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12 August 2013

Ms Vera Luz
European Banking Authority
Tower 42 (Level 18)
25 Broad Street
London EC2N 1HQ
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Dear Madam,

REF: EBA/CP/2013/07: DETERMINATION OF THE OVERALL EXPOSURE TO A CLIENT OR A GROUP OF CONNECTED CLIENTS IN RESPECT OF TRANSACTIONS WITH UNDERLYING ASSETS

Barclays welcomes the opportunity to comment on the draft regulatory technical standards on determining exposures in respect of transactions with underlying assets.

We highlight our key messages on the proposals below, while answering the specific questions posed in the consultation paper in Appendix 1.

Divergence from the Basel Trajectory

We note that the EBA proposals deviate significantly from the Basel Committee's proposed *Supervisory Framework for measuring and controlling large exposures*, particularly with regard to the granularity at which look-through to the underlying assets of a scheme is required. We acknowledge that the EBA is required to submit the technical standards to the Commission by 1 January 2014, whereas the Basel document was a consultation exercise, with the final recommendations yet to be released.

The issues addressed in the Basel proposals, however, are not specific to the EU and therefore a globally consistent approach should be the ultimate aim. Alignment is particularly relevant given banks may need to request information from transaction counterparties that is not already in the public domain. We would welcome comments from the EBA on how the European standards could be adapted following 1 January 2014 to take account of international developments.

A Balanced Framework

We agree that the existing guidelines should be strengthened and concur that the requirement to fully indentify and measure all underlying exposures is the most risk sensitive approach for measuring exposures and assessing the build up of concentration risk. We therefore agree that, where feasible and material, transactions with underlying exposures should be assessed to ensure any interconnections between these and existing exposures for the firm are aggregated.

We also welcome the continued recognition that applying look-through to all exposures to schemes regardless of materiality will pose a significant administrative and cost burden on firms without delivering any commensurate benefit to the financial soundness of the firm.

The focus of the large exposures regime should be to identify exposures which present a risk of significant unexpected loss to the bank and not extend to capturing every exposure. In determining whether look-through assessment of each underlying exposure in a scheme should apply, we therefore propose a balanced approach that considers the following:

- The largest underlying asset as a proportion of the transaction (the "granularity"); and
- The bank's total exposure to the transaction as a proportion of its eligible capital (the "materiality").

All assets above a predefined regulatory threshold would need to be identified and (where applicable) aggregated with other exposures. Where identification is not achieved, such exposures should be assigned to an 'unknown issuer' bucket and aggregated.

Exposures below the thresholds would not be measured separately, nor would they need to be assigned to the 'unknown issuer' bucket. This would generally mean that the individual retail exposures underlying such transactions would be excluded, thereby avoiding any potential conflict with data protection and privacy requirements.

We recognise that any granularity and materiality thresholds may present supervisors with two concerns:

(1) Interconnections arising 'by accident:' a bank is unwittingly exposed to issuers via a fund or securitisation where it already has exposures to the same issuer on its balance sheet;
(2) Interconnections arising 'by design:' a bank exploits the presence of a granularity threshold to disguise its true level of exposure to a given counterparty.

Thresholds should therefore be set with a view to tolerance for errors that may occur in good faith. In practice, transaction costs are likely to act as a natural deterrent on firms using structures to exploit thresholds and circumvent large exposure limits, but monitoring tools should also be designed to identify abusive behaviour.

Large exposure rules are not the only line of defence

In the case of securitisations, we believe there could be a stronger link and alignment to the requirements on securitisation retention and due diligence (CRR Part Five and EBA/CP/2013/14). Banks are required to perform due diligence on the positions underlying a securitisation prior to any investment.

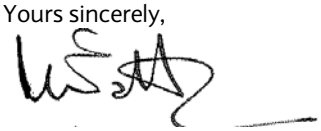
Whilst a firm may not necessarily be able to identify all underlying counterparties in a securitisation, the firm is obliged to consider the risk characteristics of the underlying assets and the structural features of the scheme prior to investing in a securitisation position. A suggestion therefore, is to consider the application of a graduated approach for these types of schemes rather than defaulting to a single unknown counterparty, especially where the firm can establish that the risk characteristic may be completely different for two different schemes.

