

14 June 2013

Mr Jesus Ibañez & Ms Victoria Saporta
Basel Committee on Banking Supervision
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Dear Mr Ibañez & Ms Saporta,

BCBS246: SUPERVISORY FRAMEWORK FOR MEASURING AND CONTROLLING LARGE EXPOSURES ('LE')

Barclays welcomes the opportunity to comment on the large exposures consultative document. We fully support the Basel Committee's overall objective to ensure greater consistency in the way banks and supervisors measure, aggregate and control exposures to single counterparties, although we do have some observations and concerns on specific aspects of the proposals.

Our response to the consultation questions is enclosed in Appendix 1. Our key messages are reflected below.

Capital quality has been strengthened

We disagree with the proposal to measure exposures relative to Common Equity Tier 1 capital only. While we recognise that the LE regime is intended to serve as a backstop, it is unclear why the capital base for this purpose should be any more limited than for the leverage ratio, where the loss absorbency of Additional Tier 1 items is not in question.

The Committee has significantly strengthened the eligibility conditions for both Additional Tier 1 and Tier 2 capital, through Basel 3 and its *Minimum requirements to ensure loss absorbency at the point of non-viability*. Capital instruments which include mandatory conversion or write-down features linked to the issuer's financial strength are capable of absorbing losses on a 'going concern' basis.

Introducing further restrictions on capital eligibility for LE purposes may significantly reduce the free capacity between a bank's true risk exposure and the backstop limit. This makes the need for risk-sensitive exposure measures more acute, as there is less of a buffer to absorb errors resulting from oversimplified methodology.

No approach is immune from model risk; simplicity comes at a price

Barclays notes the Committee's reservations regarding the use of internal models. We believe the assertion that standardised approaches are better suited to capturing peak exposures has not been proven, particularly in the case of securities financing transactions. We will have to reserve judgment on the successor to the current exposure method (CEM) for financial derivatives, although we note it is critical that the approach eventually adopted reflects netting and other measures which reduce counterparty risk.

The risk associated with internal models can and should be managed through an appropriate degree of internal and regulatory challenge. Backtesting provides an historic perspective on model performance; the use of prescribed benchmark portfolios enables a forward-looking assessment, highlighting differences in approach which can then be challenged by supervisors. If deemed necessary by the Committee, additional conservatism could be introduced in the exposure measure through the use of peak (rather than expected) exposure, stressed underlying assumptions, or a combination of these factors.

Unlike internal models, fixed standardised approaches cannot adapt quickly to significant changes in market conditions or to new products. Consistency and comparability are only desirable goals if we can be sure that the outcome is not 'consistently wrong.'

The LE framework should not create perverse incentives

We agree that the large exposure rules should act as a supplement to risk-based capital requirements, so it is important that the framework does not undermine broader regulatory objectives. For example, we welcome the Committee's recognition that imposing limits on exposures to central counterparties could act as a disincentive to central clearing. Consequently, we believe that these exposures should be reported, but not limited.

Given experience during the financial crisis, we understand the Committee's focus on contingent credit risk to unfunded protection providers, although we would note there is substantial overlap between the LE proposals and other measures adopted in Basel 3. We do not believe funded credit protection should be addressed in the same way, particularly liquid financial collateral. In some cases, the proposed 'risk shifting' approach could act as a disincentive for banks to enter into exposures on a secured or mitigated basis. Banks should not be required to trade off legitimate credit risk management activity against LE.

The need for proportionality

We agree that the focus of the LE framework should be the risk of loss due to unexpected default by a single counterparty. But it is not practicable for the framework to exhaustively capture all possible sources of risk and all possible relationships between counterparties. Materiality considerations should be permitted in the following areas:

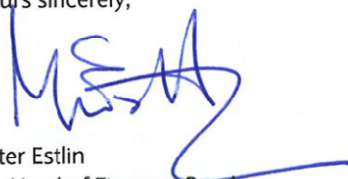
- identification of connected counterparties due to economic interdependence;
- recognition of second-order risks to collateral issuers, in the event that a counterparty defaults and the bank is unable to realise value from the collateral;
- look-through approaches for collective investments schemes and securitisation transactions; and
- additional risks in collective investment schemes and securitisation.

Implementation in 2019 allows time for further testing and enhancement

With simultaneous proposed changes to the definition of capital, measurement of exposures, rules for aggregating counterparties, rules for looking through structured vehicles and limits to GSIBs, the potential for unintended consequences should not be disregarded. The current QIS exercise will not address the full impact – for example, neither the replacement for CEM nor the revision of solo entity calculations is being tested. Barclays would advocate an explicit monitoring period, similar to the approach taken for the leverage ratio, with the opportunity for the Committee to revise and refine the proposals before final adoption in 2019. Furthermore, we believe this could also allow competing options to be tested thoroughly – for example, comparing whether standardised approaches or internal models estimate peak exposures more robustly.

