

March 2015

Mr. Bill Coen
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Dear Mr Coen,

CAPITAL FLOORS: THE DESIGN OF A FRAMEWORK BASED ON STANDARDISED APPROACHES ("SA Floors")

We appreciate the opportunity to comment on the Basel Committee on Banking Supervision (BCBS, the Committee) proposal to revise the Basel standard on SA Floors, and share with you our views on the proposed framework of capital floors based on standardised approaches.

We have contributed to the work of the Joint Trade Associations (IIF, GFMA, ISDA) on the summary comments and consultation questions and support these industry wide efforts.

In summary, we believe the introduction of Standardised Floors (SA Floors) might be unnecessary given a number of regulatory reforms that enhance transparency and comparability and effectively act as a floor for model risks (such as the leverage ratio). Should the Committee decide to introduce new SA Floors then the design and calibration should:

- Only be finalised once the underlying standardised rules are final; and
- Ensure that floors only bite in exceptional circumstances where IRB RWAs would otherwise be outliers.

The key themes from our perspective are set out in this covering letter.

Principles of risk capital

In our view, the key principles of risk capital are that it:

- Is proportionate to the risk incurred;
- Is calibrated to ensure sufficient capital in the system;
- Incentivises the use of prudent risk management (through hedging and recycling); and
- Avoids excessive variability for similar risks.

Internally modelled (IM) approaches are more sophisticated than standardised approaches (SA) and able to be more reactive to changes in the risk profile of the asset. Recognition of hedging is also more closely aligned to internal risk management practices.

We believe that introducing binding capital floors would push more banks towards the SA and, in doing so, reduce incentives for modelling sophistication and make hedging more likely to target regulatory recognition under SA rules effectiveness rather than true risk management or risk reductions.

Furthermore we believe that capital floors do not provide sound risk assessments across jurisdictions, which can result in unduly penal capital requirements that will hinder growth in some emerging markets such as South Africa where the four largest banks operate under advanced IRB approaches.

Rather than adding capital to the system through floors, we would suggest that the focus should be on transparency and disclosure. We believe the suggestion in the Fundamental Review of the Trading Book (FRTB) to calculate and disclose SA for market risk to be an improvement to the information that is available to investors and regulators. This should encourage those groups to ask more questions of institutions as to how their IM and SA differ to understand how an institution manages its risk and capital.

Role and objectives of capital floors

We believe that capital floors may not be necessary in the light of alternative and complementary measures that already are in place, or under development within various regulatory, supervisory and industry levels. Therefore, we suggest the Committee defers a final decision on whether to proceed with capital floors until a full review of the revised regulatory capital framework has been completed.

We understand that the concerns of regulatory standard setters and the broader market around excessive dispersion in the calculation of RWA. However, appropriate calibration and differentiation remains essential. Modelled RWAs may legitimately be lower than SA RWAs and differing risk management techniques and risk appetite can lead to variations in pricing and hence capital requirements for a given portfolio of positions. We therefore do not believe it appropriate to seek comparability through standardisation. Rather, we would propose a focus on improving the toolkit available to supervisors as part of the regulatory assessment process, and the broader market through improved disclosures.

Models should continue to play a role in fostering sound risk management, improving the understanding of risk and guarding, to some extent, against herd behaviour. Floors that bite too often (i.e. outside a stressed scenario) would discourage model development and applications for use in regulatory capital to the detriment of valuable risk management practices supported by risk sensitive models.

Capital floors and leverage ratio

The BCBS views about the complementary nature of the proposed capital floors to the existing leverage ratio regime do not reflect the high level of overlap between capital floors and leverage ratio requirements given the similarity in their stated objectives. More detailed comments on this are included in our response to question 3.

Design of the capital floor framework

We agree with the BCBS that differences in the treatment of provisions between IRB and SA-CR are material and should therefore be eliminated for SA Floor calculations.

Both options presented by the Committee in paragraphs 21 to 24 of the proposals are mechanically suitable to impose floors but require further work to ensure conceptual soundness and transparency needed for a consistent implementation.

