to ensure that 'the costs, as well as the benefits, of purchased credit protection are appropriately recognised in regulatory capital.

The difference between the timing of recognising capital relief and the timing of expenses being recognised in the income statement is a function of the interaction between the regulatory and accounting frameworks. These respective frameworks have different objectives, therefore such timing differences are common and often entirely appropriate. In this context, the nature of the arbitrage the Committee seeks to address is not entirely clear – as noted above, we believe an industry roundtable will assist in this regard.

In order to help progress the debate, we have focused on what we believe to be the Committee's key concern, namely securitisation transactions that result in capital arbitrage. As a result we have considered below the significant risk transfer requirements in light of high cost of protection. As regards non-securitisation transactions, however, the nature of the perceived abusive activity is less clear as single name and untranched portfolio transactions are materially different to securitisation transactions. We would propose that such transactions are not included within the scope of the proposals until further clarity is provided on the nature of any related problems.

Introduction of pro-cyclicality

The consultation document suggests that the cost of protection can be too high for riskier assets. Cost of protection will move as credit spreads narrow and widen. The current proposal creates disincentive for banks to effectively manage their credit risk position during a period of wide spreads since this would result in a punitive capital treatment that potentially conveys an inaccurate reflection of the bank's true capital position, on the basis that the transfer of risk is considered meaningless. In contrast, the same charge would be much lower for a bank buying protection during a period of narrow spreads.

The consultation document infers a relatively benign impact of the proposal on RWA relief available. However a corporate name with 150% weighting would be approximately equivalent to a B credit rating. CDS spreads for that credit quality are between 300 and 1000 bps, effectively eliminating all RWA relief, even if the cumulative premium is materially lower than the risk transferred (assuming 40% market standard recovery). We recommend that, should the proposals be implemented as drafted, RWAs are capped at the level of the original underlying asset.

The proposal reduces the measures that a bank has to manage risk and this would result in banks selling down loans that are subject to rating migration. This would put further pressure on the spreads of the name which may lead corporates to seek lending from distressed fund managers, rather than a banking syndicate, which could work effectively with a company through a stress period.

We acknowledge the Committee's concerns around abusive activity. In order to effectively address those concerns, we recommend that the Committee identifies the capital arbitrage trades and their common features, and puts in place specific and targeted criteria that disallow that type of activity. The current, more general, proposal risks capturing a broad range of transactions, many of which are unlikely to be undertaken for capital arbitrage purposes, and thereby penalising genuine commercial activity. This may lead to unintended increases in the complexity of transactions and ineffective risk management practices.

The consultation document makes reference to two types of transaction – securitisation and non-securitisation transactions – and does not distinguish them in the proposals. We believe the two types of transaction must be considered separately to ensure the correct population is identified in applying the proposals and to ensure an appropriate treatment is then applied to that population.

i. Securitisation transactions

With regard to the type of securitisation transaction targeted by the BCBS 2011[2] paper, we do not believe that such types of transaction have been prevalent in the industry due to supervisory intervention since publication of the 2011 paper. It is possible to infer from the absence of problematic transactions in the market that current Pillar 2 provisions in the Basel framework to address the appropriateness of protection recognised against certain exposures, in particular first loss credit enhancements, has served its purpose, namely to prevent execution of such transactions.

However, we agree with the Committee's concerns for the need to address abusive behaviour and believe that an explicit Pillar 1 charge might be appropriate. This can provide transparency to the industry as well as supervisors, and goes some way to address unlevel playing fields that may be otherwise created by supervisory reliance on Pillar 2. However, additional supervisory guidance under Pillar 2 may also be considered.

[2] High-cost credit protection: statement issued by the Basel Committee" paper published on 16 December 2011.

In order to capture the correct Pillar 1 charge, however, it is imperative that the Committee, regulators and the industry understand what features of a transaction are considered to augment the risk of capital arbitrage. There then needs to be discussion on the extent to which those features lead to meaningful transfer of risk, before determining an appropriate Pillar 1 treatment. As noted above, we ask the Committee to participate in an industry roundtable to facilitate this. We understand that, should the Committee publish, for example, a list of features, they should not be considered exhaustive.