I hope you find our comments and suggestions helpful. Please do not hesitate to contact Sam McAuliffe (sam.mcauliffe@barclays.com or +44 20 3134 1176) 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. The Committee welcomes views on the proposed definition of large exposures and on the proposal for reporting.

We do not object to the definition of large exposures, the proposed reduction in the reporting threshold for large exposures (LE) to 5% of eligible capital, or the proposal that all such exposures should be reported to supervisors.

We note these changes will significantly increase the volume of LE data that supervisors need to consider, so we would question whether supervisors need further support on the monitoring and investigative tools that should be employed. For example, we would assume that an exposure marginally above 5% of eligible capital warrants a different response to an exposure above 20% of eligible capital. It is important that the reporting threshold is not seen as a de-facto limit by supervisors, especially given that the proposals on exposure measurement and capital eligibility would increase the relative size of many existing exposures.

The Committee proposes that exposures should be reported both pre- and post credit risk mitigation. We would like further clarity on the status of netting under these arrangements, particularly in respect of portfolio measures such as the internal models method (IMM) or any successor – for example, IMM is only calculated as a net measure, so there is no pre-mitigation exposure valuation available.

2. The Committee welcomes views on the criteria proposed for the identification of connected counterparties when they pose a single risk.

We agree with the criteria for assessing interconnectedness by virtue of ‘control.’ We also agree that it is important – albeit challenging – to consider economic interdependence, not just ‘control’ in a legal or accounting sense.

In assessing economic interdependence, a proportionate approach is needed: the aim should not be to exhaustively capture every possible interrelationship, but rather to establish which connections could give rise to large exposures from the perspective of the bank. For example, current EU guidelines recommend that counterparty exposures which represent 2% or more of own funds in their own right should be investigated intensively for other connections. We recognise it is technically possible for exposures below this threshold to be interconnected, producing a large exposure in aggregate, but we believe the following principle should apply:

“...all interconnections to the knowledge of an institution shall be recognised, independently of the size of the exposure. As the determination of interconnection is dependent on the one hand on economic judgement, and on the other hand on the information available to, or gathered on a best effort basis by the reporting institution, it is possible that different institutions will arrive at different results when analysing the same entities. Supervisors should be aware of this issue and subject to the specific case may [accept] or challenge such differences.”¹

Supplementary, targeted guidance may be required in areas where the Committee has specific concerns regarding economic interconnection. For example, to support a consistent approach by UK banks, the FSA issued specific guidance on the treatment of Asset Backed Commercial Paper conduits and other structured finance transactions.²

3. The Committee welcomes views and quantitative information on whether the limit should be based on CET1 or Tier 1.

Barclays accepts the Committee’s reasoning for excluding general provisions from the capital base against which large exposures are measured.

We disagree with any more general exclusion of Additional Tier 1 (AT1) and Tier 2 (T2) instruments from the large exposures capital base. In particular, it is not clear to us why the large exposures backstop should require a

¹ CEBS (2009) *Guidelines on the implementation of the revised large exposures regime*

² FSA (2012) *Large exposures regime – groups of connected clients and connected counterparties*

narrower capital base than the leverage backstop, which is based on Tier 1 (T1). We recognise that the financial crisis highlighted concerns over the loss absorbency of items beyond CET1, but the LE proposals should not disregard the steps regulators and banks have subsequently taken to strengthen the quality of capital.

We believe a simple distinction between ‘going concern’ and ‘gone concern’ capital is less relevant where instruments include features leading to mandatory conversion into CET1 or write-down of principal on occurrence of pre-defined triggers. Such features ensure these instruments are capable of absorbing losses on a ‘going concern’ basis following conversion; in the case of AT1, the ability to cancel coupon payments provides further loss absorbency before any trigger event. We note that a number of jurisdictions, including the UK, have encouraged banks to issue capital of this type to address shortfalls and reduce contingent exposure for the domestic taxpayer.³

We recognise that the majority of AT1 and T2 instruments currently in issue do not have conversion or write-down features. By the time the proposals take full effect in 2019, we would expect the Committee’s stated *Minimum requirements to ensure loss absorbency at the point of non-viability* to have redressed the balance. If deemed necessary, any remaining historic AT1 or T2 items subject to phasing out could be excluded from the large exposures capital base.

Limiting the capital base to CET1 would significantly reduce the absolute amount permitted under the limits, before taking account of any of the other proposed changes on exposure measurement. Using Barclays as an example, the impact on a pro-forma basis would be as shown below. The current EU proposals are also included for comparison, whereby the amount of T2 capital eligible for large exposures purposes will be limited to one third of T1:

	T1+T2 capital	CRD IV	T1 capital	CET1 only
25% limit	£14.6bn	£13.3bn (-12%)	£9.7bn (-34%)	£9.6bn (-34%)
15% GSIB limit	£8.7bn (-40%)	£8.0bn (-47%)	£5.8bn (-60%)	£5.8bn (-60%)
10% GSIB limit	£5.8bn (-60%)	£5.3bn (-65%)	£3.9bn (-73%)	£3.8bn (-74%)
Assumed LECB	£58.2bn	£51.5bn	£38.6bn	£38.4bn

Source: Table 57, 2012 Barclays Pillar 3 disclosures. All capital measures are shown at the Barclays PLC consolidated level, after expiry of transitional arrangements and phasing out of all ineligible instruments. Brackets indicate change relative to a 25% limit based on T1+T2 capital measured on this end-state basis. Under current rules, consolidated LECB (T1+T2 capital) is £72.2bn, giving a 25% limit of £18.0bn.

