

27 September 2013

Basel Committee on Banking Supervision
Centralbahnplatz 2
CH-4002 Basel
Switzerland

barclays.com

Dear Sirs,

CAPITALISATION OF BANK EXPOSURES TO CENTRAL COUNTERPARTIES

Barclays welcomes the Basel Committee's consultative document "Capitalisation of bank exposures to central counterparties" (BCBS253) and we acknowledge the importance of the issues raised therein. We have also contributed to the FOA/GFMA/IBFed/IIF/ISDA response and are supportive of the points raised in that document.

Barclays has been active in client clearing of futures for over 20 years and OTC's for 4 years, providing access to over 50 markets worldwide via both Barclays Bank PLC in Europe and Asia and Barclays Capital Inc, our Futures Clearing Merchant entity in the US. Our current market share in OTC client clearing is in the region of 20 – 30% on new business and approximately 40% cumulatively, the latter figure evidencing our early commitment to OTC in advance of other institutions..

Based on our leading position, we are often asked by regulators, central counterparties and our clients to comment on the operational and capital implications of future market developments. The operational results of early stage OTC Clearing have been encouraging with more Initial Margin (IM) in the global financial system to protect against systemic counterparty risks. However, some of the proposed requirements regarding capital and funding will make it difficult for major clearing providers such as Barclays to provide clearing services in a sustainable manner. The potential outcome is a shift to lower rated, unregulated clearing members who may not bear all of the costs. We believe there are some modifications that could be made by global regulators that would enhance the capital efficiencies of clearing, reduce the end-cost to client and ensure market liquidity without undermining systemic protection.

We are concerned that changes made to the framework since BCBS227 have eroded incentives for banks to act as clearing members. We shall set out some of the potential capital disincentives in detail below. Whilst the consultation does not specifically address leverage, we would like to cross reference to our response to BCBS251 where we highlight that clearing a clients trades will result in significantly more reported leverage than if the trades had been left on a bilateral OTC basis. To the extent that the leverage ratio operates as a binding constraint rather than a backstop, this could have an additional significant impact on the broader incentives to act as a clearing member. We consider some of the interactions with leverage in appendix 2.

We welcome the Committee's attempts to assess the impact of its requirements on the clearing industry via the QIS on incentives. Regrettably we have not been able to participate on this occasion due to the timing of the exercise and our focus on Basel 3/CRD IV implementation, but have contacted the PRA to explore other ways of providing useful information. We would suggest the industry bodies and regulators work together to design a broader exercise for 2014. This could encompass other impacts such as the effect on leverage, as well as testing finalised requirements for the non internal models method and margining.

We recognise that even with the increase in risk weighting for trade exposures to QCCPs there is a clear incentive for firms to clear their derivatives via clearing members on qualifying CCPs rather than leave them as bilateral trades subject to CVA. Our concern is that there is little incentive and potential significant disincentives from banks subject to the Basel regime to act as clearing members on CCPs. It is not clear that non-bank participants could provide alternative capacity.

In addition, liquidity and funding requirements increase the cost of running a clearing business and thus increases the barrier to entry.

- One example is the “residual interest” concept required by CFTC. A broker has to maintain a residual interest in each type of customer funds sufficient to exceed the sum of all customer margin deficits at all times. This proposal appears to be based on the assumption that all customers with margin requirements will fail to meet that requirement at the same time, which might be too conservative.
- In Europe, LCH is currently live with RTTR (real-time trade registration), which requires all positions to be funded before trades can be cleared. LCH also conducts intraday runs with intraday settlements, which require clearing brokers to pre-fund their client positions throughout the day.

In the current construct, due to the gap in timing between CCPs auto-debit Clearing Members in the morning and clients settle with Clearing Members later in the day, Clearing Members are essentially pre-funding for client's intraday and overnight. The industry is working towards a solution which attempts to reduce the funding gap.