With regard to Pillar 2, however, there are two points we would highlight to the Committee:

1. Further to the comment above, we ask the Committee to clarify why the existing Pillar 2 provisions are not considered satisfactory to address the appropriateness of protection recognised against certain exposures, in particular first loss credit enhancements.
2. In order to address any risk of inconsistency through Pillar 2, we recommend that the Committee consult on, and publish, guidelines to support the BCBS 2011 paper. This would assist a consistent application of the rules.

We seek clarification on the proposal to amend paragraph 554(a) for traditional securitisations. The proposed amendment is to add that "Banks must incorporate in this assessment the cost of credit protection purchased in the form of a guarantee or credit derivative that is considered material and therefore a retained position under paragraph 189(a). For transactions where a bank has not transferred significant credit risk through the purchase of credit protection, paragraph 189(a) with regard to the present value of the cost of protection will not apply." Since traditional securitisations transfer credit risk through physical sale, rather than synthetically via guarantees or credit derivatives, the rationale for this amendment is unclear.

ii. **Non-securitisation transactions**

While both this consultation document and the 2011 paper refer to such arbitrage opportunities existing "more generally under the credit risk mitigation framework", it is unclear to us how they would manifest themselves within features of a transaction outside the securitisation framework. We would also question whether any arbitrage was sufficiently material and prevalent to warrant an incremental Pillar 1 capital charge. However, as noted above, we are willing to contribute to discussions in an industry roundtable to identify the population in question and consider suitable methods to address the Committee's concerns. In anticipation of such a forum we would make the initial following comments.

The consultation document suggests that the cost of protection can be too high for riskier assets, however, as discussed above in the section on pro-cyclicality, the cost of protection will increase and decrease according to credit spreads. It would therefore seem inappropriate to apply an RWA charge based on the cost of premium in isolation. Furthermore, implementation of such a charge would create disincentive for banks to manage their credit risk effectively.

Under current regulatory capital requirements, capital is held against loss volatility/unexpected loss (UL) over and above expected loss (EL). Buying credit protection eliminates loss volatility on a name for the protected amount and this should therefore reduce capital. The cost of credit protection is capped at the amount of premium paid and, assuming it is risky, no further premium is to be paid if the company defaults. Recognition of the cost of protection in the income statement over the life of a transaction is therefore appropriate, in particular for distressed names, where material default risk exists and there is a low probability of paying the entire coupon.

Under current IFRS9 impairment proposals, which would result in a move from an "incurred loss" to an "expected loss" model, the accounting provision should mover closer to regulatory EL. We note the IFRS9 impairment proposals are expected to be implemented by 2016, and recommend that the Committee consider their interaction with this proposal.

Based on our comments above, and subject to further discussion on this consultation with the Committee, we recommend that all single-name CDS/TRS and centrally cleared credit protection trades are exempt the scope of the proposals. This would be in keeping with broader proposals under Basel III, and would provide visibility to regulators.

In addition, we recommend that the proposal should exempt credit value adjustment (CVA) hedges. A mark-to-market (MTM) accounting approach is used to calculate CVA, whereby the counterparty credit risk (CCR) exposure

profile for over-the-counter (OTC) derivatives profile is marked to market through income using a current CDS discount rate appropriate for each counterparty.

We also support the proposed exemption on exposures guaranteed by governmental entities (including sovereigns and public sector entities) and trade finance transactions with guarantees.

a) Meaningful transfer of risk

Definition

We are unclear as to what the Committee means with reference to "meaningful transfer of risk". We have inferred from the consultation document that the intention is to consider whether Credit Risk Mitigation (CRM) transactions give risk to a commensurate transfer of risk, however, we would be grateful for clarity on this point. While commensurate risk transfer is existing terminology in the framework, it is also not defined. We provide examples below of how it could be measured, as well as examples of features that could suggest transfer of risk is not commensurate.

We agree that CRM should give rise to commensurate transfer of risk. However we are concerned that, as drafted, the proposals will capture much hedging activity, including that with meaningful transfer of risk. The Committee identifies the cost of protection as the only factor to consider when assessing whether meaningful transfer exists. Since the cost of protection reflects market perception at a given point in the credit cycle, we believe that it should not be considered in isolation. We suggest below a number of factors that could be considered in addition to the cost of protection.