The treatment of securitisations for large exposure purposes should also reflect the different risks posed by the junior tranches and those posed by senior tranches. In the case of the latter, most tranches are protected by various forms of credit enhancement, and therefore the exposure to underlying assets is not equivalent to a pro-rata interest in the underlying issuer.

Whilst we appreciate the EBA's concern that recognising the protection provided by junior tranches is only effective if the firms' have the ability to frequently reassess the position to ensure that the protection is still effective, we believe this would be required in any case under CRR Part Five. The proposal to treat all tranches in a securitisation as equivalent first loss tranches undermines the construct of such structures and risks creating perverse incentives.

I hope you find our comments and suggestions helpful. Please do not hesitate to contact Ashid Shah (ashid.shah@barclays.com or +44 20 3555 8267) if you have any questions or comments on any of the issues raised in this response.

Yours sincerely,



Peter Estlin
Co-Head of Finance, Barclays

Appendix 1: Response from Barclays to questions raised in the consultative document

1. Is the treatment provided in Article 5 sufficiently clear and do the examples provided appropriately reflect this treatment?

Whilst the examples illustrating the exposures to the investment fund and first loss exposure are clear, examples which illustrate exposures to other tranched schemes critically omit the benefit afforded by the subordinated tranches under the tranched structure.

In particular, the examples ignore the fact that, in the event that all subordinated tranches are exhausted due to a total default of the underlying, the corresponding residual exposure applicable to the senior-most tranche is reduced by the sum total of all the subordinated tranches. This is illustrated by our examples included in the appendix.

More generally, the simple examples do not reflect the significantly onerous "look-through" requirements that will need to be applied to each schemes with underlying assets in order to of recognise an exposure to each underlying asset.

This is especially relevant where the actual exposure being assessed may be to a relatively small position in a senior securitisation, with a very granular underlying portfolio such as a senior US RMBS security. In this example, the scheme would have a wide range of underlying individual mortgage exposures, which will need to be recognised individually by the institution under the current proposals.

It should be noted that the inclusion and assessment of such underlying exposures will not necessarily result in any material exposure or concentration being recognised by the reporting firm but will still require that the proposed approach be undertaken e.g. where the reporting firm with the US RMBS exposure is a UK retail bank with a majority of balance sheet exposures in the UK.

Under the current proposals, where a bank cannot determine the exposure to the underlying asset, each unknown exposure would be aggregated with all other unknown exposures, including unknown exposures in other completely unrelated schemes, as if they all related to a single unknown counterparty. In the above example, where the firm is unable to assess the underlying exposures of its small senior RMBS securitisation position, this will be reflected as an unknown exposure for the bank and aggregated with other unknown exposures.

If one considers that a bank may potentially have a wide and diverse range of exposures of this type which will often be uncorrelated both to existing exposures and other scheme exposures, the resulting perverse outcome would still recognise a large unknown client by aggregating all such unrelated exposures. This would be greatly restrictive to the business when considered against capital availability, and yet the approach may not necessarily provide a sensible assessment of the underlying risks.

Whilst we agree that the approach provides incentives for banks to improve their identification of exposures, it also unfairly penalises banks for investing in schemes with underlying assets where real-time information on underlying assets is not available with a disproportionate impact on (i) retail exposures and (ii) portfolios of loans that are individually small e.g. SME lending.

We believe that a more appropriate approach would be to reflect the materiality of such exposures in the large exposure assessment, discussed as part of the question 3.

2. Is there an appropriate alternative way of calculating the exposure values in the case of securitisations, which would be compatible with the large exposures risk mitigation framework as set out by the draft CRR?

We understand from the EBA public hearing on this consultation that the EBA has the following primary concerns, which have led to the proposed treatment of not recognising any mitigation provided by the junior tranches of a scheme:

1. The rapid deterioration of the protection provided by junior tranches in times of stress.

2. The complexity and frequent reassessment required under the current approach to ensure that the protection provided by the subordinated tranches is still effective.

