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The Basel Committee for Banking Supervision  
Bank of International Settlements  
Basel  
Switzerland

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Dear Committee Members,

Please find the Barclays PLC response to the Basel Committee for Banking Supervision Consultation Paper 362 "Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches". We appreciate the opportunity to respond. In summary we are concerned that the proposals will result in a loss of risk sensitivity in regulatory capital and are difficult to align with previously affirmed commitments not to raise the overall level of capital in the system.

We would urge that all necessary time is taken to find the best way forward.

Yours sincerely,

A handwritten signature in black ink, appearing to read "G Soulellis", with a stylized flourish at the end.

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On behalf of

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## Barclays Response to BCBS 361

### Key Message

Barclays is grateful for the opportunity to respond to the Basel Committee's Consultation Paper 362 on constraints on the use of internal models.

We would like to raise the following key points with respect to the proposals in the consultation paper.

1. Reduction in the scope for AIRB modelling would reduce risk sensitivity in the capital framework and potentially create unintended consequences for risk management.
2. Replacement of EAD modelling with the Standardised CCF's is highly penal and not reflective of industry experience.
3. The removal of the option to model CVA would also reduce risk sensitivity and potentially penalise sensible risk management.
4. Parameter level floors would reduce transparency and penalise high quality exposures and again encourage focus on higher risk activities.
5. The proposals have additional knock-on impacts that are likely to be adverse but may only emerge through time. For example the emphasis on Through The Cycle modelling could further reduce the scope for AIRB.
6. Taken together with the proposed measures on the Revised Standardised Approach (RSA) approach from BCBS 269 (especially around EAD and CCF's) the proposals point to a substantial increase in capital (which will be confirmed in our confidential QIS submission). The proposals included in the consultation paper do not easily align with the high level commitment to maintain the overall level of capital in the system.

If the committee move towards implementation then we would encourage that this is done in a sensitive and measured manner. It is important that all necessary time is taken to get this significant change right.

The timelines for the QIS and Consultation have been very tight. It is not possible to quantify the full impact of the proposals as so many aspects are work in progress (the revised Standardised approach, overall capital floors etc). We strongly recommend there should be a second consultation and Quantitative Impact exercise where the impact of the complete reform programme can be assessed holistically and used to inform final calibrations.

As things stand it is difficult to align the full range of changes proposed with the high level commitment to keep the overall level of capital in the system unchanged. It is only after a complete assessment of the full set of rule changes and appropriate calibration that the committee will be able to meet this commitment.

### 1. Reduction in Scope for AIRB Modelling

The paper proposes significant reduction in the scope of IRB modelling for credit risk

- Imposition of Standardised approach for FI's and large corporates
- FIRB for a second tranche of large corporates

We disagree in principle with this approach for the following reasons:

- The capital framework should incorporate risk sensitivity. Risk sensitivity of the capital framework must be maintained to ensure appropriate capital allocation. Assessments that are made internally by banks allow for the most accurate measurement of their underlying levels of risk. Broad bucketing of risks can overlook the relative sensitivities, incentivising banks to seek higher risk assets as a means of boosting expected returns.

Basel II was introduced to reduce the scope for such regulatory arbitrage and a loss of risk sensitivity threatens to encourage a return to such behaviours.

- We recommend the continued incorporation of risk sensitivity in the capital framework by taking into account the various statistical methods that help to deal with sample size insufficiency. We recommend that these be fully explored by the committee as potential alternative ways to model low default portfolios in a risk sensitive manner.
- We believe that the scope for the Standardised approach to generate risk sensitivity may be overestimated. For example, it is Barclays view that the Committee may overestimate the number of Corporates and FIs with entity (rather than group) level ratings and consequently the appropriateness of the RSA as an alternative to internal modelling. This is particularly the case for subsidiaries of large groups. For such entities the industry will either have to seek external ratings (with unwelcome cost implications) or treat as unrated.
- If the use of the Standardised approach is extended then the cut-off point between AIRB and Standardised should be well-considered and evidence based rather than arbitrary. Barclays recommends that alternative ways to extend sample size are explored, such as utilising industry-wide data or consortiums to synthesise existing pools of data.
- We understand that industry responses suggest a range of options that have the potential for greater risk sensitivity than the Standardised approach. We urge that these be considered (but only after assessment of the quantitative impact). Our modelling team suggest that utilisation of the hypothetical portfolio exercise where all firms rate the same exposure could be a useful way of calibrating firms' own risk estimates to the industry average reducing variability solely due to modelling decisions and techniques.