The above analysis is on a pro-forma basis and therefore does not reflect:

- replacement of ineligible AT1 and T2 instruments; or
- the additional capital that may be retained within the group or issued in order to meet end-state Basel 3 and local capital requirements.

We do not think it is the case that the higher minimum requirements under Basel 3 will lead to a significantly higher LECB, thereby dampening the effect of tighter LE requirements. This is because many of the impacts of Basel 3 adjust the capital base directly rather than increasing RWA. In the case of Barclays, an additional £8.4bn of CET1 would be required to meet our targeted 10% CET1 ratio, assuming £468bn of projected RWA. This would only permit a further £2.1bn of exposure to counterparties subject to a 25% limit, or £0.8bn-£1.3bn to GSIBs.

³ para 28, Record of Financial Policy Committee Meeting held on 19 March 2013
<http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2013/record1304.pdf>

4. The Committee welcomes views on the extent and nature of the use of internal models (when they have received approval for being used for Pillar 1 capital requirements purposes) to measure large exposures.

We broadly agree that there should be no application of risk weighting for LE purposes, while recognising that there may be some overlap between items which qualify for a 0% risk weighting and items which will be exempt from LE limits.

We believe the suggestion that the exposure measure should reflect “*the maximum possible loss*” is not feasible. On derivative exposures, it is possible to construct theoretical scenarios in which a bank is exposed to infinite loss – for example, if interest rates or foreign exchange rates increased to infinity. We suggest the LE framework should instead seek to address a ‘severe, but plausible’ loss scenario. In most cases, the removal of risk weights ensures the scenario is more conservative than the risk-based capital framework, but we would also accept that the exposure measure itself could be defined more conservatively. As the Committee notes, some banks (including Barclays) assess the full term peak exposure derived from their IMM models in determining single counterparty limits, rather than the time-weighted, 1-year exposure measure prescribed for risk-based capital.

The Supervisory Guidance on Model Risk Management⁴ applied by US regulators observes that “*models by their nature are simplifications of reality, and real-world events may prove those simplifications inappropriate.*” But standardised or formulaic approaches to exposure measurement are also ‘models’ and hence are not immune from model risk. For example, the Committee proposes that the financial collateral comprehensive method (FCCM) should be used to determine exposures on securities financing transactions, rather than the IMM approach. The use of fixed volatility adjustments creates two potential types of model error as a result of simplification:

- the collateral is more volatile than the fixed adjustment, exposure is understated; or
- the collateral is less volatile than the fixed adjustment, exposure is overstated.

We consider this example in more detail in Appendix 2.

We understand that regulators are naturally concerned with the first type of error, which may be reduced through ensuring the approach used is calibrated conservatively. But we do not think the second type of error should be dismissed. At one extreme, a lack of risk sensitivity in the exposure measure may prevent economically productive activity from being undertaken, because a limit would otherwise be breached. More saliently, a lack of risk sensitivity in the exposure measure reduces the ability of supervisors to differentiate between banks: to what extent are the exposures reported due to a genuine risk concentration, or because of inadequacies in the exposure measure?

Barclays accepts that all of the above can also be said of approaches based on internal models. We also understand the appeal of simplicity and comparability, although we disagree that elimination of differences in measurement of the same risks is a desirable end in itself. This presupposes that the ‘right approach,’ free of model errors, is known and simply has to be applied across the board. While this is not the case, allowing diversity in internal approaches helps to guard against herd behaviour and strengthens the alignment between a bank’s own risk management and regulatory objectives.

We fully agree with the principle stated in the US supervisory guidance that “*model risk should be managed like other types of risk.*” This would suggest a need for effective control of internal approaches rather than outright prohibition. For example, the challenges of comparability and lack of transparency, which also apply within the risk-based capital framework, can be partly addressed through benchmarking with standard portfolios. It is not necessarily problematic if different models produce different results for the same benchmark portfolios, provided that the banks can explain and justify the differences to the satisfaction of supervisors. Supervisors should also have sufficient tools to address excessive dispersion in results.

⁴ <http://www.federalreserve.gov/bankinfo/srletters/sr1107a1.pdf>

5. The Committee welcomes views on the proposal to calculate exposure value of banks' investments in OTC derivatives.

We are naturally cautious regarding a proposal to use the CEM's successor for LE purposes when the details have yet to be released, but we welcome the Committee's decision not to impose CEM or the standardised method at this stage. It is important that the successor approach reflects the features of derivative exposure management realistically, with appropriate allowance for netting, margining and short-term close-out.