Capital disincentives

1. We are concerned regarding the proposal to take a higher of K_{ccp} and $Cover^*$. The two calculations are on very different bases, stress loss vs expected exposure and we struggle to understand how it would be possible to calibrate the right risk weighting for an exposure which could be derived from either of these very different measures. Within this context, we appreciate the efforts made by BCBS to move away from having the CEM methodology underpin these calculations towards the NIMM. The DF^{cover^*} is expected to dominate unless the NIMM is inappropriately calibrated (we are still awaiting the results of the QIS on NIMM).
2. As stated in responses to previous consultations, we do not concur that default fund contributions should be capitalised at 100% (1250% risk weighted). They are a third loss exposure and such capitalisation would be greater than a direct investment in the equity of the CCP (which would be considered $DF_{ccp, junior}$). We continue to be of the opinion that default fund contributions should have a risk weighting less than that of a holding in the capital of the CCP. Historically such exposures are low risk and clearing is not a high margin business. Consequently the outcome is likely that participants will be disincentivised from becoming clearing members if the capital requirements are disproportionate and they are unable to generate sufficient return to justify the capital allocated to that business. The logic offered that a 100% capital charge on some part of the capital contribution to default funds ensures that it may be lost without material negative impact on the capital ratios of the clearing member could be extended to any exposure.
3. The treatment of unfunded default commitments appears to be an explicit double count of capital requirements. The treatment of the funded commitment in either the ratio or the tranche approach is based on the higher of the cover ratio or the K_{ccp} based on NIMM which already takes into account all trades on the CCP and future volatility in them. This double-count need not be capitalised and can be contrasted with the capitalisation of other committed lines where the risk associated with a draw hasn't been capitalised elsewhere (e.g. within K_{ccp}). While the proposed cap mitigates the extent of the double count, it would be preferable not to double count at all.
4. Over the course of the various consultations since Basel 3 we have seen the risk weighting of trade exposures go from 0% to 2% to the risk sensitive range 2-20%. Even at these levels there is a clear incentive for end users to clear, however, this is another unhelpful factor for clearing members to consider in offering clearing services. It is unclear why BCBS are seeking to drive up overall levels of capitalisation against CCPs either through the risk weight on the trade or via incentives to over capitalise the default fund.

The original BCBS227 proposals were onerous in some areas, e.g. the treatment of client facing trades (which still attract CVA albeit on a shorter margin period of risk), but on the whole there was no clear disincentive to be a clearing member. We are concerned that whilst leaving some of the least favourable aspects of BCBS227 unchanged, the revision of the treatment of exposures to QCCPs may have shifted the balance of incentives markedly.

The QIS on incentives is clearly an important exercise to ensure the requirements are appropriately calibrated. As stated above, we would encourage the Committee to run a more extensive exercise during 2014 to test the full range of impacts, away from the immediate pressures of Basel 3 implementation and year-end reporting.

We have included our answers to the questions posed in the consultative document as an annex to this letter.

Please do not hesitate to contact Roger Versluys on +44 20 7773 2791 if you have any questions or comments on any of the issues raised in this response. Furthermore, we would be happy to participate in any fora (either at a BCBS or UK PRA level) to discuss the issues presented in this paper in more depth.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'P. Estlin', with a long, sweeping underline.

Peter Estlin

Acting Chief Financial Officer
& Group Financial Controller
Barclays plc
+44 207 116 5085

Q1: Which of these two proposed methodological approaches best satisfies the objectives which the capital treatment seeks to achieve and why?

We are concerned that neither approach appropriately meets the objectives that the Committee has set itself. Taking the objectives in turn:

1. Adequate capitalisation of the bank exposures to CCPs under a stress scenario;

Both approaches are based on the reference level of default fund (RLDF) calculated as the higher of DF^{Cover*} and K_{CCP} . DF^{Cover*} is based on a stress loss at a high confidence level whereas K_{CCP} is based on an expected exposure. Consequently a higher of approach is comparing "apples and oranges" and is expected to result in excessive capitalisation (compared to an "equivalent" banking institution), especially when combined with the risk weightings proposed for these exposures.

