

6 July 2016

Mr. Bill Coen
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on Banking Supervision
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Dear Mr Coen,

REVISIONS TO THE BASEL III LEVERAGE RATIO FRAMEWORK

Barclays welcomes the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) consultative document "Revisions to the Basel III Leverage Ratio Framework¹" ('the consultative document'). We have contributed to the work of the Trade Associations (GFMA, ISDA) on their joint response to the consultative document and are supportive of these industry wide efforts.

We are fully supportive of the BCBS's objective to re-calibrate and re-design the leverage ratio. Particularly where this seeks to address material imbalances between different accounting regimes, such as the treatment of regular-way purchase / sale of financial assets, or reflects developments in the wider regulatory capital framework, such as introducing Standardised Approach to Counterparty Credit Risk² (SA-CCR) for measuring derivative exposures.

While we agree with many of the changes the BCBS is proposing, there are areas where we believe further consideration is still required. These include the use of Credit Conversion Factors from the Standardised Approach to Credit Risk³ (SA-CR) as currently calibrated, the proposed modifications to SA-CCR, and the introduction of Systemic Risk Buffers.

Lastly, we are concerned that while the leverage ratio should be simple, elements of risk sensitivity are being introduced, or at least consulted upon (for example the proposed currency haircuts for cash variation margin, or the existing E-C add-on for SFTs). Not only are these aspects better addressed in the risk sensitive capital framework, but if applied here would also introduce unnecessary complexity. Moreover, since these amendments

¹ <http://www.bis.org/bcbs/publ/d365.pdf>

² <http://www.bis.org/publ/bcbs279.pdf>

³ <http://www.bis.org/bcbs/publ/d347.pdf>

tend to be applied asymmetrically, they often lead to overly prudent outcomes unrepresentative of a bank's balance sheet leverage.

Treatment of regular-way purchases and sale of financial assets

We consider the intention to level the playing field across the different accounting regimes that prevail across major global financial centres to be a key and welcome development in the BCBS's proposed revisions.

In response to the specific consultative questions posed by the BCBS, Barclays supports the adoption of Option B to permit netting down of settlement receivables with settlement payables. While there are several technical arguments explored in the broader industry responses on the subject, we would reinforce the following points:

- i) Delivery versus Payment (or Receipt versus Payment) settlement mechanics ensure that banks will either have the security or the cash corresponding to the purchase / sale of that security on their balance sheets, but not both.
- ii) Where settlement fails, on a DvP basis, the settlement risk arising from any price differences is capitalised. Historic data, available to all national regulators from regulatory returns and Pillar 3 disclosures, shows that this is relatively small as a capital charge. This price risk is more of a market risk based charge and to apply a leverage ratio backstop via Option A (and grossing up) would overstate the leverage inherent in a bank's balance sheet arising from failed settlements. In turn, this could adversely affect liquidity in markets which are particularly high velocity such as government securities and listed equities markets, or cause pro-cyclicality issues during times of high market volatility.
- iii) The overwhelming majority of regular way settlement balances clear as scheduled even during periods of heightened market volatility. Allied to developments in market practices, such as the NSCC's Continuous Net Settlement System, the risk of excessive leverage building up in the system is not exacerbated by the settlement of regular-way purchases and sales of financial assets.

We also consider that the conditions laid out by the BCBS are clear. However, we would urge the BCBS to ensure that these conditions do not conflict with the accounting regimes that already permit an Option B style of reporting for settlement balances, most notably USGAAP. That is, principles could be established to ensure that the implementation of Option B is consistent with respect to the following:

- i) Definition of Activities – the current definitions of market-making and broker-dealer activities may differ across jurisdictions where Option B is already permitted. The accounting frameworks define these and may still give rise to discrepancies that BCBS may wish to mitigate in its leverage ratio framework.

- ii) Consolidation – balances can be consolidated from broker-dealer / market-making entities on a line by line or aggregation basis. While the BCBS standard will apply at a consolidated level, the method of consolidation should be made clear, particularly for those banks not operating to this standard currently.

Credit Conversion Factors (CCF)

The recent SA-CR consultative document introduced revisions to the CCF calibrations to be used in the risk based regulatory capital framework. While not unexpected that this would be adopted into the leverage ratio framework, in particular so that the overall framework is simple and coherent, many of the comments we made in relation to the SA-CR consultation still hold here.

In particular, the re-calibrations were noted as increasing capital requirements, potentially significantly in the case of trade finance related activities. This increase, when applied across a bank's whole population of off balance sheet items (as opposed to the part under standard rules only), will have a disproportionate impact upon trade finance business, where the CCF would for leverage move from 20% to 50-75%.