We are not persuaded by the assertion that "*non-internal model methods are better suited*" to capturing a peak loss exposure than internal methods. Echoing our comments above, the same models used for IMM can be adapted to produce a peak exposure measure over the full term of the netting set, or by using the stressed EAD assumptions required by paragraph 98 of Basel 3, or both.

6. The Committee welcomes views on the proposal for how the exposure value of banks' investments in securities financing transactions should be calculated, in particular on the need to deviate from the risk-based capital requirement rules given the objectives of a large exposures framework.

As Barclays has IMM approval for determining the capital requirements for securities financing transactions, we are naturally disappointed that the bank would need to implement a separate exposure calculation for LE purposes, in addition to the measure used for leverage and in addition to the measures we use for risk management. We understand the Committee's desire for simplicity and consistency, but we disagree that the proposed approach avoids the introduction of model risk; the use of fixed supervisory haircuts for volatility gives rise to potential for error in both directions.

7. The Committee welcomes views on the proposal to generally apply a 100% CCF for "traditional" off-balance sheet commitments.

We agree that, in general, there should be consistency with the leverage ratio. We welcome the adjustments for exposures relating to trade finance exposures.

We believe that the undrawn portion of unconditionally cancellable facilities should continue to be exempt from LE limits given there is no credit exposure for the bank. We recognise that there may be a concern over clients drawing down on facilities at a time when their creditworthiness is deteriorating and the bank failing to intervene. While we would suggest this is primarily an operational risk rather than a credit risk, a compromise would be to apply the 10% CCF such facilities would attract under the leverage ratio.

8. The Committee welcomes views on the proposed hybrid approach for banks that apply the "comprehensive approach" to financial collaterals.

Unfunded protection

We understand the Committee's concerns regarding contingent exposure to unfunded protection providers given the specific example of AIG cited in paragraph 5. The 'risk shifting' approach for LE would fully substitute the exposure to an obligor with an exposure to the credit protection provider, assuming no recovery from either party. This covers a scenario in which full default of the underlying is followed by or precipitates full default of the protection provider, possibly due to a hidden build-up of correlated risks. During the financial crisis, the counterparty risk capital charges against credit protection providers may not have adequately reflected the contingent risk to which banks remain exposed.

We would note that many of the changes adopted under Basel 3 already strengthen the treatment of counterparty credit risk, for example:

- enhanced requirements on the assessment of wrong-way risks;
- supplementary use of stress assumptions when modelling counterparty credit risk exposures;

- increased asset value correlation assumptions for financial sector counterparties; and
- capital requirements for credit migration risk (CVA volatility) in addition to default risk.

It is not clear to us that applying a full substitution approach would add significant incremental protection for such counterparty risks. Per our earlier comment, we recognise that double default with zero recovery represents the 'maximum possible loss,' but does not represent a 'severe, but plausible' scenario. Ultimately, our concern is that good credit risk management may be discouraged by applying a simple substitution of obligors. A bank could obtain credit protection on an asset, take steps to ensure the counterparty credit risk on the protection provider is minimised – for example, via credit support agreements – and even purchase eligible hedges for the CVA volatility risk. All of these steps would be recognised (and, indeed, incentivised) via the risk-based capital framework, but not for LE purposes. At the extreme, a bank might be compelled to leave a credit exposure unprotected if full substitution would otherwise cause a limit to be breached.

Replacing unfunded credit protection

From industry discussions with the Large Exposures Group, we understand the Committee may also be concerned with the risk of loss when a protection provider becomes insolvent and the underlying exposure is left unprotected. Three scenarios could subsequently follow:

- (1) The bank is able to replace the credit protection.
- (2) The bank is not able to replace the credit protection and the underlying exposure immediately defaults; this implies there is material correlation between the underlying exposure and the original protection provider i.e. wrong-way risk.
- (3) The bank is not able to replace the credit protection and holds the underlying exposure unhedged; the bank is required to hold regulatory capital against the exposure and may incur credit losses during its remaining lifetime.

We believe the costs of replacing credit protection under the first scenario would be captured in the counterparty risk exposure measured against the original protection provider.

An appropriate response to the second scenario, where wrong-way risks have been identified, would be to disregard the credit protection. Alternatively, if the Committee is concerned about build-up of exposure to protection providers, the full notional could be considered as an exposure to both the underlying and the protection provider.

