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BIS 84-011032
18.10.13

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30 September 2013

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

Dear Sirs

BCBS257: CAPITAL REQUIREMENTS FOR BANKS' EQUITY INVESTMENTS IN FUNDS

Barclays welcomes the opportunity to comment on the consultative document. We agree with the committee's analysis that the current framework has some ambiguities that could lead to inconsistent treatment of funds across banks. Barclays has contributed to the joint Global Financial Markets Association (GFMA), Institute of International Finance (IIF) and International banking federation (IBFed) response and are broadly supportive of the comments contained therein. Barclays broadly supports the hierarchy of approaches that is proposed in this consultation. However, to be effective we believe the framework should be targeted and proportionate. In this light we raise the following concerns to the committee.

Interaction with fundamental review of the trading book

The defined scope of the consultation is banks equity investments in the banking book. However the committee intends ensure a consistent approach is applied to equity positions in funds in the trading book during the fundamental review of the trading book. We do not believe that the proposal in its current form would be suitable to the nature of trading book activity. Fund activities in the trading book are typically managed on a net delta basis with most trades being executed to facilitate client access. This contrasts to a long banking book or investment strategy. Additionally the volume and turnover of funds held in the trading book could impose severe due diligence and operational requirements on firms if an approach designed for the banking book is directly read across.

Interaction with other consultations

We note that the Committee is considering under separate consultation the merits of the Non Internal Model Method ("NIMM") for calculating exposures on derivatives. This is expected to be more risk sensitive replacement of the Current Exposure Method ("CEM") approach. The Committee is undertaking a Quantitative Impact Study ("QIS") in relation to NIMM to consider the impact of replacing CEM on risk based requirements. We would request that the Committee expands this study to consider the effects on leverage and counterparty risk in the context of look through on funds in order to provide a holistic impact of the NIMM methodology.

3rd Party calculations

Custodians are likely to have the greatest clarity on the positions of the fund given their access to data. It is not clear why such calculations should be penalised with a one notch downgrade compared to banks undertaking the calculations themselves. Ultimately the one notch downgrade might discourage the development of a market in such services.

Scope of funds

FSB concerns on the mitigation of systemic risks posed by shadow banking entities, has been expanded to a broader review of all funds in the interests of consistency. We suggest that such an approach is not necessarily risk sensitive as it ignores the differences across funds. Systematic safety could be better enhanced by a targeted framework. We recommend that banks holding index tracking funds, subject to certain qualifications detailed in the appendix, be allowed to directly look through to the Index risk. This is referred to as the Direct Look Through Approach (DLTA).

Materiality Filter & Calibration

We agree that the LTA is the most risk sensitive approach. However it should not automatically be assumed to be the most appropriate approach without consideration of materiality of investment or type of fund. Referring to the fundamental review of the trading book, figure 2[1] (page 58), the lowest category of losses was assigned to equity investments. Therefore it is unclear what evidence there is that such investments present systematic risks that require whole sale changes to risk weighting. We would further note that many of the spill over effects of shadow banking entities to the regulated banking system have been from securitisations. This framework has undergone significant improvements in recent years.

We recommend that a materiality filter be applied by assessing:

(i) the size of the holdings in funds versus capital of the firm; and
(ii) the size of unknown exposures versus total Net Asset Value (NAV) of the fund.

The size assessments should be made on a net delta basis if the intention is to ensure that proposals can be read across to the trading book.

To determine materiality in (i), one could look to paragraph 358 of Basel II[2], where aggregate equity fund exposures in the banking book were greater than 10% of the total capital of the firm. For (ii), once over an agreed regulatory threshold then such positions would be deemed material by virtue of having such large unknown/undisclosed exposures within the fund.

Where material, as defined above, we would recommend the application of the DLTA, LTA, MBA, and FBA with revised leverage adjustments, this is discussed in further detail in the appendix. Below that threshold, we recommend that a greater emphasis be placed on banks' due diligence processes. A supervisory slotting type approach, as used for specialised lending, may be used to determine risk-weights. Such an approach will recognise risks in funds that are not captured in the current proposals which focus on balance sheet and instrument leverage. It would further remove operational complexity of the proposed calculations. For example, to calculate the counterparty credit risks embedded in fund's derivatives and securities financing transactions would require detailed knowledge of netting and collateral agreements such as ISDA-CSA as well as detail of collateral postings.

