



March 2015

Mr. Bill Coen
Secretariat of the Basel Committee
on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

1 Churchill Place
Canary Wharf
London E14 5HP
United Kingdom

Tel +44 (20) 116 1000

barclays.com

Dear Mr Coen,

REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK

We welcome the opportunity to comment on the consultative document and are fully supportive of the Committee's objectives to ensure the continued suitability of the standardized approach to calculating the capital requirements for credit risk exposures.

We have contributed to the work of the Joint Trade Associations (IIF, CFMA, ISDA) on their comments and are supportive of these industry wide efforts.

Our key topics are as follows and set out in more detail further below:

- Removal of external ratings and replacement with less powerful predictors of default;
- Negative impact on lending to SMEs;
- Increases in capital requirements;
- Comparability and consistency with other regulatory standards;
- Market entry barriers;
- Risk sensitivity and granularity;
- Risk factors for claims secured by residential real estate;
- Exclusion of credit derivatives without restructuring credit event; and
- Timing

Removal of external ratings and replacement with less powerful predictors of defaults

One of the stated objectives of the revision of the SA-CR is to reduce mechanistic reliance on external ratings by providing alternative measures for risk assessments. However, we are concerned that the proposals now eliminate the use of ratings entirely for bank and corporate exposures and use other risk drivers to predict defaults.

Based on our analysis, some of the proposed risk drivers have significantly less predictive power than external ratings. Accordingly, we believe that the proposed adaptation of the proposals would significantly reduce risk sensitivity.

We are concerned that the Committee opts for the lowest common denominator by accepting jurisdictional limitations on the use of external ratings as given parameters. We do not support the replacement of external ratings that are independently set and available to all banks where they have more power to predict defaults than alternative risk drivers. The consequence of this would be to reduce

the resilience of the regulatory capital framework which contradicts the stated objectives of the proposed revisions of the SA-CR.

Instead, we recommend the Committee evaluate which risk drivers have the most predictive power to forecast defaults. If these are external ratings for large or listed corporates and banks then they should continue to be used for the calculation of risk-weighted assets (RWA) (at least in jurisdictions where this is not prohibited by national law).

To meet the objective of reducing reliance on external ratings, external ratings could be:

- Combined in a matrix with other risk drivers with power to predict defaults such as non-performing assets ratios or net profits for banks or cash-flows/turnover for corporates;
- Available as basis for RWA as long as certain financial ratios are met. However, these would need to vary depending on the industry and the size of the obligor; or
- Combined with announcements of future rating actions or outlook statements of external ratings agencies..

Separately, we acknowledge that for unrated exposures, the proposals could result in an increase in risk sensitivity. However, we urge the Committee to fully consider which drivers are the best predictors of default and are widely available for use in an objective way. In our view and as set out in more detail later on in this document, these would be:

Exposure types	Objective and available risk drivers to predict defaults
Banks	External ratings
Corporate - large / listed - SME	External ratings Behavioural criteria, delinquencies
Retail	Financial collateral, delinquencies and time on book
Residential real estate	LTV and delinquencies
Commercial real estate	LTV

Negative impact on lending to SMEs

To use revenues and leverage as risk drivers for corporate exposures could have a significant impact on lending to SMEs with reduced competition and higher pricing. We note from the proposals that lending to smaller enterprises would often attract a risk weight of 300%. The proposed risk drivers often play no role in credit approval processes of SMEs that do not have statutory obligations to prepare detailed financial statements. Therefore, we propose the Committee to consider alternative concepts to derive RWA for SME lending which could include a combination of behavioural and financial input variables.

Increase in capital requirements

The Committee states in the consultative paper that it did not intend to increase capital requirements under the SA-CR. However, we note a number of significant increases in applicable risk-weights, reductions in available credit risk mitigation techniques and increases in haircuts for collateral. The context for these changes is not currently clear.

These will be particularly relevant once the SA-CR serves as a floor for IRB and we are very keen to understand how this framework can be recalibrated to achieve capital neutrality vs the existing standardised approach.

Key items include:

- Risk-weighting of 300%

The application of a “penalty” risk-weight of 300% for bank and corporate exposures where the required risk drivers are not available is a significant change to the SA-CR. Under the current SA-CR, bank and corporate exposures that are unrated would be subject to a risk-weighting of 100%.

We understand that the Committee associates such exposures with higher risk and hence a higher capital requirement. However, to approximately triple otherwise applicable RWA seems disproportionate.

We believe that final changes should only be implemented once the results of a full impact study are available. The intended timeline, whereby the revised SA-CR will be finalised by the end of 2015, in combination with the timing of the current QIS, would not seem to allow for a sufficiently detailed assessment to take place. It is a critical concern that the time available for the current QIS will leave banks with little time to source the necessary data to reliably estimate the total impact of the penalty 300% risk-weighting, since firms need to differentiate on a best efforts basis between exposures where they do not have this information today (but it could be sourced in time for implementation) and where this information may not be available.

- Treatment of short-term interbank claims

Under option 2 of paragraph 63 of the 2006 Basel Framework, investment-grade and unrated short-term interbank claims are risk-weighted at 20%. Under the SA-CR proposed revisions, comparably more narrowly defined short-term interbank claims would only benefit from a 20% reduction to the risk-weight otherwise applicable for bank exposures.

The Committee proposes this preferential risk weight to short-term interbank claims to avoid a negative impact of market liquidity in interbank markets, yet the proposal constitutes a significant increase in applicable risk weights which should be subject to a detailed impact assessment before finalisation of the standards.

A key risk of the proposed approach under a stress scenario is that risk-weights of bank exposures will increase due to lower capital ratios. This would have a knock-on impact on risk-weights applicable to short-term interbank lending and could influence the willingness of banks to lend to each other in a crisis scenario. Whilst this may be intentional in order to reduce interconnectedness in the financial system, we believe there are sufficient disincentives elsewhere in the liquidity and G-SIFI regimes.

- Conversion factors

The Committee proposes to introduce a 10% conversion factor for unconditionally cancellable commitments (currently 0%) and 75% for non-cancellable commitments (currently 20% for below one year and 50% for above one year).

The Committee explains that this proposal is designed to align the SA-CR with conversion factors applicable under the F-IRB approach. We do not agree with the level of conversion factors applicable under F-IRB as these do not reflect the internal drawdown history of credit commitments that we use to calibrate A-IRB conversion factors. We understand this to be the case for others in the Industry.

We recommend that the Committee uses the results of the QIS where banks report their A-IRB conversion factors to re-calibrate conversion factors of commitments for both F-IRB and SA-CR (instead of simply adapting SA-CR to F-IRB).

We note that the A-IRB conversion factors that we report in our QIS already entail various prudent assumptions and buffers that we are happy to make available to the Committee for any necessary calibration work.

- Approaches to be excluded

The Committee is of the view that the SA-CR should not allow internal models to be used to set capital charges. We agree with the Committee that the purpose of SA-CR is to derive risk-weights without using models. However, the calculation of exposures for OTC derivatives and SFT is outside the scope of the SA-CR. Therefore, in particular the Internal Model Method (IMM) (which is the most relevant approaches on the proposed list of exclusions) should continue to be an acceptable basis to determine exposures at default under the existing IMM permissions issued by competent authorities.

We would not think it appropriate for exposure calculations for derivative under approved IMM models to be dictated by the availability of an approved IRB model for the relevant counterparty. Such an approach would also mean that the Committee would be centrally withdrawing permissions of non-IRB banks to use IMM, thus privileging IRB over non-IRB banks.

Comparability and consistency with other regulatory standards

We appreciate the Committee's desire to increase comparability and consistency. However, we note that when combined with the floor proposals the result might be to encourage firms to adopt more homogenous business models and consequently exacerbate future crises.

We believe the objective of increased comparability can be achieved by requiring banks in jurisdictions where external ratings cannot be used for regulatory capital reporting to disclose ratios on the basis of external ratings in their Pillar 3 reporting.

Our recommendations would also help in making standardised rules more consistent across risk categories for RWA purposes and also with other regulatory standards such as liquidity requirements:

- SA-CR versus Sensitivity-based approach for market risks (SBA-MR)

The FRTB proposals for trading in both corporate equity and debt (credit spread) instruments delineate between industry sectors. However, the proposed revisions of the SA-CR apply a one-size-fits-all approach by looking at corporate revenues and accounting leverage across industries.