The third scenario is captured by the proposal to report exposures on a pre- and post-mitigation basis. Alternatively, the residual exposure to the asset could be set equal to the amount of regulatory capital that would need to be held against the asset in the banking book, absent any hedging.⁵

Financial collateral

We are not persuaded that the 'risk-shifting' principle should be applied to liquid financial collateral, where the exposure methodology aims to convert the collateral into a cash-equivalent realisable value, after adjusting for volatility during the close-out period. Unlike a guarantee or credit derivative, no additional financial burden is placed on the issuer of that collateral in the event of the underlying obligor's default. As per paragraph 124 of the Basel Accord, collateral should not be recognised as risk mitigation where there is a material positive correlation with the obligor. Therefore our chief concern in an enforcement scenario is not whether the collateral issuer will default, but rather that we should be able to realise sufficient value to cover the credit loss or otherwise use the assets in our business (for example, to raise funding). Factors such as market liquidity and issue size are likely to be of greater relevance here than size relative to our own capital resources.

As a practical matter, we would observe that much non-cash collateral is in the form of sovereign bonds, which are not considered in the Committee's proposals.

⁵ For example, a bank obtains credit protection on a \$100m bond. The bank is subject to a minimum regulatory CET1 ratio of 9.5%. The bond would attract a 100% risk weight if held without hedging in the banking book. As well as marking a counterparty risk exposure to the protection provider, the bank would report an exposure of \$100m x 100% x 9.5% = \$9.5m to the bond.

Many collateral agreements give counterparties the ability to substitute freely within a pre-agreed schedule of items, subject to economic haircuts – for example, ‘any AAA security’ or ‘any EuroStoxx equity.’ This presents the scenario that collateral recorded as an exposure to issuer x could in fact become an exposure to issuer y before the counterparty’s default. We do not think it is practical or desirable to limit flexibility in collateral arrangements; the collateral belongs to the counterparty and is subject to their own investment objectives. Nor do we think it would be feasible to require the exposure to be marked against each and every potential collateral issuer; this would lead to the perverse outcome that a bank could be penalised under the LE framework for entering into a secured rather than an unsecured exposure. The example illustrates that a simple limits-based regime for exposures to single counterparties is perhaps not the most effective tool for addressing the complexities of contingent risk and multiple defaults.

9. The Committee welcomes views on whether the approach proposed for calculating exposure values for trading book positions raises specific issues.

Subject to our response to Q10, we agree with the approach proposed.

We note the proposed treatment of option exposures and welcome the Committee’s recognition that such non-linear items can provide offset to linear holdings of the same underlying risk. But we view the focus on a ‘total loss’ scenario for the underlying asset as having the potential to generate distortions, particularly with regard to deeply out-of-the-money options. For example, a deeply out-of-the money put option would generate a profit (and hence a ‘negative exposure’) in the extreme scenario where the underlying asset falls to zero, even though intermediate scenarios could give rise to a greater overall loss for the bank.

On balance, we think it would be preferable to follow the delta-weighted approach from the risk-based capital framework for exposure measurement on options. Non-delta risks should continue to be capitalised in the risk-based framework.

10. The Committee welcomes views on the proposals for offsetting long and short positions, in particular when these positions are in different issues.

We agree that long and short positions in different instruments from the same issuer should be considered for risk offset when assessing large exposures. We also agree that short positions should only be recognised to the extent that the underlying instrument is *pari passu* or more junior than the hedged item. We believe this principle is sufficiently clear and that there is no need for the proposed bucketing approach, which may lack the granularity to restrict offsets appropriately – for example, positions in another bank’s AT1 and T2 instruments would both fall into the “subordinated debt” bucket, despite the clear difference in seniority.

We note the Committee’s comments regarding the treatment of positions hedged by credit derivatives and the desire for a simple approach. We understand that the haircuts applied in the risk-based capital framework address the potential for the hedge to be less effective, due to interest rate or FX-related valuation changes or because of structural features in the credit derivative. We have no objections to the proposal, but we would be equally supportive if the recognition of credit derivative hedges was limited in the same way as it is for risk-based capital.

Given the typically shorter holding horizon in the trading book, we agree that it is not appropriate to offset positions across the banking and trading books. We believe further clarity is needed on the treatment of internal hedges between the banking book and the trading book; if these are recognised for risk-based capital purposes they should also be valid for LE purposes.

11. The Committee welcomes comments on the proposal regarding interbank exposures and in particular in which cases specific exemptions would be warranted.

We agree with the proposed treatment of interbank exposures. We welcome the Committee's pragmatism with regard to certain intraday and overnight exposures. We believe the exemptions applied in the EU provide an appropriate template, namely:

- *"in the case of foreign exchange transactions, exposures incurred in the ordinary course of settlement during the two working days following payment;*
- *in the case of transactions for the purchase or sale of securities, exposures incurred in the ordinary course of settlement during five working days following payment or delivery of the securities, whichever the earlier;*
- *in the case of the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking or financial instruments clearing, settlement and custody services to clients, delayed receipts in funding and other exposures arising from client activity which do not last longer than the following business day;*
- *in the case of the provision of money transmission including the execution of payment services, clearing and settlement in any currency and correspondent banking, intra-day exposures to institutions providing those services."*

Source: Article 379(6), Regulation on prudential requirements for credit institutions and investment firms

12. The Committee welcomes comments on the calibration of the granularity of the threshold and whether the mandatory application of the look-through approach to the transaction where an underlying exposure may exceed the granularity threshold will raise specific issues.

