

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

January 2014

Re: Basel 4 - Fundamental Review of the Trading Book (BCBS265)

Barclays welcomes the opportunity to comment on the Basel Committee's consultation document "Fundamental Review of the Trading Book" (BCBS265, "FRTB" and the "Review") and we acknowledge the significant amount of work that has gone into this second consultation paper and the importance of the issues the paper seeks to address.

We fully support the work of the TBG in conducting a review of capital requirements for the trading book and the need to reform capital standards for market risk.

Whilst we note that the Basel 2.5 revisions were successful in driving an increase in capitalisation of the trading book in direct response to the financial crisis, we agree that they did not fully address the shortcomings of the overall design of the regime as well as the perceived weaknesses in risk measurement under both the "internal models-based" and "standardised" approaches.

We believe that there is no evident requirement to further increase the level of capitalisation for trading book risks beyond that of Basel 2.5 and that the Review should seek to ensure a more coherent allocation of that level of systemic capital; and seek to retain the incentives for reporting banks to gain regulatory approval for the more advanced methods of calculating capital. Models are important risk management tools but we wish to highlight the potentially increasing divergence between the models used by banks in managing their risks and the highly amended models being proposed for regulatory capital calculations. The current framework with its diverse array of overlapping capital charges, incorporating varying degrees of stress, look-back periods, liquidity horizons, confidence intervals and multipliers, is challenging and expensive to maintain, difficult to communicate (internally and externally to regulators), and to explain.

We recognize that following the initial response to the crisis, the need for the Basel Committee to consider, over a longer time frame, the weaknesses of the resulting framework with a view to building a more cohesive and robust framework. We welcome the decision to re-visit the timeline for completing the FRTB, which we think should also allow for a more iterative approach to calibrating the various charges and finalising the policy. Due to the fundamental nature of the changes proposed, the industry will require time to

construct the tools necessary to engage meaningfully in Quantitative Impact Studies (QIS), especially given the ongoing work related to the implementation of Basel III/CRD IV, both for regulatory capital and leverage and the balance sheet. We also believe more than one QIS will be required to calibrate the proposals effectively. This would be similar to the approach taken to calibrate and finalise the Basel II framework and we believe the changes proposed within the FRTB for market risk are as fundamental as the changes for credit risk under Basel II.

In the response outlined below we present our key messages on the proposals, while we have provided additional details and comments via the various submissions of the joint trade associations (IIF, GFMA, ISDA et al).

Key Messages

Barclays has played an active part in a broad range of industry discussions since the proposals were published, and we support the work of the Joint Trade Associations (IIF, GFMA, ISDA et al) in responding to the paper. In particular, we support the industry's proposals for a revised FRTB timeline (Appendix to the letter dated 6th January, 2014) based on the time banks will typically need to build/enhance, test and validate the new tools required to calculate the proposed charges for a QIS. Extending the time that is scheduled for the completion of the FRTB is crucial in order to enable effective industry participation in an iterative calibration and policy review process. However, we agree that if the final version of the revised models based approach and revised standardised approach were to align more closely with the alternative proposals put forward by the industry then the lead time necessary to put in place the required infrastructure could be shorter.

Alternative to the revised standardised approach

We support the alternative methodology proposed by the Joint Trade Associations for the standardised approach to Market Risk capital calculations, based on risk sensitivities that are already produced (the Sensitivity based Standardized Approach [SSA]).

While it is important to recognize that both the FRTB's "cash flow" proposal and the SSA rely on model outputs for their calculations, the SSA leverages off an existing suite of models and risk metrics already used in pricing and risk management. The SSA would be able to take advantage of an extensive control framework built up over many years governing the pricing models. In contrast, the cash flow approach would require greater development work, with a significant amount of new testing and validation required for model outputs that would reside outside the existing control and risk management frameworks, used for regulatory capital purposes only.

An approach based on well-defined risk sensitivity measures can be built into the framework set out in the FRTB (GIRR, CSR, recognition of hedging and diversification etc) and would not require significant change to the proposals. Given the widespread use of risk sensitivities across the industry, we think it has the potential for a level of consistency and comparability at least as good as that of the cash flow approach, but with the benefit of closer integration

to institutions risk control frameworks, lower industry costs and a shorter lead time to implementation.

The Cash Flow approach:

In this section we provide more detailed feedback on the cash flow approach.

The 'worked examples' document acknowledges that there is double-counting of risk between the credit spread and default capital charges, suggesting various workaround approaches for the purpose of the QIS. There is also likely to be double-counting between the equity and default risk charges, as the latter incorporates both debt and equity positions.