Credit risks are by far the most dominant driver of risk-weighted assets from an overall industry viewpoint. It seems counter-intuitive that a significantly higher level of complexity is prudentially required for the SBA-MR. We believe that the Committee should consider defining risk drivers by the type of industry and size of the obligor to serve as basis to derive risk weights under the SA-CR.

- Drive to reduce reliance on ratings

The default risk component in the FRTB proposals is based on external credit ratings so it would seem inappropriate to use such as basis for RWA for markets risks if they are discarded for the purposes of calculating RWA for credit risks.

Similarly, the proposed securitisation rules include SEC-ERBA (for those jurisdictions which are not disbarred by law from using external ratings). It seems contradictory to continue to allow ratings on securitisations (a root cause of the credit crisis) yet disallow them on corporate exposures where ratings performance was not subject to the same degree of criticism.

External ratings are more robust than the proposed two-factor models that we perceive to increase risk through oversimplifying the criteria that identify a borrower as a high or low credit risk. While we agree that concerns over due diligence and mechanical reliance need to be addressed, we reiterate the value of the due diligence applied by rating agencies before issuing an external rating assessment (compared to individual banks relying on financial ratios that they will generally need to source themselves).

- Interconnectedness of regulatory standards

External ratings are not only used as basis for RWA and haircuts under the current SA-CR but also for market risk, securitisation and liquidity requirements. Before deciding to eliminate external ratings from the SA-CR we recommend the Committee to thoroughly analyse the implications that this could have on the overall regulatory framework.

Market entry barriers

The proposed changes are likely to impose incremental market entry barriers for entrant banks and reduce competition due to additional complexity and data requirements of the SA-CR.

Currently, smaller or regionally-oriented banks with relatively simple business models have a choice to use external ratings in their SA-CR. If they do, for sovereign, bank and corporate exposures, risk-weights of 20 or 50% are available for investment grade exposures, 100% applies for non-rated exposures and 150% for sub-investment grade exposures respectively.

A risk-weighting of 300% for exposures for which certain risk drivers are not available is a significant change in the fundamental approach of applying risk-weights. For entrant banks, this change in the paradigm will require significant investment in regulatory capital reporting processes so that an unsustainable penalty risk-weighting of 300% can be avoided.

This additional complexity of the SA-CR may therefore introduce barriers to entry for new banks and complexity to small funders who may not have the capacity to absorb the additional reporting requirements. The impact of this would be lower competition in the banking sector within the UK, potentially leading to less innovation and higher pricing, particularly for SMEs.

Risk sensitivity and granularity

The Committee seeks to substantially improve the risk sensitivity of SA-CR. In our view, the additional granularity that would be introduced under some of the proposals would not necessarily result in an increase in risk sensitivity:

- The range of applicable risk-weights between 60% and 130% in the corporate exposure class does not reflect the low risk attributable to exposures to large main index companies. Some of these achieve higher external ratings than G10 countries which for now continue to attract risk-weights of 0% under the SA-CR (albeit we expect that the Committee will be issuing proposals for sovereigns in due course).
- The introduction of a specialised lending category in the corporate exposure class with flat risk weights.
- Haircuts of debt securities where we do not believe that residual maturities above ten years warrant double the haircuts applied to residual maturities of up to ten years.
- The lowest category of LTV for residential real estate exposures is <40% which implies risk equivalence of LTVs of for example 10% and 39%.

Other aspects such as the proposed restriction on the use of IMM and additional restrictions on the eligibility and availability of credit risk mitigation techniques are at odds with the objective of increasing risk sensitivity and should be reconsidered once the results of the QIS are available. Generally, we do not support oversimplifying the standardised approach at the cost of risk sensitivity and incentives to prudently manage risk. This will become much more important once modelled RWA are floored with standardised RWA calculations.

Risk factors for claims secured by residential real estate

We support the introduction of a more risk sensitive approach for residential real estate. We agree that LTV is an important indicator of losses, but consider that DSC would be inappropriate as there are many conceptual and operational challenges which would limit the effectiveness of its use. We have considered other alternative measures including age of the facility and propose that days past due is used to supplement LTV. This is something that all firms will be able to implement and provides a real differentiation in the likelihood to default. For LTV we strongly recommend that consideration is given to distinguishing between owner occupier and other forms of residential real estate.

In the UK, for example, the proposed changes have potentially significant ramifications and would be inconsistent with the general direction of government policy to stimulating the housing market through higher LTV lending under the Help to Buy initiative and recently announced ISA initiative.

If standardised risk weights were applied in the UK mortgage market, either directly or through an un-adjusted risk weight floor, this could have a significant impact on mortgage prices for otherwise “low risk” sub-80% LTVs and therefore house prices. Barclays 2014 stress test results indicated a high correlation between rate increases, levels of customer impairment and sharply declining house prices.

Exclusion of credit derivatives without restructuring credit event

The Committee proposes to no longer recognise credit derivatives that do not specify restructuring as a credit event as a minor change to the treatment of credit derivatives as credit protection.

We believe that this is a highly significant change to the eligibility of certain credit derivatives as credit risk mitigation techniques.

In certain jurisdictions such as in the US, due to bankruptcy and clearing regulations, the market convention is that standard credit derivative contracts do not include restructuring. Therefore, in the absence of the relevant regulations to change in the future, credit derivatives purchased for US corporate and bank exposures would not be eligible under the revised SA-CR. Furthermore, US exposures require creditor consent for a restructuring, hence any restructuring can be blocked by the creditor and consequently a CDS would be a valid hedge.

Considering the size of US credit markets, it cannot be expected that excluding standard credit derivatives from risk mitigation techniques is significant enough to push market participants to change standard terms. Rather, users of credit risk mitigation techniques would have to request restructuring to be inserted as a non-standard clause in their contracts. This means that trading volumes in these instruments will be thin and therefore more expensive.

We believe that this point needs to be reconsidered to maintain incentives to prudently manage risks and the objective of the Committee to reflect the riskiness of exposures in the SA-CR.

Timing

We acknowledge the challenges of revising the credit risk SA, especially since the new SA framework is intended to be applicable across all types of banks and to be used as basis for the planned capital floors. We are also aware of the timeframe set by the FSB (in conjunction with the G20) to finalise the reforms of the regulatory capital framework.

However, given the significance of the proposed changes, we consider the timeline to finalise the proposed SA-CR revisions by the end of 2015 to be overly ambitious particularly given the package of other reforms anticipated at the same time (e.g. floors and FRTB). In particular we believe there is insufficient time for banks to provide quality impact data and for the Committee to thoroughly analyse the results and implement resulting changes to either the approaches or the calibration.

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 What are respondents' views on the selection of the capital adequacy ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel 3 in order to ensure a consistent implementation?

What are respondents' views on the selection of the capital adequacy ratio?

We have reservations about selecting capital adequacy ratios as driver for RWA purposes due to their pro-cyclicality and possible stress-compounding effects. The proposals would require banks to hold more capital against bank exposures during times of financial stress and less capital during more benign times. This negates the effects of countercyclical capital buffers and contradicts the more fundamental objective of making capital requirements less pro-cyclical. We also note that this is inconsistent with the proposals for residential mortgages where property value might be held constant to reduce pro-cyclical effects.

Additionally, the reference to CET1 ratios for bank exposures is circular which makes its calibration mathematically challenging. Risk weights are proposed to be based on CET1 ratios, the introduction of SA floors leads to lower CET1 ratios in the future, which in turn lead to higher risk weights.

Stress-compounding effects will be exacerbated by a similar effect to be expected from threshold deductions applied to regulatory capital for investments in the capital instruments of other banks. The more significant losses of banks will be in the next market-wide downturn, the lower the threshold for deductions from regulatory capital will have to be set by Basel 3 banks. This will set valuations of bank equity and debt exposures under pressure as banks will be forced to reduce holding and exposures to other banks.

We appreciate that rating agencies assess banks on their financial strength based on a CAMEL score (capital adequacy, asset quality, management, earnings, and liquidity). Some assessors add sensitivity to market factors such as the size and composition of the trading book to their methodologies. The important point is that these factors are part of a comprehensive and tested methodology. Selecting just two drivers to apply a two-factor model is less robust and prone to errors in the anticipated power to predict defaults and as such in deriving risk-weights.

The Committee assessed a significant bank sample, including **rated and unrated banks**, to conclude that the proposed risk drivers outperform the current credit ratings-based approach for predicting bank failure.

We do not agree with this conclusion because our own analysis conducted for **rated banks** which we consider a more relevant basis to make this comparison. Our results show that external ratings are superior to regulatory capital ratios and non-performing assets:

We analysed the statistical performance of external ratings and asset quality and regulatory capital ratios in predicting 1-year default events. The analysis is based on a data set consisting of US and global rated banks and investment firms (securities traders) during 14 years of data history.