Finally, we are concerned with the calibration of the FBA at 1250% and make an alternative proposal for funds meeting certain criteria in the detailed response in the appendix.

We provide a diagram illustrating our proposed approaches in Appendix 2.

I hope you find our comments and suggestions helpful. Please do not hesitate to contact Neil Oberoi if you have any questions or comments on any of the issues raised in this response.

Yours sincerely,

Peter Estlin
Acting Chief Financial Officer and Group Financial Controller, Barclays

[1] Fundamental Review of the trading bookhttp://www.bis.org/publ/bcbs219.pdf

[2] Basel II: International convergence of capital measurement and capital standards a revised framework – comprehensive version http://www.bis.org/publ/bcbs128.htm

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

1. The committee welcomes views on: (i) the proposed definitions of leverage and (ii) options for incorporating leverage into the calculation of risk weighted assets

Balance Sheet Leverage

The financial leverage definition proposed is an accounting definition which we agree is simple. However this could be subject to significantly different netting or balance sheet presentations. This does not aid transparency across institutions and could result in institutions seeking out funds listed in the most favourable accounting environment. It could, according to accounting convention, create perverse outcomes. Consider a fund that received cash collateral to mitigate its counterparty risk. If it grossed up its assets leverage may be increased under Total Assets / Total Equity. Such a fund received a higher risk weight than an identical fund that does not receive collateral for its derivatives.

The paper considers financial leverage as a stand-a-lone characteristic and then applies this to a derived risk weight. A more risk sensitive approach would be to consider where the fund is applying leverage for example to the most illiquid or liquid holdings. Also it does not consider sufficiently the form of the leverage, for example short term repo funding could present considerable risk for the fund.

Instrument Leverage from derivatives

We understand that as currently drafted there is no difference in approach across LTA and MBA. Leverage from instruments is taken into account by using the gross notional of derivatives and other products that that are risk weighted in Paragraph 84 of Basel II[3]. This is not consistent with the consultations for derivatives on the leverage ratio in BCBS251, where only credit derivatives generate leverage exposures. Further, in this proposal banks are required to take an additional counterparty credit risk charge into account which uses the same notional with no offset.

Banks are highly leveraged and complex, the proposed leverage ratio of 3% means a 33 times leverage, which is in excess of most hedge funds[4]. The Basel proposals allow positions in financial institutions that are in aggregate below 10% of the bank's common equity to be risk weighted rather than deducted BCBS189[5] paragraph 81 to 83. Therefore the proposal to incorporate financial and instrument leverage in the risk weight function for funds is disproportionate unless the value of such assets represent a material position to institutions.

Whilst theoretically possible it is unlikely that funds would provide sufficient granularity of information to apply the proposed calculations on derivatives from a leverage perspective unless a firm had a material holding in such a fund (potentially triggering regulatory consolidation). Even if such information was available it would represent a huge commitment of resource to undertake the due diligence. If exposures are immaterial it is unclear how this would contribute materially to systematic safety. The current text suggests that if no information on leverage can be found a risk weight of 1250% is applied, we suggest an alternative approach below.

Alternative options for incorporating leverage where funds are material

The application of the hierarchy provides sufficient incentives for a firm to receive detailed portfolio composition files from fund managers or qualified third parties. This should be supplemented by further information on leverage in order to provide the appropriate scalar to risk weights rather than the framework proposed. This increased effort is commensurate with the funds now representing material exposures.

Alternative options for incorporating leverage where funds are immaterial

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[3] Basel II: International convergence of capital measurement and capital standards a revised framework – comprehensive version http://www.bis.org/publ/bcbs128.htm

[4] BIS Working Papers No 260 Estimating hedge fund leverage http://www.bis.org/publ/work260.pdf

[5] Basel III: A global regulatory framework for more resilient banks and banking systems – revised version June 2011 http://www.bis.org/publ/bcbs189.htm

Leverage should be incorporated into a holistic risk review of the fund, this takes place by front office and risk functions before the investment is even made. See answer to question 2 for further details

2. The committee welcomes views on the proposed policy framework.

Interaction with fundamental review of the trading book
In the scope of application the committee notes that it intends to apply a consistent approach to trading book positions. Whilst in principle we agree that there needs to be consideration of both trading and banking book positions there also needs to be recognition of the different activities across such books as the current risk based framework does. Consequently we do not believe the proposals as drafted are suitable for the trading book.

