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20th February 2015

Re - Fundamental review of the trading book: outstanding issues (d305)

Barclays welcomes the opportunity to comment on the consultative document. We would also like to acknowledge the open, constructive engagement between the Committee's expert group and the industry as the proposals continue to evolve.

We recognise the significant progress made by the Committee since the previous round of consultation. In particular, we strongly welcome the continued development of the sensitivity based approach ("SBA"), over the cash-flow based approach, for the standardised calculations. There is still more work to be done to ensure the framework only makes use of the most relevant sensitivities, remains accessible to banks of differing scale or complexity, and can respond to different market conditions. But we believe the Committee has made an important step towards its stated objective of greater consistency and comparability in trading book regulatory capital calculations.

We are contributing to the work of the Joint Trade Associations (IIF, GFMA, ISDA) on the consultation questions and points of technical detail and broadly support these industry wide efforts. In our own response, we would like to briefly focus on some key themes from Barclays perspective.

Finalising the trading book framework

We recognise that industry comments around timing, or the need for additional impact studies, are often perceived as attempts to postpone or alter the course of regulatory reform. Barclays believes the Committee's timetable for FRTB is ambitious, but achievable, provided that a clear distinction is drawn between finalising the design and the calibration of the framework. Major design questions can be resolved, before using the regular cycle of Basel III monitoring exercises to refine the parameters prior to implementation. We would suggest a minimum period of at least 12m prior to "go live" in which both the design and calibration are fixed, as this would allow firms to appropriately assess and manage the impact of the changes over a reasonable period of time.

Clear direction on calibration and systemic capital

Barclays understands that the 'Basel 2.5' reforms (BCBS193) achieved an increase in the level of system-wide capital for trading book risks. From discussions with the Committee's

expert group, we believe the focus of the FRTB is to ensure a more coherent framework for calculating and allocating the existing levels systemic capital. It would be helpful if the Committee could reaffirm that the goal is not to materially increase systemic capital levels, and that the final calibration of the FRTB parameters will seek to reflect this. We accept that the impact on individual firms may differ significantly, relative to the profile of their risk positions.

Barclays notes that the revised standard rules for market risk are based on similar concepts to the internal models approach, albeit with a greater level of prescription. We believe models still have an important role to play in terms of fostering better risk management, improving understanding of risk and guarding, to some extent, against herd behaviour. But adopting a modelled approach for capital reporting is not a costless option for firms or, indeed supervisors; while there may be some synergies with risk management, firms are unlikely to make the associated investment if the only possible outcome is higher Pillar 1 capital requirements, particularly given the relative complexity of the revised standard rules and the proposals for a standardised floor in d306.

We would welcome the Committee's views on how they would expect the revised standard rules to perform relative to the internal models approach – for example, whether it would generally deliver higher requirements than the advanced approaches, and whether there would be capital incentives for banks to pursue the advanced approaches. We believe an acceptable trade-off would be to restrict the revised standard rules to primary risk sensitivities, calibrated conservatively, reducing the potential for complexity within the standardised approach in favour of simplification. In those areas where banks could meet the Committee's modelling standards, this means there would be a clear capital incentive to pursue the more risk-sensitive, advanced approaches.

A consistent approach to risk sensitivity and complexity

With a move towards mandatory standardised calculations, potentially acting as a floor, we would encourage the Committee to examine potential inconsistencies between the FRTB and standardised charges for other risks. For example, the default risk charges within the FRTB revised standard rules are based on credit ratings, whereas the proposals for standardised credit risk (d307) seek to remove the use of credit ratings for default risk on corporate and bank exposures. Similarly, the final standards on counterparty risk (BCBS279) use fixed volatility assumptions and a type of Black-Scholes formula for the risk on options, whereas the market risk charges proposed are based on actual sensitivities.