All of the standardised capital charges seek to recognise the effects of hedging and diversification, but use 'number of positions' as a proxy for diversification. This can produce perverse results, for example:

- (i) \$100 invested equally in the 10 largest constituents of the S&P 500 Financials: \$32.21 capital requirement
- (ii) \$100 invested in a single fund which tracks the S&P 500 Financials: \$50 capital requirement

Both the equity requirement and the credit spread requirement could be simplified by giving greater recognition to products based on highly liquid indices. The general instruction for an index or basket is to either:

- a) decompose into the constituent products; or
- b) if the entire basket/index can be assigned to a single category, treat as one position assigned to that category; or
- c) assign to the residual bucket

Under the current proposal, it is unlikely that (b) or (c) would be selected given the 'number of positions' effect illustrated above. A simpler approach would be to have a 'diversified index' category, with prescribed entry criteria and risk weightings calibrated to reflect their deeper liquidity.

The equity risk component requires the use of categorical data which may not be applied by firms consistently. As a test, country of operations is open to considerable ambiguity, as the paper acknowledges in passing by its reference to multinational issuers. A more objective reference would be country of listing.

The commodity risk component also makes use of categorical data e.g. 'location' and 'grade'; the granularity of these inputs should be specified by the Committee to ensure a consistent approach internationally. We would suggest the following principle from the EU's Capital Requirements Regulation (Article 357(4)):

"For the purposes of calculating a position in a commodity, the following positions shall be treated as positions in the same commodity:

- a) positions in different sub-categories of commodities in cases where the sub-categories are deliverable against each other;
- b) positions in similar commodities if they are close substitutes and where a minimum correlation of 0.9 between price movements can be clearly established over a minimum period of one year.”

Alternative to the revised internal models based approach – and factoring in Liquidity

We support the idea of better capturing market liquidity risks in the trading book capital charge, and we understand the core objectives of the FRTB in proposing how to achieve this (“To ensure consistency in capital outcomes, and in balancing the trade-off between simplicity and risk sensitivity”, pg 4, BCBS 265). However, we share the joint trade associations concerns with regards to the potential gaps and complexities in adopting an approach based on “varying liquidity horizon” (“LH”) Expected Shortfall (“ES”) measures, and support their work in proposing an alternative approach based on scaling ES model outputs, which we believe avoids the pitfalls of overlapping time series, and the issues related to the implied correlation between time series from different LHs.

We believe such an approach can be more successful in achieving the stated objectives of the regulators (consistency, simplicity and comparability) and additionally has the potential to preserve a risk sensitive metric that could be used for risk management purposes. We think it is unlikely, given some of the gaps and complexities in the varying LH ES measure that any firm would choose to use such a metric for risk management purposes.

One of the primary concerns we have is the lack of responsiveness in the ES measure as proposed, due to the interaction between the look back period and the longer LHs. For example, using a Historical Simulation model, a minimum 2-yr horizon for ES is needed assuming risk factors with 250 day LHs are included in the portfolio, where 12m worth of P&Ls could be constructed, the latest of which would start 250 days ago. The latest P&L in the proposed ES would discard the most recent history for risk factors with shorter LHs – thus, if we were to enter a more volatile period than our stressed period, then these risk factors would be underweighted in the regulatory capital calculation. It would take up to 1 year for ES to fully respond to increasing market volatility in risk factors with shorter LH. It is mentioned that the horizon period might need to be shortened if the model does not respond to surges in volatility. However, the model lag would make such an approach ineffective.

An additional problem with the proposed varying LH approach is the effect it has on risk factor correlations. This is twofold: firstly it destroys long standing or gradually shifting risk factor relationships, e.g. strong negative correlations between equity prices and implied volatilities and secondly, it will result in a correlation structure that is very volatile over time. Both of these factors, and in particular the second, would make this model unsuitable for risk management purposes. The stressing of risk factor correlations is achieved through the use of the stressed period. We believe that the proposal to control the overall model diversification using the constrained and unconstrained ES measures is a better understood, more predictable and transparent approach to address concerns over correlations.

If the FRTB were to continue to pursue the “varying LH” approach, we would also suggest that the Review carefully consider how the proposed risk factors could generate unrealistic scenarios for certain portfolios and trading strategies. The proposal to map each risk factor category to a given liquidity horizon does not typically align well to how desks would manage risk. For example an instrument and its hedge may be assigned to different liquidity horizons providing disincentives to hedge risk (e.g. HY + HG bond, or an equity option and underlying). Further, the use of tenor, similar to the proposals for the standardised approach, should be considered.