## 2. Replacement of EAD modelling with the Standardised CCF's

It is proposed to limit the scope for modelling EAD with much wider use of new RSA CCF's. We disagree with both the principle and the penal nature of the alternative RSA CCF's (as we have already commented in our response to RSA CP 256)

- Whilst we agree with using consistent CCF's for Off-Balance Sheet Trade products for the IRB, Standardised approaches and those used under Leverage Ratio, we do not agree with the proposals for Undrawn Commitments. We ask the Committee to continue to allow wider use of EAD Modelling with a more granular product based approach to CCF's for Undrawn Commitments where it can be justified by data and loss experience and especially where they are shown to be Unconditionally Cancellable.
- The combination of the present proposals to remove CCF modelling in most cases together with a 50% SA CCF floor, and the unduly high regulatory CCF levels proposed under the RSA significantly overstate the risk associated with cash commitments and contingent facilities. Additionally, Barclays view is that the current proposals don't differentiate between the abilities of different banks to manage drawdowns. Active management of drawdowns enables banks to unilaterally cancel or limit additional drawdowns for instance when they identify any sign of deterioration in the creditworthiness of the borrower.
- We also included in our response to BCBS256 that the 0% CCF for unconditionally cancellable exposures should be maintained. Banks can easily and quickly cancel available credit lines at any sign of distress to nullify the risk of exposure. One area where we currently apply a 0% CCF is for headroom relating to Trade Finance and Receivables Finance related facilities that are unconditionally cancellable. The level of drawdown under Trade Finance and Receivables Finance is particularly influenced by business volumes that enable a company to obtain funding for sales or purchases. These often reduce before a company would go into default and therefore the assertion of a high level of drawdown before default (save for fraud where fictitious invoices are submitted) is not evidenced in our view. Withdrawal of this option could adversely affect the provision and availability of trade finance and associated economic activity.

### 3. CVA Modelling and IMM

The consultation proposes to remove the scope for CVA modelling. We disagree with this proposal. Barclays view is that the BCBS should reinstate the IMA-CVA approach. The reasons underlying this recommendation are as follows:

- The use of internal models for CVA would be most reflective and sensitive to real risk as well as promoting sensible risk management practice. Removal of IMA-CVA will mean that the ongoing calibration that is achieved through the use of a historical scenario based Expected Shortfall calculation will be lost as banks are required to use prescribed regulatory shocks.
- A Standardised approach fails to reflect the true underlying economic risk and also raise the cost of prudent hedging, which will be passed on to end-users, potentially driving end users to leave their risks unhedged, or to pursue less-expensive hedging options outside of the regulated banking sector.
- CVA risk will remain material despite greater use of central clearing and margining for non-centrally cleared transactions.

Also, with respect to the IMM-floor Barclays view is that the floor on the IMM approach should not be imposed. This is due to the fact that the flooring is by design less accurate as it incorporates a Standardised approach, which is less sophisticated. Also, flooring can incentivise the wrong behaviour, effectively promoting taking of risk until the floor is reached. So there is less transparency of the risk being built up, and less comparability across banks in terms of where risk is being taken.

We understand from footnote 10 in the current BCBS Consultative document that even if a firm has to use the Standardised approach for certain exposure classes under the current proposal, it can still use IMM-CCR for these counterparties (unlike in SA-CR). Barclays welcomes this clarification and fully agrees with separating the two modelling approaches as IMM and Credit Risk modelling have different purposes and are based on different sets of data. This is an important distinction to maintain and Barclays would like to confirm whether this applies to all counterparties under the Standardised approach or only those prescribed by 362 (Large Corps, FIs etc).

### 4. Parameter level floors

We assume that the proposed LGD floors are to be applied at the collateral/exposure level. We note that the existing rules already mandate a 10% EAD weighted floor. This being the case, our comments are as follows.

We disagree in principle with the proposal to introduce parameter level floors. This interferes with the integrity of the modelling process and the calculated risk estimates. If models are fully compliant and accurate and then calculate low PD's or LGD's then those estimates should be allowed to stand.

We also believe that the proposed floors are too conservative. For example a 10% LGD floor for retail mortgages even for very low LTV lending is not borne out by our experience of zero losses. It may be that this proposed floor has been guided by experience of residential property markets where a prolonged legal process significantly reduces the net present value of any recoveries. However, it is not appropriate to the United Kingdom. Barclays mortgage book is a high quality well secured book. Around 35% of exposure has a modelled DT LGD of less than 10%. This floor would be nonsensical and potentially orientate risk appetite towards higher risk exposures and penalise the very best quality customers. Furthermore, we can observe that during the recent downturn period (January 09 to November 10), Barclays average observed LGD was 3.6% (with a max of 3.8%). This is significantly lower than the proposed floor of 10%. At the very least, we would expect that if a floor were to be applied then this would be LTV sensitive.

On the Wholesale side the 25% floor is very high for example for swaps with very senior claim against deal assets.

### 5. Capital floors

Barclays does not see the introduction of output capital floors (based on the Standardised approach) as being necessary at this point in the context of the current proposals being made. Additionally the leverage ratio is already in place as a non-risk sensitive backstop to address model risk. At the very least, these proposals should all be fully

embedded, and their impacts assessed and monitored, before the introduction of output floors is considered any further.