Whilst we appreciate that the rapid deterioration of the protection may have been a feature of specific types of securitisations in the past, the generalisation across all securitisations greatly undermines the economic features of vanilla structures and does not account for the significant amount of regulatory change that governs securitisations under the current framework.

Within a securitisation framework for example, there are important differences between the various tranches. Such structural differences, which reduce loss probability and severity, should be an important consideration in any exposure assessment, commensurate with the principles of risk recognition. We strongly believe therefore, that the current proposals excessively compensate for the relatively low risks that these concerns pose in practice, specifically around the build up of credit risk exposures to the underlying assets.

Principally, the proposals do not recognise the significant amount of regulatory change that has occurred to the securitisation framework to reduce the levels of risk inherent in a firm holding any securitisation position. The effect of these changes has been two-fold - an increase the capital requirements associated with holding these positions and an improvement in transparency and risk management by imposing regulatory requirements to conduct appropriate due diligence prior to holding any securitisation position.

Under Article 406 of the CRR (as proposed under Article 122a of the Capital Requirements Directive[1]) for example, banks can only invest in securitisation positions where they are able to conduct thorough due diligence and comprehensively assess the position in order to understand the risk characteristics, the underlying exposures and all structural features. This requirement applies both at the point of investment and also on an on-going basis. The concern around the inability to assess the exposures on an ongoing basis is therefore, in our view, overemphasised.

In addition, developments in the securitisation markets following the regulatory requirements under CRD 2 and Credit Rating Agency regulation (CRA 3), have led to many of the factors which contributed to the rapid deterioration of the subordination in structures, being resolved.

We therefore disagree with approach of not recognising the protection afforded by the subordinated tranches to more senior securitisation tranches. The recognition of the protection, consistent with the approached proposed under the CEBS[2] proposals, more accurately reflects of the risk inherent in a tranched position.

However, we note the EBA's concern around the risk of sudden breaches in of large exposures due to exhaustion of subordinated tranches. Whilst we appreciate that sudden breaches could cause a material breach in a large exposure limit for an institution, the risk of such a breach would be directly proportionate to the size of the exposure under the scheme, and hence to the materiality of the exposure to the reporting institution.

In our view therefore, a large exposure framework that accounts for the materiality of exposures for the reporting institution is therefore a necessary requirement to building a more robust and sustainable large exposure framework. We elaborate on this in the answer to question 4.

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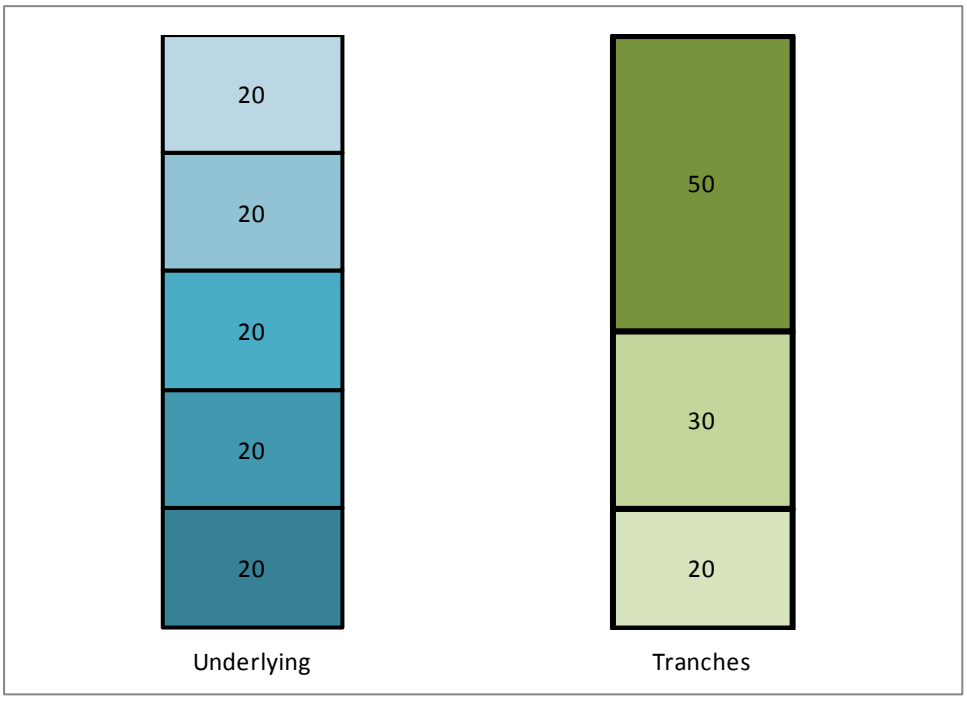
1 *Guidelines to Article 122a of the Capital Requirement Directive*