In the context of a backstop measure on capital requirements, the leverage ratio will likely become the binding constraint on capital in a wider number of cases than is perhaps anticipated or intended by the BCBS, with consequences for pricing and availability of credit.

We would urge further consideration of this calibration in the context of both the SA-CR, including the consequences of BCBS 362⁴, and leverage ratio frameworks.

Modifications to SA-CCR

We welcome the adoption of SA-CCR as a replacement for the current exposure method (CEM). There are a number of modifications that the BCBS has suggested to the finalised version of SA-CCR that banks have been working towards implementing. The key areas of concern with these modifications are set out below.

Sold protection add-on for credit derivatives

We are supportive of the scope of the written credit derivatives add-on being expanded to include credit options as it helps capture the true sold-protection exposure of the business. However, we do not consider that the BCBS's proposed "binary" conditions on strike price achieve this objective. CDS options are Non-Knockout and their standard transaction terms specify that if the option is exercised at expiry, the holder will be compensated for all losses incurred from any default of the reference names prior to exercise date. Based on this property, we also believe that un-exercised options with the right to purchase credit protection should be allowed to partially offset any protection sold on the underlying directly. Please also recall that CDS options largely reference credit indices and not individual names.

⁴ <http://www.bis.org/bcbs/publ/d362.pdf>

For all cases, we consider that the most appropriate representation of the credit exposure on sold protection via credit options would be the delta weighted notional. While relying on deltas may seem incongruent with the risk-insensitive leverage ratio measure, the SA-CCR used in leverage does incorporate the supervisory deltas for the Potential Future Exposure of options. The current BCBS proposal uses strike as a measure of risk which we believe is inferior to a delta measure; supervisory deltas use the strike as an input parameter.

We believe that symmetrical offsetting is crucial to maintaining a functioning credit market, since a portfolio of credit options is ordinarily hedged by selling protection on the underlying. The delta approach would also allow options with the right to sell the underlying to be brought into scope for the computation. This is an intuitive extension of Put-Call Parity, where a combination of options can replicate the underlying exactly. In this context, CDS options being physically settled is an important point.

We note that other alternatives to a delta approach might include formulation of a maximum loss exposure equivalent. If this can be made sufficiently simple, we believe it may be appropriate for inclusion in the leverage ratio framework and could be a more appropriate measure than the current proposal. We have provided an example of how this might work, along with potential shortcomings, in Appendix 1.

In addition to the above, paragraph 31 of the BCBS proposal leaves open to interpretation the phrase 'same material terms.' We urge the BCBS to re-consider whether this statement is necessary given the other conditions already required for offsetting sold protection add-ons, and if so to be more explicit in what terms this relates to. Lastly, for the definition of wrong way risk, we ask that the BCBS includes the full definition within the leverage ratio framework as opposed to cross-referring to other parts of the prudential framework to avoid over-complicating the rules governing the sold protection add-on.

Application of alpha to RC Component

Barclays supports the view that the application of an alpha multiplier of 1.4 to both the Replacement Cost and the Potential Future Exposure overstates the leverage inherent in derivatives transactions. In our view it would be more appropriate to limit the alpha to the PFE term, countering (as it does in the Internal Model Method) any deficiencies in the assumptions used to derive the unknown path that the exposure might take in the future.

Furthermore, the Replacement Cost is an objectively quantifiable balance sheet item, which conforms to the original premise of the leverage ratio; applying a fixed uplift via the alpha seems arbitrary and forces another departure from balance sheet reporting that would have to be explained.

PFE multiplier set to 1

We do not agree with the proposal to set the PFE multiplier to 1 in the SA-CCR EAD calculation. Currently, negative mark-to-markets (MTM) serve to reduce the potential

future credit exposure in CEM via the net to gross ratio (NGR). Bringing this effect into the SA-CCR multiplier was intuitive and maintained the recognition that negative MTM in a netting set is exposure reducing.

It is not clear why this effect should not be maintained in the leverage ratio version of the SA-CCR. We would welcome further insight into the BCBS's rationale here and are happy to share more detail of our analysis in this regard. For the sake of clarity, we consider that this effect should apply equally to cleared and uncleared derivatives.

Client clearing impacts

We support the further investigation of the exposure-reducing effects of initial margin for client clearing businesses and would oppose any treatment that results in IM grossing up exposures in relation to client clearing. Our view is that this IM should not be viewed as increasing leverage exposure.