Factors to consider

Most pertinently the cost of protection will move as credit spreads narrow and widen. The current proposal creates disincentive for banks to effectively manage their credit risk position during a period of wide spreads since this would result in a punitive capital treatment that potentially conveys an inaccurate reflection of the bank's true capital position, on the basis that the transfer of risk is considered meaningless. In contrast, the same charge would be much lower for a bank buying protection during a period of narrow spreads.

The following is a non-exhaustive list of commercial rationale factors that could be considered in addition to the cost of protection in assessing whether there is meaningful transfer of risk.

- P&L impact – does the pricing structure exposure the investor to risk of loss of principal?
- Risky or riskless premium:
    - A guaranteed protection premium suggests that a fixed fee is paid regardless of default events or other changes to the transaction. This may be seen to be akin to a loan, and therefore questions the economic substance of the protection trade.
    - Transactions where premium is payable until the default event do not carry the same cost as transactions where the premium continues to be paid after a default event.
- Economic Capital implications – how does the RWA relief recognised compare to the Economic Capital relief recognised?
- (Expected) maturity of the trade
    - Where a transaction includes a call option that allows the protection buyer to buy the risks and rewards of the reference obligation back from the protection provider earlier than the maturity date of the protection trade, protection costs should not be calculated for the full life of the protection trade, especially if there is reasonable ground to believe the option will be exercised.

Certain transactions may have high protection costs, but also contain rebate features whereby the protection buyer receives a refund if there are no losses on the underlying portfolio within agreed timelines. Certain rebate triggers and their function should be considered in line with the commercial rationale factors above. Examples of such rebate features include:

- Expectations of incurring losses after x years.
- Potential mispricing in the market which leads us to pay higher costs.

We also note that the "High-cost credit protection: statement issued by the Basel Committee" paper published on 16 December 2011 ("2011 paper") provides examples of features that supervisors should consider, although have

not been referenced in this consultation. We recommend the Committee revisit these examples and consider them further in drawing up a list of structural features that can be used to identify abusive activity:

"Supervisors also should focus more attention on credit protection transactions that exhibit the characteristics noted below.

- Protection premiums are high relative to the amount of the exposures being protected - for example, when the cost of protection over the life of the protection contract approaches equals, or exceeds, the amount of the exposures for which protection is being purchased. Rebate mechanisms (ie where the protection seller agrees to refund parts of the premium to the protection buyer according to the performance/deterioration of the protected exposure) are an indication of excessive premium and, consequently, regulatory arbitrage.
- Transactions where the exposure being protected has not been fair valued and losses on the exposure have not been recognised in earnings. This situation can increase the potential for a transaction to involve regulatory capital arbitrage in the form of deferral of loss recognition.
- Transactions where the potential for reduction in risk weights or regulatory capital as a result of the transaction is greatest. This is most likely in transactions where the exposures for which protection is purchased would otherwise be assigned a high risk weight, for example, exceeding 150%. Nevertheless, the potential for arbitrage still exists for relatively lower risk-weighted reference exposures, and supervisors may also need to focus on individual transactions level that raise concerns due to unique deal features.
- Protection premiums are not proportional to the exposures being protected. This can occur, for example, when (1) premiums are guaranteed over time without respect to write-downs or default of the reference exposure (that is, the premium payments are not a proportion of the amount of still performing positions of the protected portfolio), or (2) upfront premiums or premiums payable at termination have not been recognised in retained earnings.
- Structural features of the transaction that can increase the total cost of credit risk mitigation. These features can include: high transaction costs for the protection buyer; obligations of the protection buyer to the counterparty to post additional collateral; additional payments at maturity required of the protection buyer; and, early termination of the transaction at the option of the protection buyer. Other features that should lead to increased scrutiny include pre-agreed mechanisms, for example 'at-market unwinds', where the protection seller and protection buyer agree that the transaction can be terminated in the future at an agreed upon 'market' value where calculation of the 'market' value is pre-specified."

http://www.bis.org/publ/bcbs_nl16.htm

b) Supervisory flexibility

We recommend that the supervisory flexibility in Pillar 1 is removed to improve comparability and transparency of the capital calculation, and that Pillar 2 is used to address any particular transaction specificities that cannot be captured adequately in Pillar 1.