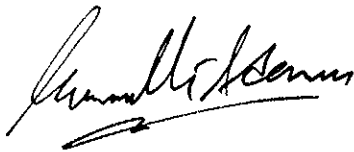
Timing

We consider the proposed timing to finalise SA Floors by the end of 2015 to be very ambitious as key elements of the new capital regime and particularly the SA-CR, SA-MR and SA-OR are still under development.

These elements, including a calibration of their expected application, should be confirmed before SA Floors are finalised.

We hope that you find our comments and suggestions helpful. Please do not hesitate to contact Roger Versluys (roger.versluys@barclays.com or +44 20 7773 2791) if you have questions or comments on any of the issues raised in this response.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Meen Adams', with a stylized flourish underneath.

Meen Adams
Chief Accountant

Annex 1: Responses to questions raised in the consultation paper

Q1. Assuming the respective floors were calibrated to achieve the same level of required capital, what are your views on the relative merits of a risk category-based floors and an aggregate RWA-based floor? What are your views on a floor based on exposure class?

There are advantages and disadvantages to each of the proposals. Before reaching a final conclusion on this, it is necessary to see further detail on calibration and so how the SA Floor is intended to bite.

Floors by major risk category:

- Are more straightforward to calibrate for the Committee;
- Help banks to plan RWAs by risk categories;
- Avoid cross-funding of headroom between IM and SA; and
- Require further disclosures which we believe supports the objective of transparency.

Aggregated floors:

- Are relatively simpler to apply;
- Allow banks to continue to disclose their pure IRB capital ratios; and
- Allow cross-funding of headroom between IM and SA.

A challenge with aggregated floor is the lack of coherence between the standardised and advanced approaches in each of the risk categories. The FRTB's SBA and SA-CCR are designed and answer their purpose as approximations of their advanced equivalents. At the same time, we do not believe that the current SA-CR and SA-OR proposals are sufficiently risk sensitive and as such good proxies for RWA that would otherwise be calculating under IM.

If the capital floor framework allows cross-subsidisation as a principle, the consultative proposals suggest a higher overall floor. Therefore, we support the concept of applying floors at the level of major risk categories to give scope for a differential calibration. In other words, if credit and operational risk proposals for SA remained as risk-insensitive as proposed, we prefer lower floors to apply to them individually.

Q2. What are your views on the relative merits of the two options for adjusting for differences in the treatment of provisioning for credit risk?

Differences in the treatment of provisions should be evaluated in light of changes to IFRS 9 that will be effective before implementation of the proposed capital floors.

Regarding the relative merits:

- Both options are suitable as floors from a pure mechanical viewpoint should the Committee decide to implement aggregated floors;
- However, the stylised example in Box 2 of page 8 of the consultative paper leaves room for interpretation on how the application of floors is mechanically designed to work.

While the stylised example sets out how adjustments should be applied they do not show how floors are mechanically applied to the adjusted levels of RWAs or capital resources.

Furthermore, Option 1 requires clarification.

As stated in paragraph 22, Option 1 “effectively transforms the IRB measure of capital into a standardised approach measure of capital”, by postulating that both EL and UL must be capitalised.

This leads to an increase in the amount of capital resources available in the numerator of the IRB ratio, as the bank would “add general provisions when calculating its capital ratio for the purpose of calculating its capital ratios under the internally modelled and standardised approaches (ie its total capital resources would be $100 + 33 - 3 + 8 = 138$ ” (Box 2).

Similarly, the denominator of the Option 1 IRB ratio should increase, to include the RWA equivalent of EL. In the stylised example, this would mean that for the purpose of the floor application, capital resources are 138 for both SA and IRB, versus SRWA of 1,150 and IRWA of 887.5 ($800 + 7 \text{ EL} \times 12.5$).

However, the example provided in Box 2 makes no reference to a correction of the denominator under the IRB approach. We seek clarification of whether correcting the denominator was indeed intended by the BCBS.

The alternative would be to keep the capital resources and RWA unchanged under IRB option 1 (133 and 800 respectively), but this would not align the measures of capital between the IRBA and SA.

We are at the disposal of the Committee for any more detailed work on how the mechanics should be designed and communicated so that a consistent understanding and implementation can be ensured.

Q3. Do you have any other comments regarding the design of the capital floor?