We strongly agree with the over-arching requirement to strike an appropriate balance between the significant effort that will be required by institutions to identify exposures in very granular portfolios and the financial stability benefits being achieved as a result of capturing these exposures. We note this feature is not present in the current EBA consultation paper on schemes with underlying assets;⁶ we support the Committee's efforts to establish a workable approach that can be applied on a consistent basis globally.

The same consideration of applying an appropriate balance should also be extended to incorporate the materiality of exposures to schemes. A mandatory requirement to apply look-through based on the single criterion of granularity does not accurately reflect the underlying risk of the exposure, especially where this requirement is applied without consideration of the corresponding materiality of the exposure, in the context of the reporting institution. As an example, a small non-granular scheme which is immaterial to a reporting bank will require a significant effort to capture each individual underlying exposure whilst providing no additional benefit in the assessment of single name concentration risk.

The proposed calibration of the granularity threshold of 1% of the total value of the transaction will similarly increase the operational burden without a corresponding benefit on the recognition of underlying material exposures, especially if this assessment does not consider the materiality of the exposures for the reporting bank.

In determining whether lookthrough should apply, we would propose that banks consider the product of:

- the largest underlying asset as a proportion of the transaction; and
- the bank's total exposure to the transaction as a proportion of its eligible capital.

All assets above a predefined regulatory threshold would need to be identified and (where applicable) aggregated with other exposures. Where identification is not achieved, such exposures should be assigned to an 'unknown issuer' bucket and aggregated.

We would not propose that any assets under the threshold should automatically require lookthrough. We understand this approach may present two concerns for supervisors:

⁶ EBA (2013) *Draft Regulatory Technical Standards on the determination of the overall exposure to a client or group of connected clients in respect of transactions with underlying assets under Article 379 of the proposed Capital Requirements Regulation*

- (1) interconnections arise 'by accident:' a bank is unwittingly exposed to issuers via a fund or securitisation where it already has exposures to the same issuer on its balance sheet;
- (2) interconnections arise 'by design:' a bank exploits the presence of a granularity threshold to disguise its true level of exposure to a given counterparty.

In the case of securitisation, we believe some mitigation for the first point is provided by national regulations on investor due diligence. In the EU, banks are required to perform due diligence on the positions underlying a securitisation prior to any investment. Equivalent rules apply in the United States and in many other jurisdictions. While this may not mean identification of each individual exposure, it should ensure the risk characteristics of the underlying assets are assessed. For example, a bank that already had significant balance sheet exposure to pharmaceutical companies would take a cautious approach to any securitisation with significant underlying exposure to the pharmaceutical sector; the same concerns would not necessarily arise for the bank if a securitisation contained exposures to the automobile sector.

On the second point, we note that the LE framework is intended to provide a simple backstop. We would not view changing its general design as the most appropriate or proportionate response to abusive behaviour by individual banks.

From industry discussions with the Large Exposure Group, we understand the Committee is open to suggestions on how to reflect the effects of credit enhancement in the LE framework. Barclays suggests that the existing guidance in the EU provides a simple approach: banks would reduce the exposure to each underlying asset by their pro-rata share of any credit enhancement, subject to a floor of zero. If deemed necessary, this approach could be limited to seniormost securitisation positions as defined in *BCBS236 Revisions to the Basel Securitisation Framework*.

13. The Committee welcomes comments on the proposals for the treatment of the identified additional risks in the large exposures framework.

We recognise the Committee's concerns on the build up of additional risks and the proposal to capture these within the large exposures framework; however, we believe that most significant sources of systemic risks are already captured via the other limits proposed under the LE framework and the existing risk-based capital requirements.

The proposal for banks to consider undefined and yet potentially extensive ranges of possible sources of risk is unlikely to provide a meaningful metric to assess the build-up of risk, whilst having the effect of displacing resources. As suggested in our response to question 12, any requirement should be applied with appropriate recognition of the materiality of the exposure for the reporting institution.

A potentially unintended consequence of requirements on 'additional risk' exposures would be to restrict business activities in markets with less developed competitive environments. As an example, a particular market may have only one significant market participant providing appropriate fund management expertise who meets certain counterparty credit rating requirements. Such limits would therefore serve to limit exposure and thereby restrict growth in such markets.

14. The Committee welcomes views on the options for the treatment of banks' exposures to central counterparties (CCPs).

We welcome the Committee's recognition of the special status of central counterparties and the potential adverse consequences of applying a simple limit to such exposures. If option 1 was adopted, the need to avoid conflicting with the G20's recommendations on central clearing of standardised products would mean setting a limit so high as to be rendered meaningless. But we agree that it is important for supervisors to be able to detect risk concentrations to CCPs and to probe the reasons for them – for example, whether this is due to insufficient market depth or because of an active decision by the bank to minimise exposure to certain other CCPs. We therefore support option 2 as the most pragmatic solution in the near term.