Credit standing of the clearing members is not factored in when calculating RLDF as DF^{Cover*} is estimated without taking into account ratings of the clearing members (note in the current consultative paper, like the previous one, when calculating K_{CCP} , $RW=20\%$, corresponding to A-rated institutions in line with the ratings of major clearing members in large and internationally active CCPs, is used; presumably a $RW=75\%$, corresponding to BBB-rated institutions, would be used in calculating K_{CCP} , if major clearing members were BBB-rated in a CCP. Changing RW from 20% to 75% is unlikely to make K_{CCP} higher than DF^{Cover*} given the reasons listed earlier). The consequence of this is that with everything else being equal a hypothetical CCP with only AAA rated members will need the same amount of capital as that for a CCP with only BBB-rated capital.

Given that (a) CCP's own contribution toward the default fund is usually much smaller than those from the clearing members, and (b) $RLDF = DF^{Cover*}$ and in general $DF_{CM}^{Pref} \approx DF^{Cover*}$ for major CCPs, the ratio approach will lead to a 1250% capitalization rate for prefund member DF contributions.

Given that in most CCPs we have $DF_{CCP} < RLDF \leq DF^{Pref}$

$$K_{CM_i} \approx \frac{DF_i^{Pref}}{DF_{CM}^{Pref}} \times [C_2 \times DF^{Cover*} + C_1 \times (DF_{CM}^{Pref} - DF^{Cover*})]$$

This also leads to a 1250% capitalization rate for prefunded member DF contributions if

$$DF_{CM}^{Pref} \approx DF^{Cover*}.$$

Given the fact that initial margins are ~10x to 20x of the DF contribution for most (major) CCPs that have prefund DF (not all CCPs have prefunded DF contribution from members at the moment), RWA for the prefunded member DF contribution is more than 10x higher than that for the trade exposure even assuming that they will be capitalized at 5% under the new consultative paper and initial margin posted is not segregated. Basically (major) clearing members have spent significant amount of resources to build up (and/or enhance) their infrastructure such that they can estimate the trade exposure accurately (enough) to meet the regulation requirement, but these calculations will have no real material impact for the overall RWA.

Consequently we believe that objective 1 is likely to be failed by both approaches as either (in combination with the other proposals) will result in the significant over capitalisation of default fund exposures.

2. Promotion of clearing;

We are very concerned that the framework yields incentives not to be a clearing member. The treatment on NQCCPs is harsh and yields capital requirements in excess of bilateral trading. The BCBS227 treatment was not unambiguously favourable for clearing (albeit it was a significant improvement on the proposals in BCBS190 and BCBS206). The crux of the incentive question was whether the reduction in bilateral charge versus the client (5 day MPOR rather than 10 day MPOR) would more than offset the marginal default fund requirement at 1250%.

Our concern is that [pending results from the QIS] the saving on the client leg is unchanged and the capital requirement at 1250% for the default fund will be levied on a significantly larger "exposure". Furthermore the capital treatment of commitments to top up the default fund was already factored into the Method 1 and Method 2 calculations. Paragraph 61 recognises that the charge for default fund commitments would be additive to that on the funded contributions on the ratio approach. Consequently there is a reduced incentive/greater disincentive to clear client trades under that approach.

The incentives to be a client of a clearing member on a qualifying CCP remain as the client is not exposed to the default fund and will benefit from an exemption from CVA and potentially beneficial risk weighting, albeit it is unlikely to be as low as the 2% available under the interim rules.

3. Recognition of the inter-relationship between the types of exposures banks have to CCPs;

This has does not appear to have been considered for the DF calculation. The only apparent recognition of the interaction is in the variable risk weighting applied to trade exposures.

4. Promotion of robust risk management practices by banks and CCPs, including incentives to prefund default funds

The use of DF^{cover*} does not take into account one of the key risk management practices used by CCPs, the membership criteria. The approach does not consider the credit standing of the CCPs members. Furthermore, the RLDF calculation appears to be insensitive to member risk weighting as initial estimates show that an increase in risk weighting from 20% to 75% is unlikely to make K_{ccp} higher than DF^{cover*} .

The dominance of DF^{cover*} could, in the absence of uniform CPSS/IOSCO standards regarding cover 1 or cover 2 and stress testing result in differing levels of capitalisation. More conservative CCPs with larger stress shocks would generate higher levels of CM capitalisation for DF contributions. This would not incentivise appropriate risk management by the CCP.