The consultative document asserts that reducing the maturity factor in the PFE component for client clearing transactions to the margin period of risk (5 days) affords significant exposure reduction that is in line with the G20's objectives for ensuring that incentives to clear remain. However, we would view the inclusion of IM in the PFE multiplier for client clearing as helping ensure this incentive endures.

Margin requirements for uncleared derivatives

We are concerned that the modifications proposed to SA-CCR do not take into account the impending changes for margin requirements on uncleared derivatives.

For example, banks will have to either post additional cash, creating receivables for leverage ratio purposes, or hold additional third party assets to post as initial margin (IM). At the same time, the IM received will not be permitted to reduce derivative exposures for leverage ratio purposes even though banks will be prohibited from using that IM to increase their own leverage. This asymmetry creates a tension between the two regimes that is significantly more pronounced than in the risk-based framework; one way to address this tension would be to recognise the exposure reducing effects of IM in the leverage ratio framework.

Leverage Ratio buffers for GSIBs

It is important that calibration of the minimum leverage ratio framework is internationally consistent and reflects that the leverage ratio is a back-stop measure. This will serve to ensure comparability across published leverage ratios and should yield an even playing field for banks.

We consider that any additional requirements for G-SIBs should be in the form of buffers, as opposed to higher fixed minimum requirements, and should reflect a bank's systemic importance. We are supportive of the risk-based framework serving as a baseline for any

additional requirements, akin to the UK PRA's framework. However, buffer calibration must be sized appropriately to maintain the current relative importance of the leverage ratio.

Furthermore, we do not support the alignment of the consequences of a breach in the leverage ratio buffer with the corresponding risk-based framework given that leverage is a backstop measure. Any extension of hardwired restrictions on distributions or instrument conversion will add to the complexity and risk profile of the equity and AT1 market. Instead, where there is concern over a bank's leverage position we support the use of existing measures by national regulators to ensure any breach of a leverage ratio buffer is temporary, such as bilateral discussions on recovery actions and the submission of capital plans.

Further Considerations

The CCP resolution planning framework and regulatory capital framework for CCPs' clearing members should be considered together and in a more holistic way. For example, additional loss sharing mechanisms such as partial tear-ups of netting sets following a clearing member default. While these, and other mechanisms, may only be deployed against very remote events, the industry has had to consider whether these changes affect regulatory capital measures, including the leverage ratio. We have been concerned that any effects here could be materially outsized in a leverage ratio context and would urge the BCBS and CPMI to set out guiding principles to ensure a common understanding across the industry in this area.

Finally, we welcome the removal of double counting around provisions; however, other areas remain where the leverage ratio framework is double counting exposures, such as for the treatment of overlapping securitisation exposures. We would encourage the BCBS to either set out a general principle to mitigate such double counting, or seek to address each area with prescriptive text to avoid leverage being overstated on exposures where losses can only be borne once.

We hope that you find our comments and suggestions helpful. Please do not hesitate to contact Dipal Patel (+44 (0) 20 3134 1105, Dipal.Patel@Barclays.com) if you have questions or comments on any of the issues raised in this response.

Yours sincerely,



Gary Romain
Finance, Head of Policy

Appendix 1

Sold Protection Add-on For Credit Derivatives

Furthermore, in the Example below, we also consider an alternative non-risk based approach to the delta method using a maximum loss exposure computation under the assumption that all options get exercised. This solution relies on the property that credit options are physically settled, allowing the holder of the option the right to purchase credit protection at option expiry regardless of its moneyness.

This proposal allows partial offsetting of sold protection proportional to $(1 - \text{Upfront Option Strike})$. One drawback of this non-risk based approach is that banks could minimize their sold-protection add-on by purchasing out-of-the money options. This shortcoming further highlights why delta would be a more complete approach by limiting the effectiveness of out-of-the money options as Sold Protection Add-On hedging tools.

Example

Consider a portfolio of options where a bank owns an option to buy credit protection on an index at upfront strike of 10%. The bank has also sold another option where the bank has an obligation to sell credit protection on the same underlying index at an upfront strike of 5%. Since credit options are physically settled, the owner of the option always has the right to exercise their option at option expiry.

The default exposure of the portfolio is 5% which should correspond to the sold protection add-on of the portfolio. Under the current BCBS proposal, the sold protection of this portfolio would be 100%; however the maximum default exposure can be capped at 5% through exercise of the out-of-the money option.

This model-independent approach would see the notional of options in scope scaled by $(1 - \text{Upfront Price Strike } \%)$ which represents the option's default exposure.