The current proposed degree of flexibility given to supervisors is such that implementation of proposals is unlikely to result in consistent application, thereby undermining the Committee's aim in relation to transparency and comparability of RWA calculations. It is already incumbent on firms to address risks not appropriately dealt with in Pillar 1 in their Pillar 2 assessments and Supervisors have the ability to take action if the firm has not acted appropriately.

Examples of supervisory flexibility that we believe should be removed:

- Choice of a materiality threshold that may be higher or lower than 150% risk-weight on the reference asset.
- Choice of a materiality threshold that is based on qualitative features that are not necessarily defined by the proposals.
- Choice of multiple approaches to assess recognition of protection costs.

c) Operational complexity and incremental cost

We recommend that impact analysis be undertaken to quantify the incremental RWA that would be held, based on proposals prior to any final comment from the Committee.

The current proposals, especially with regard to non-securitisation transactions, would lead to a disproportionate level of operational complexity, leading to increased monetary cost to resource implementation of the proposal.

We ask the Committee to confirm whether the proposals are intended to apply to transactions executed after a future implementation date or whether they envisage adoption of any grandfathering provisions. Our recommendation, if the current proposal were to be implemented, is that they apply to new transactions executed after the implementation date, with all historic trades subject to grandfathering provisions.

Additionally we request confirmation of whether the current proposals are expected to be implemented at trade inception or on an on-going basis. To the extent the proposals were to be implemented to securitisation transactions with certain features only, we would be supportive of on-going periodic assessment.

d) Interaction with other parts of the framework

Given publication of the Committee's consultation document "BCBS236: Revisions to the Basel Securitisation Framework" in December 2012, we recommend that the Committee considers the implication of potential interaction between the two proposals. The securitisation proposal will lead to higher risk-weights on all securitisation positions relative to today. Implementing a 150% risk-weight threshold under this proposal will mean many more positions are captured by the rules and lead to significant increases in capital requirements.

We seek clarity from the Committee on how the proposals would interact with the Large Exposures regime. We assume any incremental exposure calculated as a result of these proposals would not contribute towards LE limits on the basis that the exposure represents a timing difference between capital relief and income statement impact, rather than credit risk.

2. Comments on technical guidance

While our immediate recommendation is that the Committee participates in a joint industry forum to discuss the proposals in more detail, we understand that the Committee would benefit from initial comments on the proposal as drafted. We therefore set out below brief points to engender further discussion in a bid to reach the most appropriate outcome.

a. Methods to calculate the PV of premia

The proposed NPV methods for securitisation do not capture the principal at risk for the investor as they only discount the premium income for the bank, but not the loss of capital and time value of having the principal outstanding for a certain period. The principal at risk for the investor is equivalent to capital for the bank, i.e. it is a loss absorbing instrument in a different form. For a proper capital assessment this loss absorbing feature should be incorporated. Given the capital function of the principal at risk this should be discounted at a risky rate, for example the coupon on the tranche or the cost of capital for the protection buying bank. The NPV of the transaction will end up close to zero assuming this is executed at the market implied risk rate.

One of the proposed premium NPV methods for securitisation allows for the income of the portfolio to be deducted from the premium paid. However this leads to unintended side effects and prohibitively negative capital treatment across a credit cycle. Assuming a portfolio is originated in a benign phase of the cycle the spreads and cost of funding for such a portfolio will be low. Typically the drawing level of the portfolio will be low as well. When the credit cycle turns the income will remain the same but cost of hedging and cost of funds will go up. The proposed method effectively eliminates the ability to hedge loan portfolios at that point in time as there will be no capital relief possible (unless the point above is taken into account). For many loan portfolios (SME and small corporates for example) the only hedge available is through securitisation. The proposal is therefore pro cyclical and would force banks to restrict credit to such borrowers in order to preserve capital during stress.

b. SRT assessments

We recommend that operational considerations should consider efficacy via Pillar 1 securitisation SRT and CRM operational conditions. As noted above, valuation is a factor to consider, but in addition to other relevant factors. The proposals for securitisations (paragraphs 554a and 555d) potentially conflate efficacy of risk transfer and valuation. As noted above, additional factors should be considered in assessing the commensurateness of risk transfer. Placing reliance on cost of protection in isolation runs the risk of ignoring pertinent commercial rationale.