Our comparison was done using a simple regression model with the only explanatory variables being:

- External ratings – we use indicator variables to estimate the effect of each alpha-numeric rating grade (dummy variables)
- Tier1 Ratio
- Impaired loans to gross loans

We summarise the model performance using Gini coefficients, which measure how well the model rank-orders observations (100% implies perfect rank ordering, 0% implies that model has no predictive power). We also look at the average predicted PD for a defaulted and non-defaulted sample,

summarised by the BG ratio (bad over good), which shows how many times is the predicted PD greater in the defaulted sample compared to non-defaulted sample. A BG ratio of 1.0 indicates that model cannot differentiate between defaults and non-defaults one year prior to default event, and similarly the larger the BG ratio, the better is the model in differentiating between default and non-defaults.

Below table summarizes the results which show that external ratings are a superior indicator to predict defaults and they could be combined with either or both on regulatory capital ratios and non-performing loans ratios.

Model	Gini	BG-ratio
Ratings only	64%	13.69
Tier1 Ratio only	17%	1.39
Impaired Loans / Gross Loans only	53%	3.32
Ratings + Impaired Loans / Gross Loans	68%	12.89
Ratings + Tier1 Ratio	55%	16.36
Ratings + Impaired Loans / Gross Loans + Tier1	68%	17.81
Impaired loans/ Gross loans + Tier 1	48%	5.04

We believe that capital adequacy ratios should be studied further over risk cycles to confirm their performance compared to external ratings. In that context, the predictive power of external ratings after the end of TBTF regimes and removal of implicit governmental support for G-SIBs in external ratings should be further analysed.

Do respondents agree that it is necessary to require calculations in accordance with Basel 3 in order to ensure a consistent implementation?

While we have fundamental reservations about using capital ratios for this purpose, we view both the CET1 and Tier 1 ratios as superior to the leverage ratio as the leverage ratio is not risk sensitive.

We agree that calculations should in theory be made in accordance with Basel 3. The required CET1 capital ratios will be available with considerable time lag from banking groups subject to Pillar 3 disclosure requirements in jurisdictions under Basel 3 regimes.

CET1 capital ratios will not be available on a counterparty-by-counterparty basis. The Committee proposes to use consolidated capital ratios as proxies for solo capital ratios if the latter are not available. This neglects that solo CET1 capital ratios can be significantly different from their consolidated group equivalents due to surcharges applicable to globally significant important banks, differences in national buffer requirements and resolutions regimes of which an adjusted use will likely lead to a misstatement of RWA for bank exposures.

The Committee further proposes “that a 300% risk weight will apply in cases where a bank is aware that one of its obligor banks has breached any binding minimum prudential standard to which they are subject by their national supervisor”. We understand the intention of the Committee to consistently require a risk-weighting of 300% for exposures to other banks that are in breach of minimum capital standards.

We would like to point out though that it may not in all cases be publicly known whether a bank is in compliance with minimum regulatory capital standards. Therefore, for simplicity and consistency purposes, we recommend deleting this requirement from the SA-CR. Otherwise, the requirement would create enforceability and consistency issues for national supervisors.

If the Committee decided to retain the 300% risk-weight for banks in breach of minimum regulatory capital then we recommend adapting a central list of delinquent banks to be maintained by the

Committee or the relevant competent authorities (which would enable firms to comply with the requirement but the practical difficulties would remain).

Q2. Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure's credit risk? What alternative asset quality measure, if any, should be considered by the Committee?

Financial strength based on CAMEL scores includes asset quality which is commonly measured by a net NPA ratio. We agree with the Committee that NPA ratios are an effective measure for distinguishing a bank's exposure to specific homogenous credit risk portfolios. However, we believe the measure is less effective for global banks with diversified credit, advisory and trading business operations.

We have some reservations about combining the net NPA ratio with capital adequacy ratios as we expect a high level of correlation between the two factors. This would be caused by the impact of provisions on both net NPA and capital adequacy ratios.

If the Committee decided to remove the reference to external ratings (which we believe are the most powerful predictor of defaults despite the known weaknesses) and if reliance will be placed on a two-factor model then we recommend selecting indicators with a low level of correlation. This could be achieved by adding an earnings indicator such as return on average assets to capital adequacy. For example, if a bank suffers unexpected losses, it will have a low capital adequacy ratio but because of its earnings strength, it might still have acceptable creditworthiness. On the other hand, a high capital ratio in isolation cannot be relied upon to assess whether a bank is capable of generating income before taxes necessary to meet its obligations.

If the Committee decided to keep the net NPA ratio as indicator to derive risk-weighted assets then we would recommend that an assessment of the implications of IFRS 9 be conducted.

Q3. Do respondents have views on the proposed treatment for short-term interbank claims?

As stated in our opening remarks, the 20% reduction in risk-weights for short-term interbank claims is proposed to apply to avoid a negative impact on market liquidity in interbank markets. It needs to be compared with the current risk weight of 20% for short-term interbank claims from investment grade or unrated banks.

The proposal leads to significant increases in risk-weights for short-term interbank claims and needs re-evaluation in light of the stated overall objective of the Committee not to increase RWA. In our view, the proposal lacks an explanation for the proposed increase in risk weights and an evaluation of potential unintended consequences on interbank funding markets and the associated liquidity risks.

In combination with the proposed risk weight of 300%, the proposals for short-term interbank claims could potentially significantly increase in risk-weights for exposures to banks during times of financial stress. The consequence could be that banks might under a stress scenario be reluctant to lend to each other.

Any preferential risk weights for short-term interbank claims with original maturities of three months and less should also be available if such claims are usually rolled forward. This is necessary to retain risk sensitivity as otherwise the risk weight of a 10-year bond will be equivalent to the risk weight of an overnight deposit that is rolled forward on a daily basis but could be called should credit spreads of the depositary bank widen. Evidence of deposits being rolled does not mean that the associated credit risks would be equivalent to long-term lending. This is consistent with regulatory liquidity standards where banks under the non-stressed NSFR regime do not obtain any long-term ASF credit for deposits that are usually rolled.

If the Committee intended to keep the requirement that “short-term claims cannot be expected to be rolled” then the Committee should clarify the term “expected to be rolled over” since a significant portion of short-term claims are usually rolled over and would only be recalled if the liquidity was required for other purposes. This pattern should in our view still allow banks to apply the preferential treatment of short-term interbank claims and as such, the term “expected to be rolled over” should be redefined. In the absence of that a perverse incentive would have been created for banks to move short-term liquidity around to optimise the applicable risk weights.

Q4. Do respondents have suggestions on how to address these concerns on the treatment of exposures to banks? In particular, do respondents have views on how to treat exposures to banks not subject to Basel 3 in a consistent and risk-sensitive manner?

Use of regulatory capital ratios as risk drivers

Our fundamental concern lies with the usage of capital ratios due to their pro-cyclicality, possible compounding effects in stressed conditions and a comparably low power to predict defaults.

The proposed application of 300% risk weights to banks that are not under Basel 3 or for which the data is not available will likely lead to an uneven playing field and an unwillingness to lend to other banks under different regulatory capital regimes. We recommend further consideration be given to the following:

- locations such as the US where only large banks are subject to Basel 3;
- emerging and frontier markets where funding sources could dry up if a risk-weighting of 300% applied by virtue of prudential capital regimes only gradually reaching Basel 3 standards; and
- short-term self-liquidating trade finance exposures for which a risk-weighting of 300% is not commensurate with the low risk, drive up pricing across the industry and may have an adverse effect on global trade flows.

In addition, we believe that the term “subject to Basel 3” needs further clarification. In particular, it would be helpful for the Committee to clarify whether they have official policy statements or regulations of the respective jurisdiction in mind or does the Committee refer to their own RCAP assessments to determine whether banks calculate their capital ratios in accordance with Basel 3. Unless this point is clarified, there is a risk that different jurisdictions will take views on whether third countries are compliant, leading to inconsistencies in the application.

The European Union (EU) implementation of the Basel 3 framework illustrates this risk; The EU Basel 3 implementation includes third country equivalence provisions whereby third country (i.e. non-EEA) jurisdictions are assessed for equivalence on specific provisions of the Basel 3 framework.

Regarding credit risks, the Article 107(3) of Regulation (EU) No 575/2013 allows institutions to treat exposures to third country investment firms, credit institutions and exchanges as exposures to institutions if the third country applies prudential and supervisory requirements which are at least equivalent to those applied in the EU.