There are many more conceptual and modelling challenges that need to be considered in further developing the FRTB’s approach, and these are outlined in more detail in the work of the joint trade associations (letter dated January 19th). However, we think it would be more worthwhile considering how an alternative approach to the revised internal models approach based on scaling model outputs might better achieve the stated objectives of the review. These alternatives, due to their simplicity, also have the advantage of being more straightforward to construct, of being more transparent and leverage existing modelling infrastructure.

Other key concerns:-

Trading Book Banking Book boundary

We continue to support a trading evidence based boundary as opposed to a valuation based boundary and some of the measures designed to reduce the perception of possible regulatory arbitrage of the boundary. We believe these will strengthen the current regulatory requirement.

The second consultation introduces more objective rules for determining the TB or BB assignment, including general presumptions as to what should be classified in the trading book (e.g. listed equity), and what should be classified in the banking book (e.g. real estate holdings).

We concur with some of the concerns raised by the Joint Trade Associations around the list of presumptions. As drafted the list has the potential to generate additional confusion and international inconsistency, especially as a result of differing requirements to rebut such presumptions. Furthermore, if rebutting the presumptions require prior approval there would be a disproportionate documentation burden on banks.

In particular, as well as the points raised in the Joint Trade Association letter we’d like to highlight the following points and questions:

- How would internal trades be treated? For example, a bank would tend to hedge banking book interest rate risk by having the ALCO desk (a banking book) trade with the flow swaps desk (a trading book) to minimise the number of traders facing the external market on the same product and consequently the possibility of being arbitrated. We believe that this process should be able to continue and that there should be no

requirement to show a matching external trade as the trading book would capitalise any resultant open position.

- Instruments resulting from underwriting – whilst we agree that security underwriting would typically lead to trading book positions we would highlight that loan underwriting (e.g. syndicated loan market) would tend to be a banking book position.
- Options – would this include loans with capped interest rates and their hedges? What about early termination options such as those inherent in US mortgages. What about the option hedges of such products? The question could be extended to other derivatives embedded in loan products. Under the current regime such optionality might be transferred to the trading book and managed there but the loan itself would stay within the banking book.
- Unlisted equity/funds – to the extent that the bank is providing access trades the presumption of banking book treatment would be inappropriate unless the banking book treatment of such trades and the ability to fully recognize such hedges were also amended.
- Repos – the Joint Trade Association letter notes that accounting classifications for repo differ and that this can raise unnecessary international divergence. Consequently we would be supportive of short dated repo type trades being trading book regardless of the accounting treatment of the cash leg.
- We assume that designated hedges of banking book positions may still be included in the banking book regardless of the product being used as a hedge. It would not be appropriate to split the hedge into the trading book and consequently show unhedged risk in both the banking book and the trading book. We are also interested in what would be required to designate a fair value derivative as a hedge of a banking book position. We are keen to ensure that the requirements are not as operationally onerous as hedge designation under IFRS.

Consequently we would request that the list of presumptions be “softened” to a less binding form of guidance and that the issues above be considered and reflected in such guidance. We recognise the benefit of guidance being available but are hesitant to support an overly prescriptive list of banking book vs. trading book items.

Further, although we understand the desire to impose strict constraints on switching between books after initial designation (and we agree that as in Barclays today this should only happen on rare occasions), we are very concerned that the additional provisions requiring a firm to back out any capital benefit that may result, via a Pillar 1 surcharge, could lead to operational complications and create confusion around the true regulatory capital return of the firm. This imposes an impermeable boundary by stealth. The proposal to set aside any capital benefit would either result in a static number being held as a buffer or a dynamically changing buffer. A static buffer has a benefit of relative simplicity but the cost of increasing irrelevance as the benefit will change over time or as the portfolios change. A dynamic buffer will be operationally onerous as the trading book calculations under these proposals would become so complex that running multiple parallel calculations to capture a few historic transfers will generate a disproportionate level of effort and operational risk.

Over time, for large internationally active banks, you would expect to have to report more add ons (maybe up to 10 add ons over a five-year period), complicating the reporting of Pillar 1 capital and possibly distorting the figures, which might otherwise be risk based capital numbers. As portfolios mature, and as the proposals do not envisage firms having to recalculate the surcharges through time, you would expect the capital impact calculated at the time of the transfer to become less and less relevant to the risk profile of the portfolio in question – and yet the surcharges could be in place for many years to come. Movements in capital would become difficult to report and explain and be subject to additional operational risk.