2 *CEBS Guidelines on the implementation of the revised large exposures regime (2009)*

An additional alternative, however, should there be residual concern around the build up of risk resulting in potential breaches in the large exposures, would be to allow the recognition of protection from subordinated tranches based on prescribed criteria only. These criteria could, for example, be related to the width of the subordinated tranches, reflecting the premise that a senior position afforded the protection of a very wide subordinated tranche would have a different risk profile to a senior tranche in a securitisation with a very thin subordinated position.

An even more simplistic approach would be to apply a **proportionate** recognition of protection by accounting for the subordinated tranches. This proportion could be based on the size of the tranche being assessed compared to the aggregate size of all subordinated tranches. As an example, consider a scheme with a £20m subordinated tranche, a £30m mezzanine tranche and a £50m senior tranche, as shown below. The scheme is made up of 5 identically sized underlying.



Under this simplistic approach, the application would be as follows:

- First loss tranche: 100% (£20m/£20m) exposure to each underlying i.e. an exposure of 20 to each underlying name.
- Mezzanine tranche: 60% (£30m /£20m+£30m) exposure to each underlying i.e. an exposure of 12 to each underlying name.
- Senior tranche: 50% (£50m/£20m+£30m+£50m) exposure to each underlying i.e. an exposure of 10 to each underlying name.

This approach recognises both the protection provided by any subordinated tranches as well as accounting for the size of the subordinated tranche in assessing the exposure to the underlying for the more senior tranches. Larger subordinated tranches would therefore reduce the exposure for the most senior tranches.

We recognise that the approach above is simplistic and does not factor in the potential build up of exposures in the event that only some of the underlying exposures were to default, wiping out the subordinated tranches and leaving the senior tranche exposed to the entire exposure on the residual, non-defaulted names.

However the proposed approach in the RTS, by comparison is inflexible and does not distinguish between the exposure generated by a significantly subordinated position in a securitisation and a very senior position in

securitisations with a very wide subordinated protection, although the risk profile of the two are very clearly and significantly different.

3. Would the application of requirements provided by Article 6 (3) and (4) imply unjustified costs to the institutions? Would the introduction of a materiality threshold be justified on a basis of a cost-benefit analysis? Please provide any evidence to support your response.

Barclays fully supports the notion that transactions with underlying exposures should be assessed to ensure any interconnections between these exposures and existing exposures for the firm are aggregated. However, the application of an assessment of underlying exposures cannot feasibly be applied to all exposures to underlying assets without significant operational difficulties and due diligence burdens on institutions.

This burden is further compounded where the investment is in third party schemes for a number of reasons, such as:

- Extensive system and human intervention in order to assess and record each underlying exposure in schemes, even where such exposures are known to be immaterial to an organisation, in order to avoid the exposure being aggregated into the "unknown exposure " cohort
- Costs and operational burden would be further exacerbated where underlying portfolios are continually rebalanced by third parties e.g. collective investment undertakings taking advantage of fluid market conditions
- There is the added complexity of the interplay of differing levels of market disclosure for certain schemes, which vary in quality and frequency.