The list of equivalent jurisdictions was published on 16 December 2014 in the Official Journal of the EU. Some countries including Korea or Turkey are not considered equivalent even though they have implemented Basel 3 according to the Committee’s “Seventh progress report on adoption of the Basel regulatory framework” (October 2014 report). This means that Korean and Turk banks would be treated as corporates under current EU implementation of Basel 3.

Pillar 3 disclosures as source of information will only be available for banking groups (as opposed to standalone legal entities). They will also only be updated bi-annually with a certain time lag. Furthermore, with structural reform and recovery and resolution matters there is likely to be more exposure to bank holding companies which are not typically solo regulated and which would not fall under the proposed definition of bank exposures.

Otherwise, we note that compliance with Basel 3 and as such ultimate consistency might be less of a debatable issue if capital adequacy was not the dominant driver to allocate bank exposures to a grid of RWA.

Country risk as an additional risk driver

We agree with the Committee that country ratings have become less relevant now that too-big-to-fail issues have been addressed and sovereigns should not be expected to bail out systemically important banks in future. On this basis, the only time a sovereign rating would still be relevant for the creditworthiness of a bank (on a standalone basis) is that a bank rating would have to be capped at the equivalent of the sovereign.

Bank definition

If a bank needs both to be licensed to take deposits and subject to the Basel 3 framework then the implications of the new definitions will be that both intermediate holdings companies and investment firms (securities traders) will no longer be subject to the bank treatment. Both of these would not usually be required to have a banking licence.

Therefore, we disagree with the proposed new definition of banks and propose that existing definitions of bank exposures used by various national supervisors should be adapted by the Committee. This definition applies to banks, investment firms and intermediate holding companies that are subject to the Basel 3 framework. To add the dimension of requiring a Basel 3 regulated entity to also have a license to take deposits of the public contradicts the objective of simplicity and leads to inconsistencies in the treatment of regulated subsidiaries of banking groups.

For example, lending to a standalone banking subsidiary of a banking group would be subject to the proposed treatment for banks while lending to group or intermediate holdings companies operating under the Basel 3 rules would by consequence of the proposed definition be treated as corporate exposures.

This would be particularly counter-intuitive as, apart from ring-fenced banks, the credit worthiness of banking group companies is generally superior to standalone entities given the larger degree of diversification. In contrast, we agree with the Committee to treat other subsidiaries (that do not operate under Basel 3 rules) in line with other corporate exposures. Yet we have reservations about the suitability of the proposed corporate risk drivers for finance entities for which particularly revenues cannot be calculated consistently with other commercial entities.

Trade finance

The 300% risk-weighting (even with the 20% CCF applicable to letters of credit (LC) and other trade instruments) would result in a 60% risk weight for a product where default and loss histories are demonstrably very low. It is worth noting that many emerging market banks will not be Basel 3 compliant but will frequently be involved in real economy trade business (supporting global economic growth) and so these firms will be unduly impacted by the proposed changes. Furthermore, the proposed risk weight appears to disregard the risk weight of the ultimate buyer (which may be a bank or corporate) in a self-liquidating transaction. In a self-liquidating transaction, a bank ensures that the

credit risk (risk weight) of the ultimate buyer is better than that of its customer (via credit enhancement).

Q5. Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance sheet exposures within the ratio? Would other risk drivers better reflect the credit risk of corporate exposures?

Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance sheet exposures within the ratio?

We disagree with the comments regarding the predictive power of leverage as it fails to differentiate between accounting standards, different industries and heterogeneous business models. Furthermore, accounting data is only updated infrequently, and so capital requirements may fail to take into account relevant information on the riskiness of an obligor which would, for example, be considered more timely by rating agencies to determine their external ratings.

We are concerned that the suggested metrics would be reported inconsistently across industry sectors so that certain industry sectors would receive higher risk weights purely due to structural differences inappropriately impacting the cost of funding. We also have reservations about the pro-cyclicality of both revenues and leverage which could exacerbate the effect of system-wide stress and the suitability for a broad range of corporate exposures.

Banks use internal scorecards and other credit evaluation methodologies to make credit decisions. Thereby, using a sufficiently large number of risk drivers and then averaging the results reduces erroneous scores of default predictions. To only select two risk drivers may be desirable for simplicity but will come at the cost of a lack of risk sensitive and would be prone to error.

We reviewed the statistical performance of agency ratings, revenues and leverage in predicting 1-year default events. The analysis is based on a data set consisting of over 6,300 companies with net sales greater than £40 million, 20 years of data history, 81 countries and rated and unrated firms:

- The comparison was done by using a simple type of regression where the dependent variable can only take two values (probability + unit = probit model) with the only explanatory variables being Moody's ratings, S&P ratings, combined Moody's and S&P ratings, total revenue and leverage (funds from operations/total debt) and total revenue and leverage (net debt/EBITDAR).

We summarise the model performance using Gini coefficients, which measure how well the model ranks orders observations (100% implies perfect rank ordering, 0% implies that model has no predictive power).

- We also looked at the average predicted PD for a defaulted and non-defaulted sample, summarized by the BG ratio (bad over good), which shows how many times is the predicted PD greater in the defaulted sample compared to non-defaulted sample. A BG ratio of 1.0 indicates that model cannot differentiate between defaults and non-defaults one year prior to default event, and similarly the larger the BG ratio, the better is the model in differentiating between default and non-defaults.
- The table below summarises the results of model performance using alternative default predictors. Overall, we find that agency ratings alone serve as better default predictors than revenue and leverage ratios. This is especially evident when comparing predicted PDs for defaulters to non-defaulters (BG-ratio), i.e., the ratings out-perform the two ratios 2-3 times:

Model	Gini	BG-ratio
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Moody's ratings only	69%	7.11
S&P ratings only	72%	7.63
Combined (Moody's & S&P)	76%	7.14
Revenue & leverage (FFO/TD)	70%	3.45
Revenue & leverage (ND/EBITDAR)	59%	2.69

- These results indicate that the current practice of using agency ratings leads to more precise credit risk measurement than the use of revenues and leverage ratios alone.

Incorporation of off-balance sheet exposures would make leverage ratios more meaningful but to be consistent, risk mitigating factors such as received guarantees or unused loan facilities should also be added. The proposal of *asking the relevant auditor for an assessment whether off-balance sheet commitments are material and then adjusting the leverage driver accordingly* will be overly complex and difficult to implement consistently. We therefore do not support it.

Q6. Do respondents have views on the appropriateness of the proposed treatment, especially with regard to SMEs? And about the more lenient treatment for start-up companies?

Appropriateness of the proposed treatment

We agree with a preferential risk-weight for start-up companies and we would recommend the Committee to also consider other entities than SMEs for which the proposed risk drivers are not suitable. These include:

- **Special Purpose Vehicles (SPVs):** SPVs may only have a pro-forma amount of nominal equity which is not suitable for the calculation of a leverage ratio. We would question whether the mechanic result of the RWA grid be that SPVs have a leverage of zero in this case, or whether the expectation is that lending to SPVs will always either fall into the proposed category of specialised lending or the securitisation framework.
- **Non-profit organisations (NPOs):** NPOs may not have revenues but guarantees from governments or other entities with good credit ratings.
- **Mutual funds:** Mutual funds have no leverage and therefore it is not meaningful to use leverage as a risk driver to determine RWA.
- **Private equity funds:** Banks support private equity funds through working capital facilities during the initial investment build-up phase. Repayments are made by the fund calling on the outstanding contractual capital commitments of investors rather than through the invested assets. These act as a bridge, rather than creating leverage by increasing the purchasing power of the fund. These commitments are not reported on the audited balance sheet of the fund although they do have to be recorded in the notes to the accounts. We suggest that any balance sheet based leverage metric should take these into account.

We also seek clarification around the treatment applied to newly incorporated private equity funds, which may not yet have published audited accounts but would have legal confirmation of contractual investor commitments. It is unclear from the proposals whether the 110% start-up risk weight or the 300% penalty risk weight would apply? The latter would be a poor reflection of the risk given the clear source of liquidity.

- **Associations, partnerships, proprietorships, trusts and other entities:** The definition of corporates includes incorporated entities but also associations, partnerships, proprietorships, trusts and other entities (page 10, paragraph (2.2) that will result in wealth management /

private banking clients be allocated to the corporate exposure class whenever they interact with banks through trusts and other SPVs.

