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Alfred M. Pollard, General Counsel
Attn: Comments / RIN 2590-AA45
Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
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Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Gary K. Van Meter, Acting Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
500 17th Street, NW
Washington DC 20429

Re: Docket No. OCC-2011-0008/RIN 1557-AD43; Docket No. R-1415 /RIN 7100 AD74; RIN 3064-AD79; RIN 3052-AC69; RIN 2590-AA45
Re-Opening of Comment Period re: Margin and Capital Requirements for Covered Swap Entities – Comments on Margin Requirements

Ladies and Gentlemen,
Barclays appreciates the opportunity to provide comments on the above Notice of Proposed Rulemaking (the "Proposal"), issued April 7th, 2011, following the re-opening of the comment period.

We set out below our comments.

The policy benefits that are intended to result from the imposition of a margin requirement on uncleared swaps are expressed to be (a) the reduction of systemic risk, and (b) the promotion of central clearing.

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Reduction of Systemic Risk

We support the widespread use of variation margin to offset current exposure between all participants in the market – with the exception of those entities not subject to the clearing mandate. Our support presumes that the cost of such variation margin is mitigated by there being no mandate to segregate the variation margin (although, as today, any client may always request segregation if they are willing to bear the associated cost to the Dealer) and that the re-hypothecation of variation margin received is permitted. The market would price transactions on the basis of fully available variation margin being delivered between the parties. Exceptions to this create funding asymmetries that would need to be reflected in the pricing of transactions.

Although the use of variation margin is already widespread among larger participants in the market, we believe mandating the requirement to deliver and receive variation margin with high frequency and without the use of thresholds will further reduce systemic risk at limited increased cost to the market. In relation to initial margin, however, the issue is more complex because in order to provide the protection sought initial margin exchanged between counterparties cannot be used by the recipient to fund its corresponding initial margin requirement on its hedge trade. Accordingly, the provision of this protection against unexpected loss comes at a very real funding / liquidity cost to the market.

The alternative means of protecting against an expected loss is, of course, through capital. Capital is similarly intended to cover unexpected losses at a given confidence interval. Arguably, initial margin is intended to achieve the same purpose, protecting not against the expected exposure (variation margin accomplishes this) but the potential unexpected exposures at a particular confidence interval.

In order to reduce the systemic risk that excessive credit risk generates, one could introduce a strict initial margin regime with confidence intervals that would create a very high expectation that actual loss incurred would not exceed the prescribed sums set aside as initial margin. This, we submit, is represented by the base case assumptions of 10 day 99% confidence interval set out in the Proposal and also in the IOSCO / Basel Consultative Document issued in June, 2012. Such a regime places a huge liquidity cost on the market but significantly reduces the need for capital cost to be incurred since the contingent credit risk is almost eliminated by the provision of margin.

At the other end of the spectrum is a regime where there is minimal use of initial margin. Each participant relies solely on its own capital to support the credit risk taken. The entire cost in this case is in the form of capital cost, which is borne by the surviving entity.

We submit that neither an approach that relies solely on initial margin nor one that relies solely on capital is optimal. A reliance on protecting the system entirely through liquidity cost (i.e. margin) introduces significant new risks –which may themselves be systemic in nature. For instance, the need to fund large sums of margin, periodically to roll the funding of this margin and to fund increases in the amounts required to be delivered in times of stress. Assuming we in turn have to fund an equivalent initial margin to the client as we receive under such a regime, we incur a liquidity funding cost that reduces revenue in exchange for lower capital requirements. Correspondingly, of course, a reliance on capital alone generates higher revenue (by removing the liquidity cost) but at the cost of commensurately higher capital cost.

The relationship between liquidity cost and capital cost, however, may not be linear. Whereas it may cost the same to fund each incremental dollar of required liquidity to provide additional margin, it likely will not cost the same to fund each incremental dollar of required capital. Only by allowing flexibility on the part of an entity to optimize its relative funding of liquidity and capital can an entity achieve its risk/return profile.