Whilst the approach provides incentives for banks to improve their exposure identification infrastructure, it also penalises banks that invest in schemes where real time access to underlying scheme details is not available. In some cases, the availability of such detail may not be related to the firm's ability to capture the detail in its infrastructure, but due to the level of information actually disclosed to the market by the scheme.

The availability of such detailed market information will require a regulatory impetus as complete market information on scheme underlying is currently not readily available from market sources and the limited amount of information that is currently available would not meet the requirements under the technical standards.

Creating an industry infrastructure to capture this information would also require a significant amount of time and effort from the collective industry and this is unlikely to be in place within the stipulated timeframes under the CRR.

As an example, a high-level analysis of Barclays scheme exposures indicated that little to no underlying information was available on **c65%** of total scheme exposures, representing approximately 7,000 schemes. Initial experience of assessing underlying exposures suggested that a complete analysis requires approximately 0.5 man-hours per scheme, which incorporates a qualitative assessment, control processes and any manual intervention. This suggests a cost of 3,500 man-hours applicable at each reporting cycle purely to capture all underlying exposures to schemes. This also assumes that information on the underlying scheme holdings is readily available. Where the information needs to be sourced or validated the costs could increase substantially.

A more balanced approach therefore would be to apply the large exposure assessment only to exposures that are significant in relation to a bank's capital or otherwise represent a risk to the financial health of the bank. This proposal to consider only those exposures that are deemed to be "**material**" for the reporting institution would greatly restrict the operational and financial burden of firms, by focusing the assessment on those exposures which are more likely result in a build up of concentration risk and therefore cause a breach in any large exposure threshold, as a result of aggregation with existing exposures.

Any assessment of "materiality" should also be applied in conjunction with some form of assessment for the "granularity" of schemes with underlying assets as proposed under the CEBS guidance. The "granularity test" is

also proposed under the recent Basel consultation for measuring and controlling large exposures[3]. The Basel committee accurately describes the rationale for including such a test as follows:

"This additional assessment is necessary, as it recognises that, for transactions with very small individual underlying assets, the effort of indentifying them exceeds the likely financial stability benefits."

We propose thresholds for material and granularity which are considered in our response to question 4 below.

4. Keeping in mind that such materiality threshold would need to be sufficiently low in order to justify that all unknown underlying assets of a single transaction would be assigned to this transaction as a separate client, what would be the right calibration? Would the reference value (the institution's eligible capital) be appropriate for this purpose? Please provide any evidence to support your response.

Barclays strongly agrees with the over-arching requirement to strike an appropriate balance between the significant effort that will be required by institutions to identify exposures in very granular portfolios and the financial stability benefits being achieved as a result of capturing these exposures.

Any consideration of applying an appropriate balance should therefore incorporate the "granularity" of exposures to schemes. However, a mandatory requirement to apply look-through based on the single criterion of granularity would not accurately reflect the underlying risk of the exposure, especially where this requirement is applied without consideration of the corresponding size (referred to henceforth as the "materiality") of the exposure, in the context of the reporting institution.

As an example, a very small non-granular scheme which is immaterial in size to a reporting bank will require a significant effort to capture each individual underlying exposure whilst providing no additional benefit in the assessment of single name concentration risk. Whilst we strongly support the adoption of a granularity based threshold, we would caution the use of a single "granularity" threshold in isolation, without any corresponding consideration for the "materiality" of the risk and exposure, as suggested in our response to question 3.

We also recognise that the correct calibration of granularity and materiality thresholds will need to ensure that immaterial exposures do not pose a risk to the financial soundness of the reporting institution or mask the build up of concentration risk which is not captured under the framework.

Combining a materiality threshold with an appropriate granularity threshold would ensure that sizable exposures which present a higher risk of concentration build-up would always require an assessment of the underlying to determine whether there is any connection to existing exposures of the firm, regardless of the underlying granularity.

We therefore propose a sequential approach which considers a granularity assessment in the first instance and a subsequent assessment for the materiality of the exposure to determine whether the exposure to the underlying should be recognised. A diagrammatic representation is included in the appendix.