This would result in a risk-weighting of 300% for lending to such clients as they do not fit in a grid of revenues and leverage. We believe this is possibly a significant unintended consequence that should be reconsidered by the Committee.

A solution might be to retain or to refine the current distinction between the corporate and retail exposure classes.

- Insurance companies: The corporate leverage criteria are not suitable for insurance underwriters and brokers given their low default history, prudential regulation and unique industry balance sheet characteristics.

Banks support the (re-)insurance industry through working capital facilities and letters of credit to facilitate cross border policy provision and supplement regulatory capital. In addition to this, banks also act as derivative counterparties to insurance firms for their risk management strategies.

While not comparable to the supervisory regime for banks, insurers are also subject to extensive prudential regulatory oversight (e.g. Solvency 2 in Europe and NAIC in US).

However when assessing leverage in the industry on the basis of the proposed measure (i.e. Total Assets/Equity), many insurance groups would be subject to the highest risk category, despite industry track record of stable credit metrics and very low default experience. Insurers' liabilities are often pre-funded with upfront insurance premia with claim settlements following later with durations matched on the asset side. Thus, for firms engaged in insurance markets where pay-out timing and ultimate loss ratios in aggregate are stable over time (e.g. life), high leverage (under the proposed measure) can be a feature. For example, we would see a typical exposure to Munich RE (the largest world's largest reinsurer, AA- rated) move from a risk weight of 20% under the current regime to 90% (4.5x).

Rating agency assessments provide a balanced view of the various risks that an insurer faces across both sides of their balance sheet and present a better predictor of default than the proposed two-factor model.

In addition to risk weighting, other areas where further clarification could aid risk sensitivity would be in the treatment of secured letters of credit. Such are commonly provided to insurers and are supported by a segregated collateral account at a custodian invested in liquid financial securities. These facilities are usually required by clients on a committed basis although utilisation is contingent on an insured event. Any drawings under the facility agreement are subject to strict legal requirements around collateral cover and would benefit from credit risk mitigation.

However, unutilised portions of these facilities are currently effectively treated as unsecured from an RWA perspective (as clients understandably resist collateralizing obligations that do not yet exist), which is a poor reflection of the actual credit risk. The proposed SA-CR rules are potentially open to interpretation on this point so we would welcome clarification that where a drawing is conditional on the receipt of appropriate collateral, that the undrawn facility be treated as collateralised or that a more risk sensitive alternative be proposed.

In excess of 90% of SME borrowers do not provide financial statements from where leverage and revenues can be derived. This can be explained by various forms of incorporations in different jurisdictions where the availability of financial statements depends on the size and type of business.

For SME lending up to certain amounts (generally lower complexity/exposure), automated and judgemental credit approvals depend to a significant degree on the creditworthiness of the entrepreneur. This would be assessed on the basis of credit history and data input from credit reference agencies.

For credit modelling purposes, the likelihood of defaults and losses would mainly be assessed based on behavioural criteria such as delinquencies (and length of delinquencies), usage of credit limits and cash available as a proportion of debt.

Only if financial statements were available would behavioural criteria be complemented with selective financial parameters such as profits, sales turnover, equity strength and ETV (total lending compared to total value of tangible assets of the SME held as security).

Considering these points, we firstly propose that the Committee extends the definition of regulatory retail exposures to capture certain lending to SMEs by increasing the maximum amount of lending threshold from EUR 1 million to EUR 2 to 5 million.

Secondly, we propose that a separate exposure category for lending is defined for SME with turnover between EUR 5 – 30 million for which risk-weights are set for SMEs distinguishing whether they are in delinquency or not. For delinquent SMEs, higher risk weights should apply depending on the time they have been delinquent until the 90-day period is reached when the treatment of past due loans will start to apply.

We agree with the Committee that revenue as an absolute variable would disadvantage SMEs. Therefore, if the above behavioural criteria do not appeal to the Committee, revenues should at the minimum be replaced with net profits to be expressed in relation with another variable such as the total amount of borrowing.

The proposals would otherwise affect markets through higher loan pricing for SMEs. It is also likely to lead to some lenders deciding to withdraw from the SME market, reducing competition at a time when many economists and politicians believe there should be more competition and a greater availability of funding for this important sector of the economy.

The increase in maximum risk-weights from 100% to 300% for where no data is available is a significant shift in the basic principles of deriving risk-weighted assets. Currently, in the absence of external ratings, a risk-weighting of 100% would be applied. Under the proposals, assuming no leverage and revenues are available for the same counterparties, the proposals would likely triple RWA.

Q7. Do respondents think that the risk sensitivity of the proposal can be further increased without introducing excessive complexity?
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We agree that additional risk drivers could improve the risk sensitivity whereby external ratings would improve the predictive power without adding undue complexity. One standard metric would be Debt/EBITDA, however, this metric remains a crude measure that fails to account for differences across industries/business models. Also, a consistent application can only be ensured through standardisation of the calculation formula.

The observation that only a small proportion of corporate exposures are rated can be addressed by dividing corporates into a large and a small corporate category. External ratings could be used for the majority of large and exchange-listed companies. This would address the concerns raised in question 5 about applying the same bucketing approach for SMEs.

We believe that the calibration of risk-weights for subordinated debt (250%) and 300/400% for equities is too high when compared with the 300% applicable for negative equity:

- For subordinated debt, we propose to introduce risk sensitivity by differentiating based on the credit quality of the issuer, instead of the proposed uniform 250% risk weight, an add-on to the risk weight assigned to the senior exposure should be introduced (similar to the use of a 75% instead of 45% LGD under the foundation IRB approach).
- In the same way, for equity exposures, a higher add-on than that for subordinated debt could be introduced.
- Finally, lower risk-weights for equity investments in private equity / start-up venture capital should be available (such as for example the current 190% for unexpected losses (UL), 10% for expected losses (EL) for private equity under the EU legislation). This would be conceptually aligned with the preferential 110% risk-weight for lending to start-up companies which play a significant role in economic innovation and growth.

We also recommend the Committee to consider extending the array of eligible credit risk mitigation techniques to include additional equities and bonds but also non-financial collateral such as capital goods that would create incentives for prudent risk management and further align the SA-CR with IRB. Such collateral should be subject to prudent haircuts that could be defined with LTVs for residential real estate as benchmark.

Q8. Do respondents agree that introducing the specialised lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

We disagree that introducing the proposed specialised lending enhances the risk sensitivity of the SA-CR and its alignment with the IRB. Instead, the only impact will be an increase in risk weights from currently 100% to either 120% or 150%.

The Committee proposes a simple treatment for specialised lending because it constitutes only a small part of the business of banks applying SA-CR. If this was correct, there would be no need to introduce a specialised lending category.

However, in anticipation of the proposed SA Floor regime, the SA-CR will be relevant for IRB banks with more significant specialised lending portfolios. Hence, the proposed simple and risk agnostic approach would have notable implications on IRB banks. Therefore, it would be desirable to consider a more risk-sensitive approach that:

- could be aligned with the IRB specialised lending “slotting” approaches;
- recognises that specialised lending can (depending on the financial strength, political and legal environment, transaction characteristics, sponsors and security package) be of comparably low risk; and
- could be extended to other types of lending that do not fit with the criteria proposed for the corporate exposure class. These could include lending to other special purpose vehicles, private equity and investment funds for which different risk drivers would be required.

Sub-categories should be fully aligned with IRB to adhere to Principle No. 6 set by the Committee to develop and evaluate these policy proposals (currently the proposals include a difference whereby

residential real estate would be treated in the same way as high volatility commercial real estate under the IRB approach).

Having a different definition of Specialised Lending in SA-CR (compared to IRB) creates inconsistencies and complexities for no perceivable risk measurement benefit. Aligning IRB and SA-CR slotting categories would be consistent with the proposal of using IRB equity risk-weights for SA-CR calculations.

We appreciate reservations the Committee may have with banks allocating specialised lending exposures to regulatory slots based on qualitative criteria. However, given the concept has worked under IRB for a couple of years now, we believe it could be enhanced to make it adequate for SA-CR as follows:

- Detective, qualitative controls or reviews by the local regulators as a number of key inputs will rely on local rules and regulations and market conditions; and
- Incremental supervisory implementation guidance that could be issued in future for both IRB and SA-CR.

Q9. Can respondents suggest, and provide evidence on, how to increase the risk sensitivity of the regulatory retail exposures treatment, either by differentiating certain product subcategories for which a specific risk weight may be appropriate; or by suggesting simple risk drivers that could be used to assess the risk of all retail exposures?