Current UK Prudential Regulatory Authority (PRA) requirements for Significant Risk Transfer ("SRT") require us to assess economic substance of the transaction with regards to the evaluation of its commercial rationale. In doing

so, while the regulator does not provide a definition of either "economic substance" or "commensurate risk transfer", Barclays implements its own assessment using the factors listed above.

Further to the evaluation of economic substance, certain SRT tests are performed for each potential SRT transaction with the aim of providing sufficient evidence as to whether SRT has been achieved (i.e. the cost of protection still remains an indicator of SRT however it should not be considered in isolation).

The following steps are taken by Barclays (where applicable) to determine whether SRT is achieved and whether risk transfer is broadly commensurate with the capital relief taken:

- Accounting test - The de-recognition of assets may be considered as evidence of risk transfer.
- Credit Risk Economic Capital test - Regulatory capital relief taken is considered against the standalone economic capital savings.
- Alternative test (e.g. analysis based on the k function underlying the supervisory formula)

The aim of the SRT assessment is to ensure a consistent process that considers multiple factors is followed, rather than to rely on a single criterion.

The Barclays securitisation SRT assessment focuses on the exposure of an investor to volatility of losses as the credit protection swaps loss volatility for a fixed risky premium. Unsurprisingly we find that the investor makes a high return in a zero loss scenario. Bringing in the EL for the portfolio immediately brings down the investor return due to the losses to principal and reduced future interest income (assuming risky cash flows).We then look at the exposure of the investor return to the Unexpected Loss for the portfolio.

A transaction would pass the SRT assessment if we find that the investor breakeven on all cash flows is a low multiple of EL. When applying Basel II capital levels of loss or CDS market implied loss levels the investor loses its entire investment with limited premium income due to the short time to wipe out.

c. **Treatment of losses already recognised in earnings**

We seek confirmation from the Committee that instruments that are marked to market or fair-valued are excluded (i.e. trading book and banking book FV items). Under this accounting treatment the present value of the difference between the default leg and premium leg is fully recognised in income. In this case there would be no premium left that is unrecognised in earnings to treat as an exposure and risk-weight at 1250%. We ask the Committee to confirm that, where bought protection is fair-valued, the proposed treatment does not apply.

We also seek confirmation that the rule does not apply if the exposure on which credit protection has been purchased is fair-valued. As above, this population is out of scope of the proposals given that any gains or losses on the underlying exposure are taken through the P&L.

As noted above, we recommend the Committee considers the interaction of this proposal with those in relation to IFRS9 impairments. Proposed changes under IFRS9 accounting rules would put the net present value of Expected Loss of lower credit quality assets and negative migration assets into earnings, and therefore create a reduction of the capital base. By providing against credit risk assets based on an "expected loss" model, the risk of unexpected loss associated with the underlying loan portfolio is already accounted for and, to an extent, reduced. If a bank, acting prudently, then hedges this loan or portfolio it will recognise a further expense due to hedging costs, but if no capital relief is granted this could prohibit this prudent lender practice and force banks to either restrict credit or sell migrating exposures. A bank purchasing such assets at a discount may then be able to hedge the assets creating an inconsistent approach between institutions.

d. **Treatment of maturity mismatches**

We recommend that banks use the same maturity as would normally be used for capital calculations. As per earlier comments, the current proposals risk capturing a broad range of transactions, many of which are unlikely to be undertaken for capital arbitrage purposes. In doing so, it may lead to unintended further complexity in transactions or ineffective risk management.

As an example, the consultation paper proposes alternative treatments for maturity mismatch, which the Committee recognises may arise as banks have incentive to buy shorter-dated protection as a result of these

proposals. The solution is to address real capital arbitrage trades and not to capture non-arbitrage trades that precipitate further changes to regulation.