Assessment 1: Granularity

We appreciate that the EBA has reviewed the option of strengthening the granularity threshold both at the 5% level proposed under the CEBS guidance and a much lower granularity threshold of 1% of the transaction value under the recent Basel Committee proposals, in making the current proposals.

Barclays is strongly supportive of an application of a granularity threshold, and believe it is a necessary consideration in assessing any source of concentration risk.

[3] *Basel Consultation on the Supervisory framework for measuring and controlling large exposures*

Broadly, credit risk in a portfolio arises from two sources, systematic risk and idiosyncratic risk. Systematic factors represent the effects of unexpected changes in macroeconomic and financial market conditions on the underlying sources of credit risk, whilst idiosyncratic factors represent the risks specific to each underlying source of credit risk.

In a granular and dynamic scheme, the incremental contribution of this idiosyncratic risk to the firm is reduced. This principle is also acknowledged in the CEBS guidance[4] on revised large exposures which states "*in a fund with a very granular and dynamic portfolio, the marginal contribution of this scheme to the "unexpected idiosyncratic credit risk" of the institution may be low, while the cost of a full look-through of this portfolio may be high*".

The calibration of such a threshold should be directly correlated to the **number** of scheme underlying, ensuring that each additional scheme exposure provides the least marginal contribution of risk to the firm.

We therefore do not propose deviating from the existing CEBS guidance on proposals for a granularity threshold. Under the CEBS guidance, "*a scheme may be considered as sufficiently granular if its largest exposure is smaller than 5% of the total scheme*", an appropriate threshold for granularity.

A subsequent assessment for materiality described below should be implemented in addition to the granularity assessment.

Assessment 2: Materiality

In order to achieve an appropriate balance between the capture of every source of concentration risk and the administrative burden in the capture of that exposure, an analysis of underlying sources of concentration should only be applied to schemes (or participations in schemes) which pose a sizeable source of concentration risk for the firm, or where there is already an exposure that is material to the firm.

This approach is recognised in the CEBS guidance on assessing exposures to underlying assets under the *structure based approach*. Under this CEBS approach, where a firm can ensure (e.g. by means of a CIU's mandate) that the underlying assets of the scheme are not connected with any other direct or indirect exposure in the institution's portfolio (including other schemes) that is higher than 2% of the institutions own funds, it may treat these schemes as separate unconnected clients.

We believe the underlying concept should be applied to all schemes with underlying assets. Under this approach, an active assessment should be made by firms to identify, capture and aggregate exposures which are higher than 2% of an institutions' own funds requirement. This will ensure that firms are sensitive to existing large exposures and continue to manage and assess these actively.

In addition, a mandatory look though should be applied to each scheme or participation in a scheme which is greater than 1% of a firm's own funds requirement, regardless of granularity. This would ensure that for all material exposures, the firm is required to actively assess the exposure for "hidden" concentration risk.

The reference value linked to an institution's own fund requirement is appropriate in this materiality calibration as this would allow for proportionate flexibility for firm growth whilst ensuring that the growth is risk sensitive.

A natural consequence of the implementation of the two thresholds above will ensure that immaterial retail exposures such as RMBS, credit card receivables, student and consumer loans etc will be excluded from these large exposure requirements. This outcome is appropriate given that retail schemes tend to be highly diversified and underlying exposures in such schemes would be unlikely to constitute a large exposure for most reporting institutions.

[4] *CEBS Guidelines on the implementation of the revised large exposures regime (2009)*

5. Would the requirement to monitor the composition of a transaction at least monthly, as provided by Article 6 (5), imply unjustified costs to the institutions? Please provide any evidence to support your response.

We understand the rationale to monitor the composition of a transaction on a monthly basis, especially to ensure that any build up of concentration risk is captured on a timely basis. However, such onerous reporting requirements would cause an unjustified administrative burden for reporting firms, especially where the exposures are immaterial in size to the reporting institutions and the scheme is very granular.

It should also be noted that market information on schemes is only available on a quarterly basis for most schemes at present, for example in the covered bond market.