5. It should avoid unnecessary complexity and be simple to communicate, explain, justify and apply.

Both the ratio approach and the tranche approach are significantly more complex than method 2 from BCBS227. Neither are easily justified, in particular, in reference to RLDF (see point 1 above).

In addition, it appears that there is a typographical error in the Tranches approach whereby 1.6% (for consistency with the treatment in BCBS227) is shown as 16%.

Q2: What are the pros and cons of using the greater of the minimum Cover level required by the CPSS-IOSCO PFMI or the hypothetical level of default resources calculated using NIMM as a model for calculating the relative risk of clearing members contribution to QCCP default funds? Should the Committee consider any adjustments to NIMM to improve its measurement of derivative exposures in the context of CCPs? Would it be better to use only one of these measures, or are there other suitable alternatives?*

The disadvantages of using the higher of the minimum cover level and the hypothetical level of default resources are:

- Any “greater of” approach will require higher levels of capitalisation, to the extent that the NIMM might be less risk sensitive it could result in unrealistically high capital requirements which were not required by the CCPs own regulator based on a risk sensitive stress loss. Whilst the committee might consider higher levels of capitalisation to be risk reducing, excessive levels of capitalisation could act as a significant disincentive for banks regulated under the Basel Accords to act as clearing members.
- It is unclear how such a calculation would achieve objective iv and encourage CCPs to satisfy the PFMI. CCP behaviour would be expected to fall within the remit of CPSS/IOSCO. The CPSS-IOSCO PFMI which are required to be met are already a very high standard. These standards will be maintained if not bolstered by activities such as ESMA endorsement of third country CCPs and any equivalent oversight by third country regulators

We believe that it would be better to use a single calculation i.e. K_{CCP} or DF^{cover*} and have the risk weighting appropriately calibrated for that exposure methodology. We are very supportive of the replacement of CEM by NIMM (at least conceptually) though whilst the NIMM QIS is ongoing it is too soon to determine whether NIMM is sufficiently risk sensitive to be “fit for purpose” in calculating K_{CCP} . It is expected to be an improvement on CEM but it is unclear as to whether it would recognise the significant diversification and margining benefits achieved in clearing.

Q3: What risk weights / capital charges would best achieve, or appropriately balance, the objectives set out in Section II.C? In particular, how would possibly lower values ensure that clearing members are capable of absorbing losses in times of stress without the drawing down of the default funds threatening the viability of the non-defaulting members who have contributed to them? How would the proposed 1250% risk weight affect incentives to use central counterparty clearing?

As mentioned in previous responses to BCBS190 and BCBS206 we believe that the use of a 1250% risk weight is not appropriate for members' default fund contributions. These contributions act in a third loss capacity, as the typical waterfall would be:

1. Defaulting member's margin
2. Defaulting member's default fund contribution; then
3. Non-defaulting members' default fund contributions.

A 1250% risk weighting is akin to the risk weighting applied to first loss securitisation tranches and is akin to a full write off of the assets on day 1. These funds cannot be objectively considered to be that risky, for example, they have not been called upon to bear losses during the failures of Enron and Lehman. Furthermore, to the extent that the clearing member's contribution was less than 10% of a guarantee fund it seems disproportionate to risk weight the guarantee fund at a worse level than a holding of less than 10% of the equity of the CCP.

If the credit quality of the average CM is A- or better it could be argued that the exposure to a defaulting member should be akin to the exposure to an A- counterparty after taking into account their margin balances and their default fund contributions. If in standard rules an exposure to an A- institution with an original maturity >3 months would be risk weighted at 50% it does not seem appropriate for an exposure to such entities benefitting from these other protections to be risk weighted at 1250%.

If the default fund were risk weighted as akin to unlisted equity it would be up to 400% risk weighted (or captured in the non-material holdings deduction). This is already a punitive risk weighting for an asset which did not yield

losses during the credit crises. It would be simple for periodic stress testing undertaken by national regulators/EBA etc to include scenarios where draw downs of CCP default fund charges occur. It seems punitive to calibrate the ongoing requirement for such exposures to 100% loss in the absence of a history of losses.