Interaction with disclosures and leverage ratio

The 2009 objective of the BCBS of introducing the Leverage Ratio “was to put a floor under the build-up of leverage in the banking sector and to introduce additional safeguards against model risk and measurement error by supplementing the risk based measure with a simple, transparent, independent measure of risk that is based on gross exposures”.

The key 2014 objectives to introduce capital floors are preventing undue optimism in modelling practices; mitigate model risk due wrong specifications and errors and addressing incentive-compatibility issues. All three objectives are designed to avoid that modelled capital requirements do not fall below a prudent level.

As such, we note a well-documented overlap between the Leverage Ratio and SA Floors. The BCBS should acknowledge these and design capital floors in such a way as to avoid overlap. This can be achieved by calibrating floors to only bite in exceptional cases where model-based calculations would give rise to outliers when compared with a range of benchmarks (not be limited to standardised calculations). Instead, the same effect could be achieved by exposure class types of floors or floors to certain parameters of the IRB formula such as PD, LGD or Effective Maturity.

Before doing that, however, the Committee should consider the experience with other parts of the regulatory reforms such as increased disclosure and leverage ratio before deciding whether capital floors are necessary to ensure comparability and sufficient levels of capital in the market place.

If it is determined that there is not enough comparability, BCBS should first increase disclosure by IMA firms against the SA and let the market try to use that information before introducing a capital floors that may be redundant or even lead to unintended consequences.

Capital planning and management

A key issue for banks will be to plan and manage constraints in regulatory capital requirements stemming from a three-dimensional framework between model-based, capital floors and leverage ratio requirements.

Discrepancies and conflicts between model-based and floored capital requirements can be avoided by designing SA capital requirements in close alignment with IM. As mentioned earlier, while this seems achievable based on SA-CCR and proposed MR SBA rules, the current consultations for SA-CR and SA-OR lack risk sensitivity.

If severe conflicts between the various capital requirements remain, banks will struggle to balance the interests and requirements of different groups of stakeholders such as supervisors and shareholders. Once either a non-risk sensitive capital floor or leverage ratio forces a bank to allocate capital resources to potentially low return / high cost of risk businesses to address the dominant interests of supervisors, other stakeholders such as shareholders will disagree with the negative impact on the risk and return profile and therefore reduce their investments in the banking industry. The consequence will be that banks will be forced to downsize otherwise profitable and perceived low risk business which will ultimately result in higher costs for their clients.

Banks are looking for stability and planning certainty for their capital resources and switching between having to apply floors between financial and regulatory reporting period will lead to potentially significant confusion among users of financial information.

IRB rollout

Further considerations should be made for IRB portfolios that are in rollout and immaterial asset classes for which banks have IRB exemptions. It is important that the treatment of such portfolios is addressed in the mechanics for SA Floor calculations. In the stylised example provided in Box 2 of the consultative paper, it is assumed that banks calculate RWAs either under IRB or SA approaches. In reality, however, many banks and particularly banking groups apply a combination of IRB and SA approaches to calculate RWAs in line with their permission and rollout rules. This needs to be reflected in the design and mechanics of any final floor regime.

Assuming floors to apply to major risk categories, the BCBS should also provide guidance on whether CCR and CVA are separate risk categories or parts for credit or market risks. In our view, counterparty credit risk is a separate risk category that could be allocated to credit risks while CVA should be included in market risks.

Knock-on impacts of adjustments to capital resources

Finally, the Committee will need to decide whether adjustments to regulatory capital resources under the floor regime will also serve as basis for leverage ratio and large exposure limit calculations.

For example, under option 1 of the stylised example, if the intention of the BCBS was to adjust capital resources both for IRB and SA to 138 as mentioned in Box 2, would this mean that total capital would be 138 for all regulatory requirements?

Under option 2 of the stylised example in Box 2, once the floor takes effect, the regulatory capital for calculating capital ratios is reduced from 133 under IRB to 130 under the SA Floors due to the excess of provisions over expected losses under IRB.

In contrast, had the sample bank a provision shortfall, total regulatory capital under the SA Floors would be increased so that the capital base is neutralised for any effects from the treatment of expected losses and recognition of provisions under the IRB approach.

As the regulatory capital resources change depending on whether the standardised floors takes effect the question is whether such changes constitute an amendment to the numerators of leverage ratio, large exposure calculations and total loss absorbing capital (TLAC).