We do not consider it a high priority to introduce more risk sensitivity in the regulatory retail treatment given the heterogeneity of retail exposures, whereby risk drivers would need to be specific to product groups.

A key indicator of losses for retail exposures are securities which are captured in the credit risk mitigation rules. These often comprise cash and securities eligible for credit risk mitigation so that application of risk mitigation techniques maintains a certain level of risk sensitivity in calculations of RWA.

One risk driver that is relevant for all retail products could be the number of days past due for which a separate treatment is under review by the Committee. For credit card receivables, a primary risk driver would include the length of time a balance has been outstanding on the balance sheet of a bank or credit card company.

The 0.2% diversification criterion should remain a prudential guidance as opposed to a hard-coded rule. It could otherwise constitute a disadvantage for smaller banks and impose undesirable market entry barriers. The current approach of providing discretion to national supervisors should therefore be retained.

Exposures to small businesses where personal guarantees are given should qualify as part of the regulatory retail portfolio. Moreover, the size factor for small medium enterprises (SMEs) should be set at an appropriate level so as not to disadvantage this important part of the economy. As mentioned earlier in this response, we recommend that it should be increased from EUR 1 million EUR to EUR 2 to 5 million.

Q10. Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on residential real estate?

LTV Ratio

We agree that the SA-CR for Residential Real Estate should be updated and made more risk sensitive. It is important to ensure that the risk weights are appropriately calibrated and that unintended consequences are avoided.

We consider that LTV is not a driver of default, but is a strong driver of loss once default has occurred. Our experience suggests that there is a strong difference between residential (owner occupied) real estate and other residential real estate. We would propose that the Committee gives consideration to introducing differentiated risk weights according to type.

The following table illustrates Barclays experience in the context of different LTV bands split between residential and buy to let types:

Marked to Market LTV	Residential		Buy to let	
	1 Cycle Down rate (Over 12 months)	Capital PD	1 Cycle Down rate (Over 12 months)	Capital PD
0 - < 10	0.70%	0.60%	1.52%	0.99%
10 - < 20	0.83%	0.62%	0.55%	1.18%
20 - < 30	0.91%	0.67%	1.25%	1.25%
30 - < 40	1.12%	0.71%	0.99%	1.44%
40 - < 50	1.33%	0.75%	1.06%	1.65%
50 - < 60	1.37%	0.79%	0.96%	1.77%
60 - < 70	1.63%	0.87%	1.12%	1.72%
70 - < 80	1.69%	1.11%	0.92%	1.62%
80 - < 90	2.10%	1.70%	1.91%	2.01%
90 - < 100	2.27%	1.87%	2.07%	1.94%
100 - < 110	2.80%	2.56%	1.76%	1.57%
110 - < 120	2.91%	1.39%	0.74%	4.02%
120 +	4.30%	1.68%	1.05%	2.55%
Total	1.46%	0.92%	1.10%	1.69%

The reason for the difference is a combination of (a) customer behaviour where the customer will always try to avoid loss of property, were they the owner occupier and (b) firm behaviour whereby forbearance measures are exercised and repossession is a last resort.

In terms of the LTV bands set out in the consultation (p36 para 38 table), we consider that the first band of LTV's <40% is too wide and would propose that the band is split by introducing an additional banding for LTV's of <20%. This would enable a greater differentiation for the high quality LTV exposures, which reflects the difference in loss experience within the lower band and would also have the added advantage of providing incentive to have fully secured facilities/products.

DSC Ratio

The DSC Ratio at origination is relevant for determining a borrower's ability to repay but not throughout the term of the loan because:

- **No common definition** makes it unlikely to lead to comparable capital requirements across jurisdictions.
- **Data quality:** data availability, quality and reliability may not be consistent across jurisdictions.
- **Operational difficulties:** calculating the DSC Ratio on an ongoing basis is operationally burdensome as it requires banks to periodically reassess the borrower's affordability and is unnecessary where full repayments within the terms of the loan are being made.
- **No legal right to re-asses:** There may not be a legal right to reassess the affordability of existing borrowers on an ongoing basis – terms will need to be introduced into contracts to permit this and require the borrower to provide documentary evidence of ability to repay (the mortgage that they are successfully repaying).
- **Not risk sensitive:** DSC at origination is not risk sensitive, especially for long-term real estate loans where changes to the borrower's risk profile occur during the term of the loan.
- **Not predictive:** DSC at origination of a credit is not always predictive during the term of the loan.

We expect the revisions of risk-weights for exposures secured by residential real estate to have a significant impact on housing markets in terms of pricing and liquidity and therefore recommend the Committee to assess these in detail before finalising the proposals.

For example, in the UK, the proposed changes have potentially significant ramifications and are almost in the opposite direction of UK government policy enacted through stimulating the housing market through "Help to Buy" focussed at helping excluded borrowers enter the property market through higher LTV lending. There is now further support announced in the UK 2015 budget statement through the so-called Help to Buy ISA initiative.

If standardised risk weights were applied on the UK mortgage market, either directly or through an un-adjusted risk weight floor, it will have a potentially significant impact on mortgage prices for otherwise "low risk" sub-80% LTVs. Lending rates will need to be reconsidered to reflect the increased capital requirement which could add to the cost of providing a mortgage to the consumer. This has the potential consequence to adversely impact on house prices equivalent to a significant rise in funding rate and could bring about a stress test type economic shock.

In that context, the interaction with securitisation rules should be further considered as holders of securitisation tranches will need to know SA capital charges of the underlying portfolios to be able to apply the Securitisation Standardised Approach (SEC-SA). For that updated SA-CR risk-weights of individual mortgages will need to be available to third party banks.

Q11. Do respondents have views about the measurement of the LTV and DSC ratios? (In particular, as regards keeping the value of the property constant as measured at origination in the calculation of the LTV ratio; and not updating the DSC ratio over time.)

Using origination LTV and holding it constant significantly dilutes the predictive power of the metric. A 'marked to market' LTV (e.g. based on latest HPI stats) is a much more accurate metric to use for the stated purpose. E.g. by using an origination LTV held constant, if house prices crash by 30%, this increased risk of loss will not be reflected in the risk weight as the LTV will not change (this is the approach used in Spain and is precisely why LTV profiles continued to look healthy throughout the property crash).

There is also a risk with the suggested 'current' LTV or one marked to market, in that the pro-cyclicality of the property market will allow reduction of capital held the closer the sector gets to the peak (and

hence the crash) with indices being a lagging indicator and less accurate when the crash hits as volumes fall significantly.

Barclays does not consider the DSC Ratio is appropriate as an input for SA-CR.

The DSC is trying to assess the customer's affordability at origination. For long dated products, such as residential mortgages, this is highly unlikely to remain constant over time as most customers circumstances will change significantly over time (e.g. a 20 year old customer's financial position and circumstances are likely to be very different by age 40). Therefore any measure at the origination of the loan is unlikely to be reflective of the underlying risk over time and will therefore be of little practical use.

Q12. Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?

The DSC Ratio is unlikely to be a measure that will assist comparability across jurisdictions. This is because the DSC is unlikely to be accurate over time (for the reasons described above). In addition due to regional differences between jurisdictions, including tax treatments, the change in position of the DSC over the term of a loan is likely to be different in different jurisdictions as this will be affected by a variety of factors some of which are jurisdiction specific.

Barclays would therefore recommend that DSC is not used and that alternative measures as detailed in Q13 are used instead.

Q13. Do respondents propose any alternative/additional risk drivers for the Committee's consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?

The change in risk profile for residential real estate is primarily driven by life events. However, for SA-CR institutions, these can be difficult to isolate before signs of credit deterioration are experienced.

The most common and simplest measure used by all firms is days past due. We see a strong correlation between days past due and increase in default rates and so would propose that a delinquency based measure is used to supplement the LTV bands described in the proposal.

Even where national competent authorities have taken up the option of a differentiated definition of default for residential real estate, cycle delinquency will show significant increases in default rates, as per the table below:

Cycle	Capital PD Estimate	Actual Default Rate
0	0.98%	0.10%
1	5.03%	1.05%
2	12.66%	2.86%
3	23.55%	8.08%
4	55.35%	15.49%
5	73.44%	19.04%
6	94.61%	20.68%
Total	1.52%	0.24%

An alternative measure could be “time on book” to reflect the age or maturity of the mortgage as evidence shows that most customer defaults occur early in the life of the mortgage. However, this is likely to be more difficult to capture consistently as customer and market patterns differ across jurisdictions, particularly where mortgages are rolled over period to period at each interest re-set. Such differences are more likely to be captured in firms IRB modelling approaches and may be considered as too complex for standardised risk weight purposes.