Our suggestion would therefore be to ensure that the firms monitor concentration using the **most recent** available information at all times. Any new information should therefore be immediately incorporated in the large exposure analysis.

6. Are there other conditions that could be met by the structure of a transaction in order to not constitute an additional exposure according to Article 7?

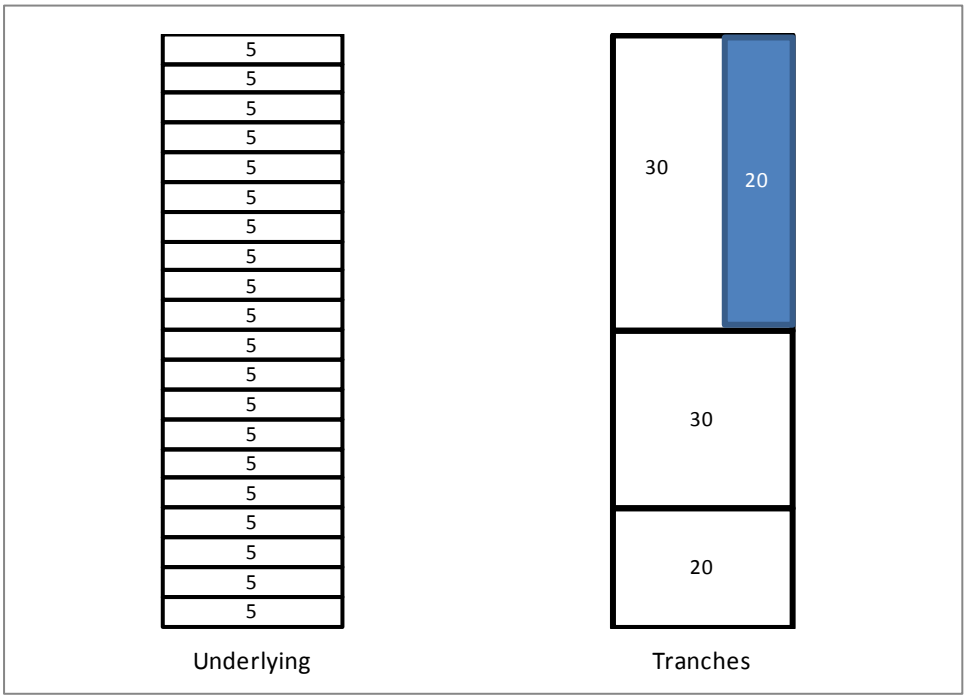
In addition to the conditions listed in article 7 2 a) and b), we would propose allowing all regulated investment vehicle authorised by a Member State or by a third country Competent Authority to be excluded from this assessment.

Limiting the scope of article 7 to UCITS only seems overly restrictive as it would result in unduly excluding regulated investment structures which already submit to stringent investment mandate regulations under their corresponding supervisory requirements.

Appendix 2 – Examples illustrating the treatment of tranched schemes under current proposals

Example 1

Consider a Firm A that invests £20m taking up 40% of the senior tranche (total size of the senior tranche is therefore £50m) in a scheme that also has a mezzanine tranche of £30m and a subordinated tranche of £20m. For simplicity, consider further that this £100m scheme is made up of 20 underlying of £5m each, as shown in the diagram below.



Under the current proposals, Firm A will recognise and exposure to each of the 20 underlying of £2m (40% x £5m).

However, if the underlying securities defaulted, the subordinated and mezzanine tranche would bear the initial losses. To illustrate, if we assume a scenario that all underlying securities default at the same time, the residual exposure that the senior tranche will have to each underlying name will be limited to 50%, as the first 20% and the subsequent 30% of the loss is borne by the subordinated and mezzanine tranche, respectively. Due to the 40% ownership interest in the senior tranche, the actual exposure to each of the underlying will therefore be £1m (40% x 50% x £5m).