Absent the use of IMM, trade exposures and default fund contributions could result in very large values being reportable to CCPs; in the case of qualifying CCPs, this would not reflect the relatively benign nature of the

underlying credit. If option 1 is adopted in the future, a suitable period should be allowed for calibration taking into account the fundamental shift in exposures towards CCPs over time as a result of mandatory clearing.

We agree that indirect access to a CCP should be governed by the same rules as for solvency purposes. By the same token, we would suggest that a clearing member should not mark exposure to a CCP to the extent that the end client bears all of the credit risk i.e. the clearing member does not guarantee the client for the CCP's default.

Additional comments from Barclays on the consultative document

Exposures to Global Systemically Important Banks (GSIBs)

Conceptually, we do not see the need to apply a lower limit for GSIB exposures. We recognise the Committee's concerns regarding contagion, but we believe that the potential systemic risks associated with GSIBs have already been addressed through:

- the GSIB capital buffers;
- the ongoing efforts to strengthen resolution and recovery arrangements; and
- proposals on structural separation/ring-fencing.

A comparison could be drawn with the approach on exposures to CCPs, where the Committee notes hard limits may not be practical given regulatory initiatives to mandate central clearing – there is tacit recognition that banks have little choice but to be exposed to CCPs. By contrast, imposing stricter limits on GSIBs presupposes that banks always have an alternative to dealing with a GSIB, which simply may not be the case with regards to scale, range of service or credit risk appetite. It could be counterproductive, for example, if a bank chose not to enter into risk management activity because it would otherwise mean incurring exposure to a GSIB.

A lower limit for GSIB exposures is only likely to be workable if (i) the exposure methodology is capable of reflecting margining and close-out features; and (ii) the capital base includes any instrument which is capable of absorbing losses, without artificial limitation. Absent this, it is possible that a bank could breach a limit to a GSIB because of oversimplification in the exposure methodology, rather than because the activity necessarily presents an additional risk of financial contagion. In essence, the cost of reflecting contagion risks within the LE framework is to accept a degree of risk sensitivity in both the exposure and capital measure.

Intragroup exposures

Barclays notes that intragroup exposures are not included in the proposed framework, but the Committee may return to this in future work. We would welcome further clarity regarding the timing of this work and confirmation that there should be no presumption of an automatic readacross from the external LE framework prior to this.

Implementation and transitional arrangements

We welcome the Committee's proposal to implement the LE framework on 1 January 2019, after full implementation of the Basel 3 revisions to capital.

We note the comments regarding early reporting and have some reservations that this could lead to front-running. As per our main comment letter, we would advocate an explicit monitoring period, enabling the Committee to revise and refine the proposals before final adoption.

Appendix 2: illustration of model risk in the FCCM approach

Under FCCM, a supervisory volatility adjustment of 10.607% applies to exposures or collateral in the form of main index equity. This assumes that the underlying transaction is a repurchase agreement or similar transaction with a five-day liquidation period.

The supervisory volatility adjustments effectively translate collateral into a cash-equivalent realisable value. Our understanding is that the adjustment reflects the price volatility the instrument could experience during the liquidation period – for example, a counterparty pledges \$100 of equities against \$100 of borrowing, defaults, and the bank not able to recover the full value when it can finally enforce on the collateral.

Volatility adjustments are applied symmetrically. For example, in a repurchase agreement, a bank could borrow \$100 of cash and pledge \$100 of equities. If the counterparty became insolvent, the risk is that the equities loaned could have appreciated in value, leaving the bank exposed to a loss when it can finally enforce on the cash.

Conceptually, equities received as collateral could fall to zero, or equities loaned as collateral could increase in value infinitely. The supervisory volatility adjustments therefore implicitly reflect a confidence level for changes in value over the specified liquidation period. No confidence level is stated explicitly for the supervisory volatility adjustments, but the ‘own-estimates’ approach mandates 99%.

Method

- We considered the five-day market price volatility of three major equity indices: EuroStoxx 50, the FTSE 100 and the S&P 500, for the 15 years from 1 January 1998 to 31 December 2012.
- Volatility was measured as the difference between the highest and lowest closing price in each five-day period, relative to the lowest closing price, irrespective of direction. For example, if the highest closing price in a given five-day period was 105 and the lowest closing price 100, the volatility measure would be $(105-100)/100 = 5\%$.
- To simplify the analysis, intra-day prices were not considered, even though these could be well outside of the price ranges measured and thus indicative of greater volatility.
- For each year, we counted the number of occasions on which the five-day volatility measure exceeded the supervisory volatility adjustment of 10.607% for the equity exposure in question.