Fundamental review of the trading book: outstanding issues (d305)

We support many of the proposals that more closely align certain aspects of the revised models and standardised based approaches with Banks' current capabilities and infrastructure, noting that the time and cost to implement some of the previous proposals would have far outweighed the benefits of doing so. We also believe that many of the refinements proposed will help better achieve the Basel Committee's stated objectives of consistency and comparability in trading book regulatory capital calculations. That said, we believe the paper could have gone further in providing greater clarity, particularly in the

draft Accord text (Annex 1), to address some of the outstanding concerns raised as part of the prior rounds of consultation, and during the on going dialogue with the industry.

We believe further clarity is still required in the following areas: the trading banking book boundary; the refined risk factor approach within the Sensitivity Based Approach and the treatment of basis risks; further clarity in the instructions set out to capture Vega risks within the SBA; the IMA capital calculation and the capitalisation of Expected Shortfall; and the risk factor coverage in the revised Internal Models Approach and non-modellable risk factors (NMRFs). We outline the issues we believe need addressing in each of these areas in more detail in the Appendix below and hope that you find our comments and suggestions helpful.

Please do not hesitate to contact Ed Duncan (Risk, FRTB Program) at Barclays if you have questions or comments on any of the issues raised in this response.

Appendix – Barclays detailed response

Topics covered:

- *Internal Risk Transfers*
- *Standard Rules Refinements:-*
    - *Basis Risks / "Correlation Method"*
    - *Asymmetric Correlation*
    - *Vega Risks*
- *Internal Models Approach Refinements:-*
    - *Liquidity Horizons*
    - *Capitalisation of Expected Shortfall*
    - *Non Modellable Risk Factors*

Trading Book Banking book boundary - Internal Risk Transfers (IRT)

We recognise that several responses to the second consultative paper (including Barclays) requested clarification of the treatment for IRTs. While we were seeking clarity as to the treatment of internal trades under the FRTB, we were also keen to ensure their treatment would preserve appropriate incentives for risk management.

Currently many firms, including ours centralise certain risks via an ALM desk structure, providing for the efficient and cost effective means by which risks can be measured, monitored, and managed accordingly – allowing for hedging where possible. To the extent possible, we transfer all the FX and GIRR market risk we can out of the banking book businesses into Treasury so that these risks can be aggregated, measured, and centrally managed. However, some of these risks are unhedgeable in wholesale markets (i.e. Base/1m libor basis risk, repricing lag on the liability books) and so remain, and will always remain, on the ALM desk. Capitalisation of residual GIRR in the banking book would be considered under the current Banking Book regime, whereas residual FX and Commodity risk would be treated under market risk rules as required.

This transfer of unhedgable risk to ALM is a key risk management practice as it allows a) the transparent measurement of the group's overarching exposure to this risk, rather than losing line of sight of them if they remain in different parts of the balance sheet and b) it allows some form of mitigation through the central hedge accounting solution. The proposed treatment for IRTs in the consultation paper, could, by increasing the costs of maintaining this arrangement, discourage the transfer of these risks and the appropriate hedging of banking book risks in this way.

Centralising the risks ensures fewer desks across the firm are required to face the street and run additional unnecessary counterparty credit risks, while enabling the bank to take a portfolio view of the risks that require monitoring and managing. Any risks left unhedged via

this process are subject to the market risk control framework and capitalised under Basel 3 standards. Limited arbitrage opportunities exist in this set up, and it's not clear further provisions requiring exact matching with external trades are required. This is also captured / will be captured through the IRRBB framework (i.e. we are currently charged Pillar IIa capital for the base/libor basis risk position)

Preserving these risks in the individual businesses will lose these efficiencies and additional governance and oversight provided within a central ALM function. Furthermore, we do not believe it would be appropriate to be charged market risk capital on residual GIRR of these balances (circa £200bn of basis risk, £150bn of lag) as they are pure banking book positions and risks – i.e. market risk frameworks do not and can not de facto bind us to almost fully offset the risks they are loading through their customers' transactions as in some cases there is no market to do so.

We also support the joint trade association's suggestion that there be closer interaction between the TBG and the TFIR on the treatment of IRTs, with a view to ensuring the changes to the trading book capital rules factor in the prudential rules for IRRBB.