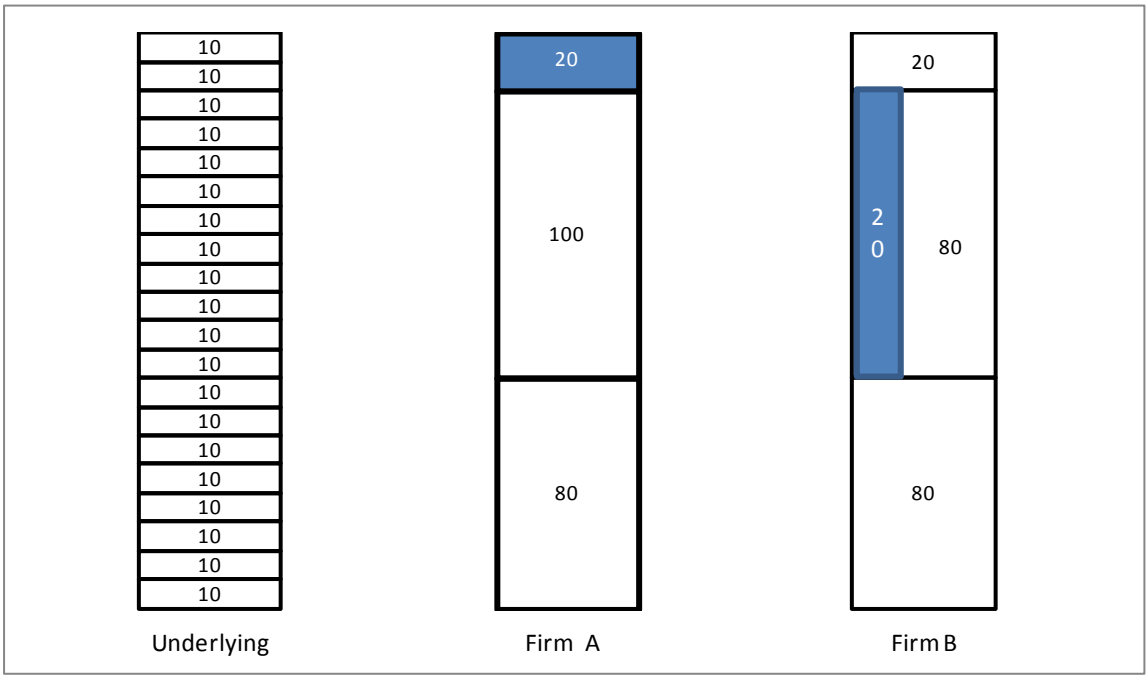
In example 3 and 4 from the consultation therefore, recognising exposure to the senior tranche in the same way as the exposure to the most subordinated tranche significantly overstates the magnitude of the exposure and unfairly penalises the investor in the senior tranche.

We do recognise however, that if the losses were concentrated to the first 10 names only rather than spread across all 20 underlying, the senior tranche would be expose to the residual 10 underlying names for the full extent of the investment.

Example 2

The examples also suggest a perverse outcome where investors investing the same amount in two different tranches, will result in recognising different exposures which are also not reflective of the underlying risk.

As an example, consider a firm A that invests £20m taking up an entire senior tranche and a firm B which invests £20m in a mezzanine tranche of the same scheme, which represents 20% of the mezzanine tranche. Consider further, that the underlying is made up of 20 underlying of £10m each, as shown below



Under this example, firm A, which invests in the senior tranche, will report a £10m exposure to each underlying. This is derived as the pro-rata ratio for this tranche (£20/£20 = 100%) multiplied by lower of the exposure value of the underlying(£10m) and the value of the senior tranche (£20m), which is in all cases will be the value of the underlying i.e. £10m.

Firm B investing the same total amount in a more subordinated tranche will report exposures of £2m to each underlying. This is derived as the pro-rata ratio for this tranche (£20/£100 = 20%) multiplied by lower of the exposure value of the underlying (£10m) and the value of the senior tranche (£100m), which in all cases will be £10m.

This outcome, where firm A investing is a senior tranche reports a larger exposure to each underlying compared firm B investing in a subordinated tranche, would not be reflective of the underlying risk inherent in each tranche.

Appendix 3 – Illustration of the application of the proposed granularity and materiality thresholds