We are very concerned that the framework yields incentives not to be a clearing member. The treatment on NQCCPs is harsh and yields capital requirements in excess of bilateral trading. The BCBS227 treatment was not unambiguously favourable for clearing (albeit it was a significant improvement on the proposals in BCBS190 and BCBS206). The crux of the incentive question was whether the reduction in bilateral charge versus the client (5 day MPOR rather than 10 day MPOR) would more than offset the marginal default fund requirement at 1250%.

Our concern is that [pending results from the QIS] the saving on the client leg is unchanged and the capital requirement at 1250% for the default fund will be levied on a larger number. Furthermore the capital treatment of commitments to top up the default fund was already factored into the Method 1 and Method 2 calculations. Paragraph 61 recognises that the charge for default fund commitments would be additive to that on the funded contributions on the ratio approach. Consequently there is a reduced incentive/greater disincentive to clear client trades under that approach.

The logic offered that a 100% capital charge on some part of the capital contribution to default funds ensures that it may be lost without material negative impact on the capital ratios of the clearing member could be extended to any exposure. Historically such exposures are low risk and clearing is not a high margin business. Consequently the outcome is likely that participants will be disincentivised from becoming clearing members if the capital requirements are disproportionate and they are unable to generate sufficient return to justify the capital allocated to that business.

The incentives to be a client of a clearing member remain as the client is not exposed to the default fund and will benefit from an exemption from CVA and potentially beneficial risk weighting, albeit it is unlikely to be as low as the 2% available under the interim rules.

Q4: The Committee invites comments on this potential risk sensitive approach to capitalising trade exposures to CCPs.

It is unclear why the committee is implementing the revised risk weights for trade exposures to qualifying CCPs. Throughout the development of the rules on capitalisation of exposures to CCPs the main focus from both sides of the debate had been the treatment of the CCPs default funds. The proposed "risk sensitive" approach appears *prima facie* to be an erosion of the main benefit of clearing for end user banks and a further erosion of any benefit for clearing members.

The existing 2% risk weight could be considered to be adequate or potentially conservative as participants trade exposures are protected by defaulting member margin, defaulting member default fund, the socialised default funds of non-defaulting members.

Q5: Do you consider it appropriate to treat initial margin, where a QCCP has legally enforceable rules that make initial margin a senior claim to variation margin in the event of losses in excess of default resources, differently from other trade exposures by retaining a fixed 2% risk weight on initial margin posted in a non-insolvency remote manner?

Yes.

Q6: Do the proposed approaches to capture commitments to top up default funds in the capital treatment of exposures to QCCPs satisfy the objectives which the capital treatment seeks to achieve? Are there ways in which the proposed capital treatment of commitments could be improved? Is the proposed α value of 0.5 appropriate?

A treatment of commitments to top up default funds should not result in additional capital requirements for default funds beyond the existing levels. As stated earlier in the response during the stress scenarios of Enron and the Lehman default losses were not borne by non-defaulting members. Consequently the proposed levels of capitalisation for prefunded default funds are significantly in excess of what would be required under a stress scenario. Furthermore, given that the capitalisation of the default fund under either of the proposed methodologies is based on the trades in the CCP (K_{CCP}) it would appear that a charge for the unfunded commitment is effectively doublecounting the risk in the CCP.

Excessive capital charges for any of the exposure types do not help incentivise banks to clear or provide clearing services for clients. This is in conflict with objective 2.

The proposed relationship between default fund levels and risk weighting on trade exposures appears to meet objective 3, however, whilst we recognise the benefits of such a relationship we do not agree that the charges are calibrated appropriately given historic losses.

We believe that the IOSCO PFMLs provide the right incentives to CCPs to robustly manage risk. Furthermore BCBS227 provided significant incentives to manage risk to CCPs, in particular to segregate IA from the CCP (as it factored into the method 2 DF calculation). We do not understand why the alpha factor of 0.5 was chosen. In previous versions of the CCP rules the Basel committee applied a 1.2 factor for unfunded fault fund contributions to incentivise prefunding the default fund. This would imply an alpha of 0.833. We are interested in knowing if there is any statistical rationale for the choice of 0.5?