3. Recommendations

Based on the comments above, we recommend the following amendments to the proposal:

Response reference	Recommendation
General	We ask the Committee to initiate an industry roundtable to identify example capital arbitrage trades and their common features, and discuss suitable measures to address the risk of those trades recurring. This will also allow the industry opportunity to seek clarification on a number of points in the consultation document. (Q2 p4) We also recommend that the Committee undertake impact analysis subsequent to those discussions to quantify the associated costs of proposals. Barclays is a willing participant in future discussion on this topic. (Q2 p4) We recommend the Committee considers alternatives to the proposed 150% risk-weight. (Q1 p4)
Scope of application	We recommend that, should the proposals be implemented as drafted, they will cap RWAs recognised on the cost of premium at the level of the original underlying asset. (Q2 p5) In order to address any risk of inconsistency through Pillar 2, we recommend that the Committee consult on, and publish, guidelines to support the BCBS 2011 paper. This would assist a consistent application of the rules. (Q2 p6) We recommend that the Committee consider the interaction of IFRS 9 impairment proposals with this proposal. (Q2 p6) We recommend that the scope should exclude the following: • Single name CDS/TRS transactions • Centrally cleared credit protection trades • Credit value adjustment (CVA) hedges • Exposures guaranteed by governmental entities (including sovereigns and public sector entities) and trade finance transactions with guarantees (Q2 p6)
Meaningful transfer of risk	We recommend that "meaningful transfer of risk" is defined as "commensurate risk transfer". Commensurate risk transfer requires consideration of various other factors, which are set out in the Appendix to this letter. (Q2 p7) We recommend that operational requirements for synthetic securitisations should consider efficacy and there should be a separate exposure value section that considers the benefit that should be obtained, notwithstanding we seek confirmation from the Committee that instruments that are marked to market or fair-valued are excluded from the proposals. (Q2 p7)
Supervisory flexibility	We recommend that the proposals remove such flexibility to improve comparability and reduce risk of unlevel playing fields. (Q2 p8)
Operational complexity and incremental cost	Our recommendation, if the current proposal were to be implemented, is that they apply to new transactions executed after the implementation date, and that all historic trades are subject to grandfathering provisions. (Q2 p8) To the extent the proposals were to be implemented to securitisation transactions with certain features only, we would be supportive of on-going periodic assessment. (Q2 p8)

Interaction with other parts of the framework	We recommend that the Committee considers the implication of potential interaction between this proposal and BCBS236: Revisions to the Basel Securitisation Framework. (Q2 p9)
Treatment of maturity mismatches	We recommend that banks use the same maturity as would normally be used for capital calculations. (Q2 p10)

4. Areas where we seek clarification

Based on the comments above, we ask the Committee to provide further clarification on the following points:

Area of consultation	Clarification sought
General	We ask the Committee to initiate an industry roundtable to identify example capital arbitrage trades and their common features, and discuss suitable measures to address the risk of those trades recurring. This will also allow the industry opportunity to seek clarification on a number of points in the consultation document. (Q2 p4)
Scope of application	We ask the Committee to clarify why they believe the existing Pillar 2 provisions do not suitably serve their purpose to address the appropriateness of protection recognised against certain exposures, in particular first loss credit enhancements. (Q2 p6) We seek clarification on the proposal to amend paragraph 554(a) for traditional securitisations. (Q2 p6) We ask the Committee to provide clarity on types of transaction and specific features therein that are considered integral to abusive activity. (Q2 p6)
Meaningful transfer of risk	We ask the Committee to provide clarity on the definition of "meaningful transfer of risk". (Q2 p7)
Operational complexity and incremental cost	We ask the Committee to confirm whether the proposals are intended to apply to transactions executed after a future implementation date or whether they envisage adoption of any grandfathering provisions. (Q2 p8) We also ask the Committee to confirm whether the current proposals are expected at trade inception or on an on-going basis. (Q2 p8)
Interaction with other parts of the framework	We seek clarity from the Committee on how the proposals would interact with the Large Exposures regime. (Q2 p9)
Treatment of losses already recognised in earnings	We seek confirmation from the Committee that instruments that are marked to market or fair-valued are excluded (i.e. trading book and banking book FV items). (Q2 p10) We also seek confirmation that the rule does not apply if the exposure on which credit protection has been purchased is fair-valued. (Q2 p10)