



5 The North Colonnade  
Canary Wharf  
London E14 4BB  
United Kingdom

Tel +44 (0)20 7623 2323

European Banking Authority  
Tower 42 (Level 18)  
25 Old Broad Street  
London  
EC2N 1HQ

15 January 2012

**Response to EBA Consultation Papers CP48 and CP49: Draft Guidelines on Stressed Value at Risk (Stressed VaR) and Draft Guidelines on the Incremental Default and Migration Risk Charge (IRC)**

This covering letter summarises the key messages that Barclays Capital would like the EBA to consider prior to finalising the Guidelines. Annexes 1 (IRC) and 2 (Stressed VaR) provide more detailed responses to the consultation papers.

**Key messages on both the Consultation Papers (CP48 and CP49):**

1. Barclays Capital supports the stated EBA objectives of the two CPs in enhanced convergence of supervisory practices and to secure a more level playing field for regulated firms.
2. Both Consultative Papers ("CP") 48 and 49 contain provisions which differ in ways which are both sub equivalent and super equivalent to comparable guidance implemented by national regulators. However, the executive summaries to both CP's contain the wording:

*"It is expected that national competent authorities around the EU will implement the Guidelines by incorporating them within their supervisory procedures within six months after publication of the final guidelines."*

While both papers are referred to as 'guidance' the wording in their scope and level of application is more consistent with rules-based regulation. For example "competent authorities shall require institutions to comply with the provisions laid down in these Guidelines." (CP48 pg9, 2.1) There are examples across the two papers where it would be difficult for a firm to comply both with their national rules and guidance and the EBA's proposed Guidelines.

Referring to the papers as both guidance (i.e. optional) and mandatory is ambiguous and makes it difficult to assess the impact of the papers, for example in decisions about where to allocate scarce resources to develop models required across various regulations. This ambiguity should be clarified.

3. We believe the EBA should consider among its aims and objectives the level playing field promoted by Basel, and in particular pay heed to the regulations being formulated in the US under the Dodd Frank Act. The evolving US framework contains significant differences to the EBA Guidelines, for example the recently released NPR relating to the exclusion of external ratings from the regulatory framework.

For all those EU regulated institutions with a significant presence in the US, these differences will contribute to the cost and operational risks in implementation across jurisdictions. At the international level, authorities must work together to produce a more level playing field.

4. We believe the timing of the EBA guidelines is unfortunate. We have been engaged in detailed discussions with our regulator on these models since the 4<sup>th</sup> quarter of 2010. During 2011 we have been required to submit detailed model documentations for approval under existing national rules and guidance, covering all aspects of the model from scope to methodology to capital impact. Where the final EBA Guidelines differ from the UK's own rules and guidance (e.g. the inclusion of sovereign bonds in IRC is not covered in the FSA's rules and guidance) we require a much longer lead in time than that implied in the two CPs. A more reasonable timeframe for responsible model development work involving material changes to a model's scope with additional validation, testing, and implementation required might be 12 months. However, until the Guidelines are finalised we cannot be sure how best to allocate the appropriate resources.

We encourage the EBA to publish more timely Guidelines that would enable firm's model development projects to incorporate necessary changes in line with EBA text prior to implementation and adoption. We note that the CRD 3 text has not materially changed since 2010 and that by the time the EBA complete its Guidelines on sVaR and IRC over 2 years will have passed since the Directive text was released from the EU legislative process (and more than 3 years since Basel published the original rules). The delay adds significant additional costs to the industry's CRD 3 projects. Having spent the last two years developing and implementing our models, it is likely that in 2012 further development and implementation work will be required as and when the EBA complete their Guidelines. We believe these costs could have easily been avoided.

Please do not hesitate to contact us if you have any questions or comments on any of the issues raised in this response. Furthermore, we would be happy to participate in any forums (either at the EBA or EU Commission level) to discuss the issues presented in these consultation papers in more depth.

Yours sincerely,



Co Chief Risk Officer  
Barclays Capital

## Annex 1:

### Key messages on CP49 - IRC:

#### IRC Scope

The scope outlined in the EBA paper is very specific and rules-based (sovereign bonds, money market loans, credit linked notes, etc), and we believe is inconsistent with the stated objectives to provide "guidance". Defining model scope tends to be one of earliest stages in the model development process, and while there is flexibility to introduce additional products and associated risks into the model at later stages, this can result in firms having to retrace initial steps. For example, a requirement to include sovereign bonds in the IRC poses unique and specific risk modelling challenges (sovereign transition matrices, correlation assumptions with financials/non-financials, recovery assumptions, etc), along with particular data related challenges – such a significant requirement should have been considered as part of the initial CRD 3 drafting process and not left until Draft Guidance published just a few weeks prior to "go live".

#### Interaction with Standard Rules

We note that under standardised rules sovereign bonds issued in domestic currency carry a zero risk weight. Under the IRC proposals such bonds are included in scope and, since charges are derived from realised Credit Default Swap ("CDS") spreads, these can be non-zero. Although it is now accepted that no sovereign provides a truly risk free rate, such instruments do not display jump to default characteristics; rather the ratings migration is somewhat steady. We do not think the standard rules should produce regulatory capital charges which are lower than the IRC.

#### Probabilities of Default

Paragraph 12.2 states that PD's implied from market prices (i.e. risk neutral PD's) shall not be acceptable for the modelling of the rating migration or default. PDs can be derived in a number of ways including from historical data (for example using internal models), from external ratings or from the market prices of instruments.

We think the EBA draft guidance on Probabilities of Default ("PD's") should be reconsidered in light of forthcoming rules and guidance on CVA and CVA VaR and also in light of the December 7<sup>th</sup> 2011 NPR publication from the US.