We believe that the public disclosure and regulatory approval requirements for such a transfer are adequate controls against arbitrage and consequently the reversal of benefits is unnecessary and unduly burdensome.

Treatment of Credit

The FRTB does not provide enough details in the proposals on the type of Incremental Default Risk (IDR) model envisaged to capture credit risk whereby firms could participate in an effective QIS exercise. The meaning of the n-factor model is not clear. Currently if such a QIS exercise were attempted, variations in the number of factors incorporated in firms models would lead to variations in the results.

The proposed use of equity correlations is also likely to generate variation in results as the approach to calculate correlations is unspecified. In particular mapping of credit to equity and for sovereigns, where no time series exists, significant modelling assumptions will be required. If equity correlations continue to be the Committee's preferred approach, we suggest that further guidance is incorporated for example whether issuer specific correlation or representative time series (e.g. by sector/region) are used.

As such, we think a single factor (systemic plus an idiosyncratic factor) Gaussian copula model based on Basel II (A-IRB) correlation assumptions, instead of correlations based on equity prices, should suffice for default risk and lead to more consistency and comparability between firms. Alternatively, if such a model was not considered appropriate for whatever reason, then we believe the Review would need to be more precise in defining the type of IDR model they would like firms to use.

However, we believe there are a number of other issues that need to be reviewed (e.g. sovereign PD floor vs. equivalent Banking Book treatment) prior to finalizing the IDR, and again, we support the comments from the joint associations on the remaining key issues.

Model-independent assessment tool for desks

We share the concerns of the joint association response that the model independent assessment tool is not a risk sensitive measure, and provides little to no information on the market risk of a trading desk.

The size of the desks assets (or exposures) does not take in to account the degree to which the market risk of the desk is reduced by offsetting trading positions that appear as balance sheet liabilities. We think the FRTB should consider an alternative approach based on a risk sensitive metric that would provide more information about the market risks at a desk level.

If an approach based on stress testing is considered, then further guidance on the scenarios to run, the calibration of the stress tests, and how the results could be used to achieve the objectives of the model-independent assessment tool will be required. The link with existing stress testing framework (maintained under the FRTB), should also be considered.

We are also concerned that the binary outcome of the model independent assessment tool will lead to difficult-to-manage “cliff effects”, with overnight changes in regulatory capital treatment, leading to unintended consequences as a result of using other quantitative standards, where the standardised approach is used when these tests fail (or a certain number of exceptions is reached). To avoid these, we think the FRTB should consider how a “blended approach”, models plus standard rules or stress based add ons, could better achieved the stated objectives.

Floors to internal models based approach

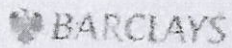
We do not think the application of floors based on the revised standardized approach provides the right incentives for initial and continuous investment in a firm’s internal risk models. Potential unintended consequences could be a growing divergence between regulatory capital requirements, risk appetite and risk management practices across the industry, such that real economic events could be missed in regulatory capital via the revised standardized approach/floor and missed in risk management/models due to the underinvestment and decaying of firm’s own internal risk models.

Credit Valuation Adjustment risk

Given that the implementation of the FRTB is not expected before [2017/18], we are very concerned by the fact that the Review does not attempt to address the exclusion of CVA market risks from the regulatory capital calculations. CVA is a very important component of fair value and risk management for derivative transactions portfolios, but the fact that only credit risk hedges can be included in ES does not promote the right incentives. CVA is an adjustment to the derivatives price itself, with associated hedging activity considered to be a part of market risk. Market risk hedging of rates, foreign exchange, etc is a more significant driver of the underlying risks of the CVA than the credit risk hedges. It is therefore our strong recommendation that the TBG reconsiders this point and Barclays will be keen to participate in discussions and working groups on this topic.

Disclosure

With regards to the level of disclosures proposed, care needs to be taken to ensure that the level of detail made publically available does not provide insight into the overall position, which could be commercially sensitive. The level of detail disclosed will be dependent on the overall strcutre and granularity of Regulatory Trading Desks. The practicalities of some



of the definitions of Regulatory Trading Desks contained in the proposal are not yet apparent.

Please do not hesitate to contact Barclays if you have any questions or comments on any of the issues raised in this response. Furthermore, we would be happy to continue to participate in the relevant fora to discuss the issues presented in this paper in more depth.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Lee Guy", with a long, sweeping horizontal stroke extending to the right.

Lee Guy
Co-Chief Risk Officer
Barclays

A handwritten signature in black ink, appearing to read "John Mahon", with a stylized, cursive script.

John Mahon
Co-Chief Risk Officer
Barclays