Q14. Which of the two options above is viewed as the most suitable for determining the risk-weight treatment for exposures secured on commercial real estate?

The Committee is considering to either not recognise commercial real estate as collateral and treat exposures as unsecured retail or corporate (option A) or assign a risk weight ranging between 75% and 120% based on the LTV ratio (option B).

Both options A and B have advantages and disadvantages and would best be combined by firstly determining the risk-weight of the relevant corporate or retail counterparty and then adjusting it downwards depending on the LTV applied for commercial real estate.

LTV works well if risk-weights are applied on the basis of individual facilities where collateral can be directly applied.

LTV works less well where RWA are calculated for borrowers that provide multiply layers of credit risk mitigation. There, banks would consider baskets of multiple collateral instruments (which may include real estate) that secure a customer group’s multiple facilities under “all monies” clauses in collateral documentation. If LTVs were calculated by borrower with multiple facilities, LTVs would likely be understated and are as such not suitable.

The use of LTV ratio as a risk driver under Option B also fails to recognise differences in real estate markets and underwriting practices and would make it difficult to define LTV thresholds that would be meaningful across jurisdictions.

In any case, the granularity of proposed LTVs under Option B should be enhanced by providing further risk-weights at the lower end of spectrums. For example, the risk profile of an LTV of 30% or below should be reflected in lower risk weights than the ones proposed for LTVs of 60%.

We do not support Option A in isolation as banks should have a prudential incentives to secure their lending against commercial real estate with legally enforceable pledges.

Q15. What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity?

Risk-weights for exposures secured by commercial real estate need to be aligned with the equivalent corporate and retail exposures. For example, a corporate that exhibits a low level of leverage according the proposed formula and significant absolute revenues subject to a 60% risk-weighting would not currently benefit from pledging a commercial real estate portfolio to the lending bank as the minimum risk-weight in the commercial real estate exposure class is 75%.

The same applies for a borrower in the regulatory retail exposure class; Here, the applicable 75% risk-weighting cannot be improved through applying commercial real estate rules. It seems necessary that risk-weights are first derived by the type of borrower and then, depending on the loan-to-value, a lower risk-weight should apply for pledges of commercial real estate.

Otherwise, option A of not considering commercial real estate a risk mitigate would seem unavoidable as an unchanged option B would for some counterparties only result in higher risk weights if pledges of commercial real estate were applied.

Q16. Do respondents agree that a risk weight add-on should be applied to only retail exposures and exposures secured by residential real estate? What are other options for addressing this risk in a simple manner?

We do not believe that it will be possible for banks to apply such as add-on for other retail exposures such as credit card receivables where lenders do not systematically know about the currency of income of the credit card holders.

However, we agree that the risk-weight add-on could possibly be applied to exposures secured by residential real estate but believe that the risk of mortgages in other currencies than the income of the borrower cannot be sufficiently addressed by such an add-ons to regulatory capital requirements:

- Banks should discourage home owners from borrowing in currencies other than their main income and, if justified in particular circumstances, the incremental currency risk could be addressed via LTV restrictions.
- National supervisors should work with consumer protection authorities to foster restrictions to avoid systemic abuse of deceptively cheap borrowing rates in historically stronger currencies as observed during the financial crisis in some European countries.

Q17. Do respondents consider the categories for which a CCF is applied under the standardised approach to be adequately defined?

We consider the CCF categories and existing trade-related contingents to be adequately defined and refer to our responses to question 6 regarding letters of credit provided to (re-)insurance companies.

Q18. Do respondents agree that instruments allocated to each of the CCF categories share a similar probability of being drawn and that the probabilities implied by the CCFs are accurate? Please provide empirical support for your response.

General comments

We disagree with the 10% conversion factor for unconditionally cancellable commitments as the constraint to cancel commitments the Committee refers to (consumer protection laws, risk management capabilities and reputational risk considerations) should not be applicable. If they were, then such commitments would not be truly unconditionally cancellable and so the 0% would not have been applied in any case.

The application of a 10% conversion factor to unconditionally cancellable commitments would increase the pricing of working capital facilities or would require banks to start charging clients for undrawn overdraft limits. Alternatively, banks would only be willing to grant businesses smaller overdraft limits which may put them under pressure during periods of lower cash flow.

We disagree with not making a difference between commitments greater than and less than one year as the approach will not be risk sensitive. It will also provide wrong incentives for banks to issue commitments for longer periods.

We recommend the Committee to further analyse both of these points as they could have an undesirable effect on the real economy during times of financial stress.

We also believe that replacing 0% CCF with 10% for unconditionally cancellable commitments, and 20 and 50% for non-cancellable commitments with 75% significantly increases a capital requirement which contradicts the stated objectives of the Committee.

Another stated objective is to move the SA-CR closer to IRB. Banks apply a 0% conversion factor for unconditionally cancellable commitments under both FIRB and AIRB which would be inconsistent with applying a 10% conversion factor for unconditionally cancellable commitments under SA-CR.

We recommend the Committee review which commitments can be included in truly unconditionally cancellable commitments such as credit card commitments or internal overdraft limits and allow banks to continue to apply a 0% conversion factor to these.

Applying a flat 75% conversion factor for non-cancellable commitments leads to similar issues; under IRB RWA calculation, shorter maturities of exposures result in lower risk weights. Changing the SA-CR to move away from using maturity is simplistic and a backwards step in risk sensitivity.

Trade Finance

Trade finance should continue to be treated preferentially to other obligations. This is substantiated by the BIS CGFS Paper (No 50) issued in January 2014. In particular:

Confirmed letters of credit:

- Losses on trade finance portfolios historically have been low
- Given their short-term nature banks have been able to quickly reduce their exposures in times of stress
- Bank intermediated trade finance performs two vital roles:
 - providing working capital tied to and in support of international trade transactions; and
 - providing a means to reduce payment risk.

With this in mind, we support a 20% CCF for confirmed LC and further propose that the 20% CCF be applicable for the duration of each transaction, i.e. not just the contingent phase of the LC, due to their historical performance and 'preferred status' based on our own experience prior to, during, and post the global financial crisis:

- We executed on average 500+ deals per month with an average aggregate exposure in excess of £1bn. Our portfolio was geographically well spread with no specific country concentration. Of the 6,000+ trade transactions with financial institutions executed per annum we only experienced one issue relating to an Export LC we confirmed.
- Exposures to FIs are tightly controlled through caps on geography, tenor and counterparty. Furthermore, limits for Trade transactions with FIs are uncommitted and unadvised with each transaction subject to individual review and approval.

Further supporting information can be found in the response to this consultation from the International Chamber of Commerce (ICC) which we have helped to draft. Further statistical analysis

can also be found in the annual ICC trade register report which covered 4.5m transactions for 2014, with a value of \$2.4 trillion and calculates a 0.9% default rate for confirmed LCs.

Q19. What are respondents' views on the alternative treatments currently envisaged for past-due loans?

The proposed add on approach can be compared with the current approach whereby the unsecured portion of any loan that is past due for more than 90 days, net of specific provisions, will either be risk-weighted with 100% or 150% depending on the level of specific provisions or 50% depending on the application of supervisory discretion respectively. Additionally, specific rules exist for qualifying residential mortgage loans and application of collateral not recognised elsewhere in the SA-CR under national discretion.

We expect the Committee to eliminate the supervisory discretion in the treatment of past due loans but would continue to support an approach whereby RWA of past due loans are calculated:

- on the basis of outstanding amounts net of provisions and partial write-offs; and
- risk weighted on the basis of the percentage of provisioning and/or time loans have been in delinquency.

Such an approach would continue to entail a certain level of risk sensitivity and would acknowledge the ability of banks to estimate losses on past due loans based on previous experience with loan losses and reflects that banks regularly update impairment based on latest information. On the other hand, a flat risk weighting would be simpler and in line with approaches applied by IRB banks that do not model defaulted loan exposures.

Q20. Do respondents agree with the proposed treatment for MDBs?

We agree with the Committee proposal to maintain the current list of "eligible MDBs" subject to a risk-weighting of 0%. We also agree with the Committee to introduce a category of "qualifying MDBs" for which external ratings continue to be used. In fact, this is a good example of continuing the use of external ratings as a strong indicator to forecast defaults without putting mechanistic reliance on them.