A market implied approach appears to be the favoured approach recommended for CVA and CVA VaR and also has been explicitly adopted as an alternative approach in the US for the determination of PDs for securitisation positions in the trading book.

#### Impact of rating change on market prices

We agree with the EBA that in estimating the impact of a rating migration on market prices firms should be allowed to choose between using either currently observed market data or an average of historical market data observed (20.4, pg20), and that as long as they are able to justify their choices and show that they are appropriate for the model/portfolio then national regulators should not be super equivalent in imposing a particular approach.

#### Upswing LGDs for short positions (12.1 pg 14)

We question whether it is possible to simultaneously comply with the first and last sentence of 12.1 (pg14) in supporting both IRB compliant LGDs and upswing LGDs. It would be difficult for us to produce LGDs consistent with the simulated economic state from our approved LGD models. We also think that modelling upswing LGDs consistently with downturn LGDs within the same IRC model framework would

be extremely challenging. We believe there are other ways in which a model can be made more consistent with the economic cycle, for example, through the modelling of recovery with assumptions of loss consistent with the cycle.

#### Hedging (19)

It might be helpful to provide some additional guidance as to what might be considered an "overestimation" of diversification or hedging effects (i.e. relative to what?) for modelling long and short positions .

#### Validation

The validation requirement under point 2.ii on page 24 implies that if you re-balance your portfolio over a shorter liquidity horizon than 1 year, that you compare the results with an IRC model with a fixed portfolio with a liquidity horizon of 1 year. This requirement to effectively maintain two IRC models and the added associated costs will discourage firms from developing the more sophisticated models. We suggest removing this requirement.

We agree validation should require firms to review actual default and migration data, but question the reference to "traded" debt portfolios in 2.iii (pg24). We propose to utilise whatever available data there is to build confidence in the IRC model output and we would not restrict this to the experience reflected in the data for only "traded" debt portfolios. We recommend the EBA remove reference to "traded" debt positions in 2.iii (pg24).

Furthermore, it would be helpful if the EBA could provide additional clarity on the types of "internal modelling benchmarks" suggested in 2.vi (pg24). At a 99.9% confidence interval in the absence of back testing determining standards for model accuracy is notoriously difficult.

## Annex 2:

### Key messages on CP48 – Stressed VaR:

We question why the EBA would accept judgment-led approaches, VaR approximations and a range of less onerous stress period monitoring techniques, when our own regulator has ruled these out. On this basis we think the EBA is unlikely to succeed in promoting a level playing field and would urge a re-think before completing the final Guidelines. A clear example of this is the inconsistency in regulatory approaches to the frequency firms are required to review the stressed period. The CRD clearly states that this is required at a minimum on an annual basis, which is echoed in the CP, with a preference stated for more frequent monitoring, whereas some regulators have insisted upon a minimum quarterly review.

#### The Period of Stress

A sVaR related capital number at a consolidated level only makes sense if the underlying stressed periods for each entity within the group is identical. Where different entities within the group identify different periods of stress, perhaps due to the different risk factors present within their respective portfolios, we do not believe the results can be added together in a meaningful way. We do not think requiring stressed VaR over different periods for different entities within a consolidated group is helpful. This has the potential to create a disconnect between Group and entity level capital requirements and creates practical problems for those firms using full revaluation in their VaR due to the computational time associated with such an approach. The guidance should clarify that a single group-wide period of stress is appropriate, even where that may not be the period of stress selected for each individual group entity on a solo basis

#### Monitoring of the period

We do not believe that trades entered in to that reduce the Stressed VaR should necessarily trigger a review of the stressed VaR period. We think firms should be required to review the stressed period in light of material changes to the risk profile of the portfolio or in response to a new period of significant stress. This we believe would be consistent with 15.2 which states that *“where Stressed VaR outputs reveal particular vulnerability to a given set of circumstances, prompt steps should be taken to manage those risks appropriately”*.

#### Use Tests

The use test is a less relevant concept for sVaR than for VaR. The further in time you are from the stressed period the more likely it is that the risk drivers and correlations become less relevant to the current portfolio and the more difficult it will become to demonstrate compliance with the “use test”. Too much reliance upon use of sVaR could lead firms and regulators to plan for too narrow a set of circumstances based on historical stress in their stress scenarios rather than considering other hypothetical scenarios that could be more damaging to the firm. .

Furthermore, we do not think the reference to limits in this context is helpful. We are not currently planning to apply risk management limits based on stressed VaR numbers as we do not think this provides useful control over and above VaR based limits which we already impose.

#### Consistency with VaR methodology

We note that the capital equation proposed by the EBA is inconsistent with the Guidance provided by our own national regulator [10.3 iii (pg15)]. In CP48, the EBA’s regulatory capital calculation for firms computing Stressed VaR (sVaR) weekly proposes an average sVaR based on the previous 12 stressed VaR numbers. The FSA’s own rules and guidance requires a calculation based on a sixty-day average,

with the weekly values of sVaR rolled each day. We do not think it is possible to comply with both and that perhaps point 3 (iii) a) and b) should be a) "or" b)?

#### Square Root of Time approach (10 Day VaR)

We believe that the requirement to review the appropriateness of the square root of time approach to scaling up a one-day stressed VaR measure is unnecessary. If the methodology required for stressed VaR must be consistent with the VaR approach, and there is an existing CRD requirement to justify this approach for the VaR, then there should be no additional need to review this technique as applied to stressed VaR.

#### Validation of stressed VaR

We do not believe the stressed VaR output provides useful information for the validation of current VaR modelling choices (15.2 under the section on "Use Tests"). If the EBA continue to incorporate this provision in their guidance, we believe it would be helpful to provide some additional ideas on what information might be considered useful in validating VaR methodology choices.