The liquidity cost of posting margin is disproportionate to the capital cost reduction. The funding cost of margin can be assumed to be linear, but the benefits of initial margin in risk mitigation are weighted towards the first dollar posted being more "valuable" in defeasing risk than the last dollar. That is why we question whether in practice the use of thresholds for initial margin has merit. If a client has to fund $10 million of initial margin anyway, we get significantly more capital relief if we can resort to this to cover our first dollar of loss than our last. (We note that the Proposal contemplates no permitted reduction of an initial margin amount by a threshold, except in the case of non financial entities.)

We believe the Basel III capital regime produces the appropriate inducements to strike the right balance between these two costs - an entity incurring a very prudent capital cost when it holds OTC counterparty credit risk or incurring a liquidity cost (but reducing the corresponding capital cost) through the provision of initial margin. Each entity has its own optimal balance point between its capital and liquidity costs, which will vary by entity depending on its access to and cost of funding additional margin relative to its cost of funding additional capital or paying a premium for the transactions it executes. Since this balance is not the same for all entities, mandating a strict initial margin regime removes the flexibility that allows an entity to arrive at the point of intersect that optimally balances these two costs and therefore may make it difficult for entities appropriately to protect themselves against credit risk at the cheapest overall cost.

Corporates provide a simple example of how this balance differs by market participant type. A corporate typically has a strong preference against incurring a liquidity cost. Corporates are reluctant to post margin, and, in lieu, pay a higher price for the transaction to cover the additional capital costs the dealers will incur. It is unlikely, however, that the corporate would be contributing materially to systemic risk. Dealers by contrast will, in the course of their risk management, have a preference to incur some liquidity cost over capital cost up to the point of equilibrium and are, therefore, willing to post initial margin in a bilateral agreement, rather than incur the larger capital costs. Therefore, we expect the Basel III rules will naturally result in widespread use of initial margin on a timetable market participants can bear. The Basel capital framework effectively operates as a proxy for a mandated initial margin regime. The incentives in Basel III – including the CVA charge and the provisions of BCBS227 - strongly favor prudentially regulated banks incurring a degree of liquidity cost to balance the capital cost. Based on these considerations, we think it unnecessary to introduce a mandated initial margin regime.

Recognizing that the provisions of the Dodd Frank Act may impose a requirement to offset credit risk with margin with the objective of reducing systemic risk, we urge the prudential regulators to have particular regard to the impact that the implementation of a margin regime may have on the desirable incentives in the Basel III framework to reduce systemic risk arising from credit risk at the lowest cost by allowing market participants to incur capital cost and liquidity cost in their optimal relationship.

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The promotion of central clearing

The second policy objective – the promotion of central clearing – is understood to be the basis for the need to set the base level confidence intervals for initial margin at the high levels proposed. The proposition is that by imposing materially higher initial margin levels for uncleared swaps than the equivalent risk held in cleared swaps, the market will be motivated to migrate products to clearing. While we do not dispute the stimulus that this "stick" could generate, we do not believe that it is necessary to achieve an appropriate and expeditious move of products to clearing. The proposed Basel III framework and BCBS 227 on central clearing contain such significant capital incentives to encourage the use of central clearing that no other incentive is required.

In the same way that the capital inducements under Basel III induce an appropriate use of initial margin, these capital provisions also create very strong motivation to clear swaps. The capital that needs to be set aside for a transaction that is cleared receives a 2% risk weight, whereas an uncleared swap with a corporate receives a much higher risk weight (for instance, 100% under standardized tables). It is worth noting that the CVA charge effectively multiplies this differential between cleared and uncleared risk by, on average, three, (since the CVA charge is intended to be calibrated at twice the default risk). Accordingly, we submit there is no necessary reason to introduce a mandated initial margin regime to meet this policy objective.

We urge the prudential regulators to take these considerations into account in the assessment of the need for and, where necessary the framework and calibration of, any margin regime adopted.

We would be pleased to respond to any questions you may have.

Respectfully yours,

Keith Bailey

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