It should be clarified whether it will be the Committee or banks with exposures to these MDBs to provide the necessary assessments. If it is the banks, then guidance will be required to ensure a consistent approach.

We also agree with the Committee that non-rated and non-qualifying MDBs should be treated as corporate exposures.

Q21. What exposures would be classified under "Other assets"? Is a 100% risk weight appropriate? (Please provide evidence where possible).

We believe that applying a risk-weight of 100% is appropriate in general as it is in line with the objective of simplicity. However, cash in hand and equivalent cash items such as gold bullion should be subject to a risk weight of 0%.

Q22. What are respondents' views on the above alternative ways to define eligible financial collateral?

We agree with the Committee that reliance on ratings for the purposes of defining the universe of eligible collateral is a second-order issue because ratings only affect the amount of capital requirements indirectly through the calculation of the exposure amount (using haircuts) and not directly through risk weights.

However, we do not support the alternative concept of investment grade to determine eligibility of senior debt as collateral as ratings are used by market participants to determine which debt instruments are acceptable as collateral when transacting. A disconnect between market and regulatory criteria would introduce additional complexity without adding value.

To deviate from that by using alternative indicators to determine investment grade / non-investment grade would lead to confusion should the outcomes be different when compared to ratings. It will also be challenging to enforce consistent application. As such this will lead to incremental supervisory costs and complexities that are not aligned with the objective of keeping the SA-CR simple and transparent.

Q23. What are respondents' views on the recalibrated supervisory haircuts shown in Table 4? What are respondents' views on how to eliminate references to ratings from the supervisory haircuts table? What could be the implications of eliminating references to external ratings?

Recalibrated supervisory haircuts

We appreciate that the Committee strives for equity haircuts to be no lower than haircuts applicable to bonds. However, we believe that volatilities of both equity and bond markets with holding periods of 10 days do not require haircuts of the proposed size and therefore we recommend the Committee to reverse the additional residual maturity buckets and to retain the existing haircuts for equities.

Elimination of references to ratings from the supervisory haircuts tables

Notwithstanding our earlier comments regarding the ongoing validity and predictive power of ratings, references to ratings could be eliminated by replacing them with risk-weights as proposed in Table 5. Thereby, haircuts can be aligned with what they would be if external ratings were used. This is consistent with how the Committee is presenting this proposal.

Risk weights are used by banks to compute their RWA without affecting the counterparty. In contrast, risk mitigation via collateral requires agreement between bank and counterparty to establish haircuts at which to transact. External ratings are a common and transparent measure used to agree on eligible collateral and haircuts. A regulatory treatment for haircuts that departs from the rating logic would only add complexity without adding value to the resilience of financial markets.

Implications of eliminating references to external ratings

Many banks use supervisory haircuts not only for the exposure calculations under the SA-CR but also for exposure calculations under the internal-model method given practical challenges to model price sensitivities of collateral alongside expected counterparty credit risk exposures.

Eliminating references to external ratings will make haircuts less transparent and less intuitive to understand. This does not only apply for regulatory capital requirements and associated haircuts but also for the management of other resources of the banks such as liquidity or market risk limits. Therefore, eliminating references to external ratings should be subject to a more fundamental review before a final decision should be reached by the Committee.

Given the relevance of supervisory haircuts for regulatory capital reporting, it is our preference to maintain the use of external ratings as basis for haircuts (and also as articulated earlier in this document, where appropriate, as basis to derive RWA) as the value of independent assessors (rating agencies) should not be underestimated compared to the alternative of banks partially doing the same task themselves (but based on less indicators and possibly inconsistently).

Q24. What are respondents' views on the proposed corporate guarantor eligibility criteria?
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Range of eligible guarantors

We disagree with the proposed corporate guarantor eligibility criteria as they add unnecessary complexity to SA-CR when compared to the current restrictions based on external ratings. As discussed earlier in this response, reduction of the mechanical reliance on external ratings does not mean that they should not be used as a basis for risk-weights at all.

Should the Committee still decide to not using external ratings to determine eligible guarantors and sellers of credit derivatives, an alternative approach could be to refer to applicable risk-weights of guarantors as determined by appropriate risk indicators.

Eligible guarantors for securitisation exposures

Restrictions on guarantors for securitisation exposures should be evaluated in the context of the final revised securitisation framework (rather than via the SA-CR proposals), the proposals for a framework for simple securitisations and be examined for unintended consequences on already fragile securitisation markets (which the European Commission is seeking to enhance).

The removal of corporate guarantors would cause further difficulty in the interpretation of the securitisation boundary. The Basel definition of securitisation, which focuses on recourse to a specific pool of assets and tranching, captures limited recourse lending where the borrower takes a first loss position. However, there may be solid legal reasons why the borrower may transfer assets to a bankruptcy remote vehicle (to protect the lender's interest) but to provide recourse to the lender. If the borrower is not judged to be an eligible guarantor, this transaction (a secured corporate borrowing) will become a securitisation. We do not believe the securitisation framework is intended to capture this circumstance. The resulting capital treatment under the securitisation framework is often disproportionate to the risk the lender is taking.

What is not clear from the proposal to remove corporates as eligible guarantors is what the Committee intends should happen in these boundary cases, would the presence of the guarantee still remove the exposure from the securitisation framework or would this approach be disallowed and such exposures be forced to continue to be treated under the securitisation framework, with the consequent disproportionate capital treatment.

We are also unclear about the rationale for this proposed change and would welcome further explanation from Committee as to why the proposals would limit regulatory capital arbitrage.

Finally, next to the above two points, we also seek clarification from the Committee that cash-funded guarantees on securities exposures can be excluded from any restrictions on the types of guarantors.

Excluding credit derivatives without restructuring

Credit derivatives without restructuring should not be excluded from eligible credit risk mitigation techniques as it would be wrong to eliminate incentives to obtain credit protection if no regulatory benefits would be available. In the US, for example, the standard credit derivative documentation does not include "restructuring" as a credit event. Under this proposed change, there will be no regulatory capital relief provided for US credit derivative No-Restructuring (NoR) contracts.

Generally, US companies use Chapter 11 bankruptcy in order to restructure their obligations. Therefore, there is no need to add “modified / modified-modified restructuring” (MR or MMR) as a credit event trigger in the US.

Other jurisdictions around the world trade credit default contracts with restructuring language since bankruptcy laws in these locations do not provide a similar structure to the US Chapter 11 code. Therefore, restructuring events can occur without a corporate bankruptcy in other jurisdictions to the US where credit derivative contracts would be triggered.

For example, one reason why modified-modified restructuring (MMR) is included in European CDS contract standard terms is because it is embedded in the majority of bond terms whereby a majority of bondholders can bind a minority into decisions such as notional reductions and maturity extension. Therefore, MMR is required to align economic outcomes of bonds with CDS. In the US, by contrast, a restructuring such as a change in maturity, interest etc. cannot be triggered outside of the US Chapter 11 bankruptcy process. There have been plenty of restructurings in the corporate sense where 90%+ of bondholders agreed but because the minority can only be forced in court, no MR would have been triggered.

In the US, there is no “tradition” to have bond terms that allow the majority to impose decisions on the minority. As such, there is little commercial reason for having MR as a credit event, as this will not help in aligning economic outcomes of bonds with CDS. To further emphasise this point, we note that there have been 94 auctions since 2005 for contracts denominated in USD. Of these, there has only been 1 restructuring credit event (CEMEX) which was not a US entity. Of US and Canadian entities, there were 57 auctions without any restructuring credit events.

We appreciate the simplicity of the proposed standard but consider it necessary to distinguish the treatment by area and contract type. A distinction could be made that contracts without restructuring as credit event would not be eligible for CDS on European and Asian underlying, while for CDS on North American companies (that offer protection despite the lack of restructuring), contracts without restructuring as credit events would still be eligible.

Exclusions from the revised framework

We disagree with the proposed exclusions of own estimates of haircuts, VaR models for SFTS and IMM for SFTs and OTC derivatives as the proposal would force banks that are under the standardised approach for credit risks but that have approved models for exposure calculations to either apply the SA-CR or to seek IRB model approval to be able to continue using their models to calculate exposures.

We believe that this would be a significant change from existing permission of banks to use models and therefore a more detailed impact assessment would be necessary not only for counterparty credit risk but also CVA capital requirements.

We consider EADs transaction-specific and RWA are counterparty-specific concepts. We do not understand why the Committee intends to create a link between the two. It would seem unjustified to use different exposures for the same derivative instrument depending on the type of counterparty and whether a bank has an eligible IRB model for the relevant counterparty.