Standard Rules refinements

Sensitivity Based Approach (SBA)

Barclays acknowledges confirmation that the "Cash Flow" based approach (BCBS265, Oct 2013) has been dropped in favour of the Sensitivity Based Approach (SBA) and we agree that sensitivities are more readily available, and easier to implement than "cash flows". This change is one we welcome, and one we supported in response to the last consultation paper. We see the increased risk sensitivity of the revised "standard rules" and the SBA as a vital component of the FRTB, making many of the other proposed changes possible and more meaningful – in particular, a credible fallback calculation to a full modelled based approach to enable desk level approvals and model performance testing, mandatory calculations and reporting and disclosures.

We have the following comments with regards to the remaining issues that need to be resolved to finalise the SBA, while observing that further important work is required to complete the framework for Securitisations: -

Basis Risks – Correlation Method (CM)

We support replacing the previously proposed Disallowance Factor (DF [90%]) with a correlation parameter (Correlation Method, CM [0.1%]). The DF is likely to be insufficiently risk-sensitive to provide a useful fallback metric to the IMA, in particular for Rates and FX. However, we recognise the CM requires banks to compute sensitivities to all regulatory specified risk factors, which may not be as straightforward for some banks as for others.

This is why we continue to believe that the FRTB should stick to prescribing a set "primary" risk factors within the SBA, that combined with a conservative calibration, will ensure the approach is accessible to a broad range of banks (both large and small) and provide banks

with the necessary incentives to continue to develop and build risk models. We do not think maintaining the DF for less sophisticated firms and/or for residual risks is a good idea, as this would undermine the core objectives of simplicity and comparability across firms.

Asymmetric Correlation

One of the consequences of the proposed approach to diversification and hedging under the SBA is that the final capital charge can be very high (relative to current VaR models or the proposed IMA) where multiple basis-type risks are aggregated. This is because the sum of the cross terms in the SBA aggregation is effectively floored by the difference between the same-sign and opposite-sign correlation matrices. The impact is largest for the CSR charge due to the more pronounced differences between the correlations parameters prescribed (90% vs. 60%). For example, on a given issuer, a long credit spread exposure on 1Y and 3Y tenors, while short on the 2Y tenor results in the 1Y/3Y tenors being highly correlated (90%), while the exposures to the closer tenors of 1Y/2Y and 2Y/3Y would be lower (60%). Thus the proposal to correlate same sign exposures at higher correlations to different sign exposures leads to unrealistic correlation matrices, whereby less correlated exposures are attributed higher correlation factors.

This problem becomes much more severe with the change from Disallowance Factor to Correlation Method for basis risk, both because of the wider range of positions affected (for CSR, not just calendar spreads, but also cash-CDS basis and single name-index basis), and because the high (99% or 99.9%) correlations between matched positions where the only net exposure is to a (small) basis. To give an extreme example, the combined capital charge for two matched cash-CDS basis positions on different names in the same bucket could be as much as 17 times the equivalent charge for two positions in different buckets (where symmetric correlation is used).

Vega Risks

The Consultation Paper proposes to treat Vega risks as linear risk together with Delta (using the same buckets), requiring Vega risk factors to be similarly defined. While this is clear, and we appreciate this is a "work in progress", the new "Preamble" text, released as part of the QIS exercise requires further clarification.

Where the further clarification section refers to three dimensions for GIRR Vega risks, the correlation computation formula seems to emit a dimension (T_i and T_j only). Also, it looks as though the Vega correlation for equity options would be based on the maturity and "moneyness" of the option only, while the Delta risk is bucketed by "size", "region", and "sector". Finally, the same section includes reference to "Risk weights" per vertex ("in basis points"), with apparently neither risk weights nor basis points used in the table that follows ("Table a"), which outlines a range of tenors rather than "a vertex".