Results

Number of business days on which five-day rolling volatility measure exceeded 10.607%

	EuroStoxx 50	FTSE 100	S&P 500
1998	6	0	2
1999	0	0	0
2000	0	0	2
2001	5	1	0
2002	10	6	3
2003	5	2	0
2004	0	0	0
2005	0	0	0
2006	0	0	0
2007	0	0	0
2008	19	18	24
2009	0	2	2
2010	1	0	0
2011	7	1	2
2012	0	0	0

Source: Barclays

Interpretation

A 99% confidence interval would imply that the supervisory volatility adjustment should only understate true volatility on 1% of business days, or 2.5 business days per annum. The results show that, over the test period, this threshold was exceeded in 6 of 15 years for Eurostoxx 50 and on 2 years each for FTSE100 and the S&P 500.

It could be argued that the period in question was atypical due to the occurrence of events such as the LTCM crisis in 1998, market interventions following terrorist attacks in the early 2000s and the global financial crisis. However, this would seem to provide little comfort given the stated purpose of the LE regime is to address unexpected losses. The fixed supervisory volatility adjustment did not (and would not) adapt to general periods of increased volatility, however temporary; this would have required a change in calibration from the Committee, which would take time to implement.⁷

Individual equities could experience greater or lower volatility than the index as a whole. For example, the S&P 500 financials sector index exceeded the 10.607% volatility threshold on 147 occasions between 2003 and 2012, compared with 31 occasions for the full index over the same period. A simple volatility adjustment for main index equities as a class is not capable of reflecting these differences.

By the same token, there are many periods in which a 10.607% volatility adjustment significantly overstated the true five-day volatility of these equities. Measured over the full 15 years, a 99% confidence level would imply a five-day adjustment of 6.922% for Eurostoxx 50, 5.489% for FTSE100 and 5.662% for the S&P500.

We have no reason to believe that supervisory volatility adjustments for sovereign bonds, corporate bonds or gold would be immune from the issues described.

Conclusions

1. The supervisory volatility adjustments approach is itself exposed to model risk.
2. While all approaches are exposed to model risk, the assertion that non-modeled approaches are better suited to capturing peak exposures is not proven.
3. The relative performance of modeled and non-modeled approaches should be tested before concluding the most appropriate measure.
4. The advantages of consistency and simplicity from non-modeled approaches should be weighed against the disadvantages of inflexibility/slow capacity to adapt to changing circumstances.

⁷

For example, the performance of securitisation and resecuritisation collateral during the 2008 financial crisis led the Committee to propose a number of changes to the volatility adjustments. These proposals were first issued in December 2010, with the earliest implementation in January 2013.

Appendix 3: summary of our suggestions

Element	Basel Committee proposal	Suggestion from Barclays
Reporting threshold	5% of eligible capital or 20 largest exposures	As proposed, with additional guidance for supervisors on application
Eligible capital base	CET1 or T1	CET1 plus capital items which convert into CET1 or are written-off on the occurrence of a trigger
Interconnection	Counterparties grouped on basis of control and economic interdependence	As proposed, with additional guidance on areas of specific supervisory focus e.g. conduits
Off balance sheet items	100% CCF, with exceptions for trade finance related exposures	Consistency with the leverage ratio, including 10% CCF for unconditionally cancellable facilities
Use of internal models	Prohibited on grounds of model risk	Use benchmarking and backtesting to manage model risk
Counterparty risk on financial derivatives	Anticipate using CEM successor approach	Test CEM successor approach against IMM
Counterparty risk on securities financing transactions	Use FCCM approach with supervisory haircuts	Test FCCM approach against IMM
Options	Simulate the effects of a total loss	Delta weighting, as per risk-based capital framework
Credit derivatives	No restrictions on offset	Follow the same restrictions as per risk-based capital framework
Instruments with different seniority	Bucketing approach	Offset limited to instruments of same or preferable seniority
Financial collateral	Report exposure to the collateral issuer	No exposure to collateral issuer
Unfunded credit protection	Full risk-shifting / substitution approach	<ol style="list-style-type: none"> 1. Record counterparty risk on protection provider 2. In cases of wrong way risk, record full notional exposure to both asset and protection provider 3. Otherwise, record residual exposure to protected asset, covering risk that protection cannot be replaced
Lookthrough for securitisation and funds	Mandatory lookthrough where assets exceed 1% of scheme	Lookthrough threshold based on asset's share of scheme, multiplied by scheme's share of bank's eligible capital
Securitisation credit enhancement	No benefit	For senior tranches, reduce exposure to underlying assets by amount of credit enhancement
Exposures to Qualifying Central Counterparties	High limit or reporting only	Reporting only
Interbank exemptions	Relate to payment/settlement systems and monetary policy	Use current EU exemptions as a template
Exposure to Global Systemically-Important Banks	Lower limit to address risks of contagion	Lower limit only if exposure measure and definition of capital are sufficiently risk sensitive
Implementation	2019	2019, after explicit monitoring period to refine and revise proposals