Fund activities in the trading book are typically managed on a net delta basis with most trades being executed to facilitate client access. This contrasts to a long banking book or investment strategy. Additionally the volume and turnover of funds held in the trading book could impose severe due diligence and operational requirements on firms if an approach designed for the banking book is simply read across. The consultation as currently drafted only considers standardised and Internal Ratings Based (IRB) credit risks and not market risk under standardised and modelled approaches.

An approach for the trading book would need to consider netting of long and short synthetic and cash positions which may be non linear in the derivation of underlying positions.

We further note many products may have no treatment under the standardised banking book framework such as convertible bonds and the committee might need to consider providing further guidance in order to avoid differential interpretation by financial institutions.

The committee has not provided a timeline for implementation and we would seek clarification on this point.

New Proposals for consideration
We put forward suggestions for three new components of the framework. In the Appendix 2 we provide a diagram to illustrate the new framework.

- (i) **Materiality Filer**
- (i) **Direct Look Through Approach (DLTA)**
- (ii) **Supervisory slotting**

Materiality Filter
The materiality filter would be used to determine which suite of approaches was open to a firm. Please see the diagram in the Appendix for an overview.

We agree that the LTA is the most risk sensitive approach. However it should not automatically be assumed to be the most appropriate approach without consideration of materiality or type of fund. Referring to the fundamental review of the trading book, figure 2[6] (page 58), the lowest category of losses was assigned to equity investments. Therefore it is unclear what evidence there is that such investments present systematic risks that require whole sale changes to risk weighting. We would further note that many of the spill over effects of shadow banking entities to the regulated banking system have been from securitisations. This framework has undergone significant improvements in recent years.

We recommend that a materiality filter be applied by assessing:

- (i) size of the holdings in funds versus capital of the firm.
- (ii) size of unknown exposures versus total Net Asset Value (NAV) of the fund.

[6] Fundamental Review of the trading bookhttp://www.bis.org/publ/bcbs219.pdf

Note the size assessments should be made on a net delta basis if the intention is to ensure that proposals can be read across to the trading book.

To determine materiality in (i) could look to paragraph 358 of Basel II[7], where aggregate equity fund exposures in the banking book were greater than 10% of the total capital of the firm. For (ii) once over an agreed regulatory threshold then such positions would be deemed material by virtue of having such large unknown/undisclosed exposures within the fund.

Direct Look Through Approach (DLTA)

Scope of Funds

The 2012 FSB consultation [8] identified five specific areas to focus on with regards to Shadow banking, the two relevant ones for this paper are (i) considering the spill over effect between the regular banking system and the shadow banking system and (ii) to mitigate risks posed by shadow banking entities. This has changed to a consideration of banks investment in funds more broadly. In broadening the scope there has been a loss of focus and proportionality and the result is that the proposed framework would not be effective in mitigating risks posed by shadow banking entities with regards to funds. The new regulations intend to incentivise a look through approach for all investments in funds held in the regulatory banking book (with potential read across to trading book). Barclays would agree that it is important to undertake due diligence and understand the component risks of fund positions however there must be reference to the materiality of the position for the bank, and the granularity of the exposures within the fund itself. We support the committee's decision not to ask Banks to form a division between funds acting as shadow banking entities and other funds. However in order to address concerns of opacity (paragraph 14 of the consultation) we recommend that the regulation would be better served by allowing a Direct Look through Approach DLTA for funds that meet the following criteria:

- Mandated to track (main) indices.
- If adequate correlation and tracking error to the index can be demonstrated over a specified period of time then the firm can assume it has the index risk.
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The DTLA would be s simplified version of the LTA which requires consideration of leverage and the counterparty risk of the fund. A firm would have to ensure it had adequate processes to ensure the fund maintained within the agreed correlation and tracking error bands on an on-going basis.