Internal Models Approach refinements:

We appreciate the proposed modifications to the incorporation of varied Liquidity Horizons based on the comments we shared last year and following the results of QIS2. We also

appreciate shortened horizons for certain FX and Rates risk factors, although the application of the shorter horizon for "currency pairs" for FX delta may require further clarity – this is due to the potential for FX triangular arbitrage.

Scaled Liquidity Horizons

Previously we were required to model shocks over the actual length of a given liquidity horizon, however it is now proposed to use a scaled Expected Shortfall from a baseline horizon of ten days to the length of the longer horizons. This will no doubt lead to greater consistency across firms models, leverage off existing technologies, and not lose any of the conservatism previously proposed.

Floored liquidity horizons between correlated risk factors

QIS2 highlighted concerns with the revised IMA whereby mixed long and short positions in related Risk Factors with different liquidity horizons, while exposes banks to basis/correlation risks, capitalized the risk factors as though there were a maturity mismatch between positions. The paper proposes to adopt the industry's suggestion that the horizons be treated as "floors", with basis/correlation risks calculated over the longer horizon. The language envisages this happening at the Trading Desk level, such that a longer horizon adopted for a certain risk factor would apply to that risk factor for the whole desk. While this is broadly welcomed, it may result in different treatment for the same risk factor across different desks, and some practicalities require further clarification, e.g. do we maintain desk level floors for firmwide ES and "partial" ES calculations?

IMA ES calculation

The proposals incorporate additional Draft Accord text prescribing the way in which ES, with varying liquidity horizons, is to be calculated, via a regulatory prescribed formula. We have noticed that the notation for this formula has been updated in Annex 4 of the QIS instructions issued in February this year. We refer to this as the "cascade" approach in the joint trade association response, and we are concerned with the operational impact such a formula may have. Although we understand the underlying rationale for prescribing the formula in this way, we are concerned as to the potential increase in the number of model runs that would be required to calculate it. We think this could be avoided by making a few simplifications to the formula, which would also lead to a more efficient daily calculation process and we support the joint trade association's recommendations in this matter.

Non-modellable Risk Factors

We support a robust process for assessing whether individual risk factors can be deemed as "modellable" or not, and agree that a systematic process for identifying, recording and calculating regulatory capital against risk factors that are not covered in the model is an important feature of the regulatory framework governing Market Risk regulatory capital calculations. We believe the best way to achieve this is via firm and supervisory oversight of the process by which firms verify and validate the data used in internal models.

Under existing Basel rules (and the Capital Requirements Regulation in Europe) we are required to ensure that internal models meet stringent data standards that incorporate a minimum annual independent review (via internal audit, independent of the model development team and the Risk function) of the data the models rely upon – including the accuracy and appropriateness of valuation and risk sensitivity calculations and consistency, timeliness and reliability of data sources used to run internal models.

We think provisions focussed on data quality in models are better suited to achieving the stated regulatory aims of a more robust risk factor identification and measurement process, than a framework that attempts to define model eligibility of risk factors based on loosely defined concepts of "representative transactions", "real" prices, and "acceptable frequency" (of observations). In addition the in/out criteria proposed of "24 observations per year with a maximum period of one month between consecutive transactions" is likely to result in a lot of operational pain and increased costs, with very little gain in terms of model coverage and/or data quality.

As a UK regulated bank we have adhered to a formal "Risks Not in VaR (RNIV)" framework for many years now, and we calculate a material component of our reported model-related market risk capital as RNIVs. The RNIV framework is intended to ensure that own funds are held to meet all risks which are not captured, or not captured adequately, by the firm's models. The framework requires us to systematically identify and measure all "non-captured or poorly captured risks". Due to the data coverage and data quality supporting RNIVs, we think it is important that the regulatory framework is flexible enough to encourage as accurate a risk metric as possible, possibly via a range of measurement techniques that would include modelled-type and stress based methodologies.

An effective framework should also provide for incentives for banks to continuously assess and develop the risk factor coverage of their models, with a key focus on data integrity. With this in mind we are supportive of the recommendations of the Joint Industry Response to the Consultative Paper.