The proposals are significantly more complex than some of the options under BCBS227 and we are not convinced that such complexity has been necessary given the perceived risk insensitivity of the proposals.

If the Committee insists on the double count for these unfunded commitments we concur that they should be capped at 3x or lower for the reasons set out in the consultation paper.

Annex 2

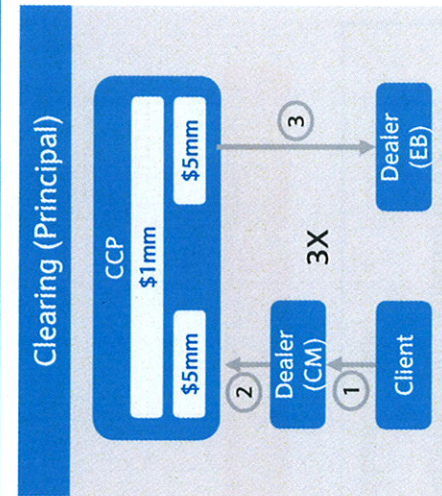
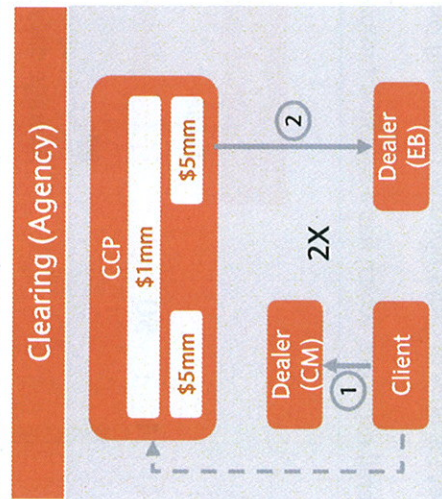
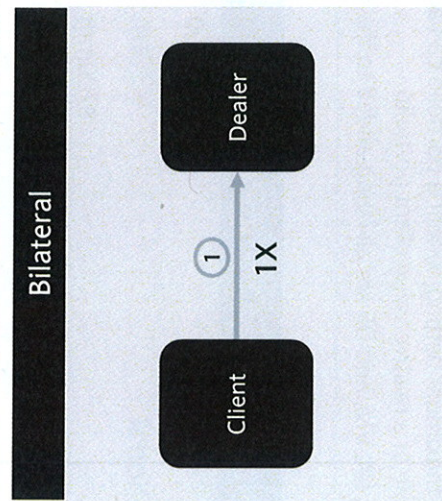
Interaction of clearing and leverage constraints

The attachments assume that the 1250% rw DF contribution is considered a not deduction from capital for leverage purposes. We request that BCBS clarify this as otherwise the significant otherwise the leverage exposure on cleared exposures are much higher (approximately 30x compared to 10x in the examples shown).

Impact on Cleared Transactions – One Trade

Size of the exposure and the treatment of collateral requires further consideration...

- ❖ The one trade example below illustrates the over-stated exposure and capital implications of current revised leverage framework
- ❖ For the single transaction, leverage exposure in the clearing model can be 2X or 3X of that in the bilateral model
 - Agency model (such as FCM model required in the U.S.) clearly has an advantage in capital compared to the Principal model (such as SCM model required in the EU)
- ❖ Client collateral is counted as exposure as well. However, in the clearing models
 - This requirement doesn't take into account the fact that in some cases, Clearing Member (CM) has no access to utilize these assets for further leverage due to asset segregation (Rule 1.25 in U.S. and full segregation in EU)



Assumptions	\$100mm 10-year IRS; \$5mm cleared IM; \$1mm DF for both Client and House			
PFE	\$1.5mm	\$3mm	\$4.5mm	
Collateral Exp	0	\$10mm + \$1m DF	\$10mm + \$1m DF	
Total Exp	\$1.5mm	\$14mm	\$15.5mm	
Capital	\$45,000	\$420,000	\$465,000	
		9.3X	10.3X	

CM and EB are assumed to be the same entity through this document