## 6. Further areas of concern

- **Credit Risk Mitigation**

We note that the consultative document is silent on the treatment of credit insurance and guarantees when applied across the Standardised, IRBA and IRBF approaches. A clarification on how this will work in practice when the corporate obligor is on the IRBF or IRBA approach and the guarantor is on the Standardised approach is necessary. Under the current IRB approach a corporate exposure guaranteed by a bank will have a lower LGD applied recognising the credit quality of the guarantor (subject of course that the resultant RWA is no lower than the RWA in respect of a direct obligation to the guarantor). By removing AIRB models for Sovereigns / FIs the criteria for Risk Weight substitution needs to ensure that exposures to AIRB counterparties with guarantees from obligors that are in-scope of Standardised treatment under BCBS 362 can benefit from the guarantees. For example, allowing the Standardised risk weight to be used in the calculation of the risk for the exposure.

Without clarification, ambiguity will prevail and it could be likely that firms will apply the Standardised approach to such corporate exposures or alternatively, will treat such corporate exposures as unsecured, notwithstanding a bank guarantee is available, which will adversely affect the firms' credit appetite to such corporates and thereby reduce the amount of credit to the mid-corporate sector. We do not believe that this is what BCBS intended and you will be keen to avoid unintended consequences for AIRB Corporate and SME customers who use for example Bank Guarantees and Scheme Guarantees from Governments to incentivise and support trade and commercial activity.

- **Through the Cycle Modelling**

We note the reference to encouraging greater use of through the cycle approaches to PD modelling. This needs to be done sensitively and with appropriate focus upon data sufficiency and history.

- **Maturity**

One of the notable implications of the proposed changes is the removal of the maturity adjustment for banks, non-bank financial institutions and all corporates with revenues above EUR 200m. A maturity adjustment was introduced by Basel in the IRB approach because evidence indicated that long-term credits are riskier than short-term credits. However, the Standardised and Foundation IRB approaches do not have maturity adjustments as provided for in the IRB approach. Barclays therefore recommends that a maturity adjustment should be retained in the capital framework to reflect the lower credit risk of short term exposures. If Basel deems it appropriate to apply the Standardised approach for certain exposure classes, then a risk weight adjustment should be applied to reflect the reduced credit risk of short term exposures.

We believe that the proposal to apply the facility expiry date in lieu of the transaction expiry date under the IRB approach is not justified, particularly given the potential impact of these changes in relation to Trade Finance contingent exposures is material. Similarly, for those portfolios that would have to move to the FIRB approach, the fixed 2.5 years maturity would be punitive for Trade Finance. Based on our own experience of Trade product behaviours, supported by the ICC Trade Register, we believe that the retention of the 1 year maturity floor waiver for specified Trade Finance products should remain under the proposed new rules for the IRB approach. We also suggest, thus avoiding variation in national interpretation of these regulations, that application of the 1 year maturity floor waiver be clarified.

- **Securitisation**

We would urge the Basel Committee to consider the broader impacts of the restrictions discussed in the proposals, in particular how they might interact with the revised securitisation framework. The Sec-IRBA is only accessible to the extent that at least 95% of the securitised assets are IRB. The restrictions proposed could see this become untenable for all but retail securitisations, or possibly some SME type securitisations.

We do not consider this to be an appropriate outcome and do not believe it was the intention behind the Committee's proposals.

The impact of not being able to access Sec-IRBA on own originated securitisations could be very significant in the context of the capital caps that will be applied; if a bank has to use Sec-ERBA or Sec-SA, the cap is based on the entire underlying portfolio being on SA-CR, whereas under Sec-IRBA the cap is based on the weighted average IRB and SA-CR capital requirements. For investor positions, the industry has been moving towards use of proxy data to enable Sec-IRBA to be used, particularly where Sec-ERBA is not permitted (given the disparity between the capital requirements between Sec-IRBA and Sec-SA). The restrictions proposed would render much of this effort invalid unless a suitable solution can be found.

We would welcome consideration by the Committee of permitting models to be used in the context of Sec-IRBA even where the RWA framework would, per these restrictions, not permit the bank's models to be used in its RWA calculations.

- **Implications of the current proposals for Market Risk models**

It would be helpful to understand the implications of the current proposals for Market Risk models, both under current regulatory requirements and the Basel FRTB text. The current EBA guidelines for IRC and Basel FRTB text include text that requires use of IRB for Market Risk where an approved or "a methodology consistent with" IRB exists. This latter use of "consistent with" already causes debate now, in whether the model is the same (e.g. for a name where a PD does not exist in banking book, but as if it were), or whether the methodology aligns to the same principles. In either case, if the use of IRB models is restricted under AIRB, clarification would need to be provided on what PD should be used for Market Risk.