Proposed Supervisory Slotting Approach

Where exposures to funds were deemed immaterial by the materiality test then the supervisory slotting approach would be open to firms on those funds that failed DTLA criteria as detailed above.

The framework as proposed does not cover the inherent risks in (hedge) funds such as asset / liability mismatches or basis risks across long and short positions due to changing or flawed correlation assumptions. Nor is there consideration of granularity / concentration of positions in the fund, asset price discovery, volatility, duration, term financing and stability of capital base. A more holistic supervisory slotting approach might capture such factors. This might further allow consideration that many of these factors have complex interactions for example restrictions of withdrawals providing the fund with a more stable capital base to ride out market fluctuations but curtailing liquidity for investors.

We recommend that a baseline risk weight of 150% be multiplied by scalars based on a holistic assessment of the risks of the funds. In principle we believe this is aligned with the adoption of due diligence requirements in the securitisation framework. The use of existing risk weights and regulatory prescribed scalars would provide a consistent framework but allow greater sensitivity for the inherent differences in funds. Funds attributed to the highest risk classification would receive 1250% risk weight with the least risky funds receiving 150%.

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[7] Basel II: International convergence of capital measurement and capital standards a revised framework – comprehensive version http://www.bis.org/publ/bcbs128.htm

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Consultative Document

Strengthening Oversight and Regulation of Shadow Banking http://www.financialstabilityboard.org/publications/r_121118.pdf

General comments on Approaches

Look Through Approach (LTA)

Whilst theoretically possible it would demand a huge input of resource to apply the LTA as currently drafted. In particular to assess counterparty credit risks on derivatives and securities financing transactions and the leverage being achieved via derivatives is particularly challenging. The approach ignores other risks as discussed above and may even penalise products designed to provide some diversification. Consider fund of funds products where looking through multiple layers would not be realistic.

A look through approach already exists for EU institutions, this has elements that are useful in the consideration of the riskiness of investments in equity funds. For example, isolation of fund asset positions from the manager, risk management policies, leverage limits and so on. In addition we note that in the European regulations there are differential requirements across the trading book and banking book. Any look through criteria should be carefully selected to avoid introducing local market specific requirements, for example, some of the EU requirements are geared towards the workings of EU funds and are harder for non-EU index tracking mutual funds to comply with.

We would also note that products with embedded derivatives are not necessarily bifurcated, for example consider convertible bonds or structured notes with call /put options. Hence forcing assessment of individual derivatives undertaken by funds is not proportional where exposures to such funds are immaterial for the institution.

Mandate Based Approach (MBA)

Broadly speaking we have the same resourcing concerns as raised above for the LTA.

Fall Back Approach (FBA)

Calibration

The fall back approach, which effectively treats positions as equivalent to first loss equity tranches of securitisations is also not reasonable given that funds are typically portfolios of different exposures with differing degrees of diversification. Alternatives would be to use a 400% risk weight to be consistent with the higher risk weight under Basel II's Simple Risk Weight Method[9] (paragraph 344). We recommend that this approach be reserved for funds which met the following characteristics:

- Open ended funds such as REITS or Investment Trusts or their equivalents that are listed on major exchanges and are already subject to detailed disclosure mechanisms should be excluded from the scope of the regulation. We note that these are unlikely to be material exposures in the banking book, but given the expectation that the fundamental review of the trading book would be aligned these should be scoped out now.

- In addition funds that are governed under recognised consumer protection law such as UCITs or Investment Act of 1940 in the US should be exempt.

Funds not meeting these characteristics would be subject to the 1250% risk weight.

Pillar 2 and Pillar 3

We also believe that pillar two might be a tool that could be used as a backstop where regulators were concerned with a given institution's exposures to funds. Additionally where an institution crossed the materiality barriers then it would be required to provide further disclosures under pillar three. For example the investment in funds versus total capital and the risk weighting approach taken.

[9] Basel II: International convergence of capital measurement and capital standards a revised framework – comprehensive version http://www.bis.org/publ/bcbs128.htm

Appendix 2
Diagram showing suggested hierarchy of approaches following materiality test