

**Meeting between Federal Reserve Board Staff  
and Representatives of Barclays  
November 22, 2011**

**Participants:** Scott Alvarez, Anna Harrington, Jeremy Newell, Jim O'Brien, Christopher Paridon, Stephanie Pisto and Laurie Schaffer (Federal Reserve Board)

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**Summary:** Staff of the Federal Reserve Board met with representatives of Barclays to discuss the restrictions on proprietary trading and hedge fund and private equity fund activities under section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (also known as the "Volcker Rule").

Among matters discussed in the meeting were Barclays' views regarding: overall impressions of the interagency proposal to implement the Volcker Rule; potential impact of the Volcker Rule and the proposal on the market for U.S. treasury and agency obligations; the scope of the proposal's implementation of the statutory exemptions related to market-making related activities, foreign activities occurring "solely outside of the United States," and risk-mitigating hedging activities; and utility of the proposed quantitative measurements for differentiating between permitted market making-related activities and prohibited proprietary trading. A copy of the discussion document Barclays provided to Federal Reserve staff is attached below.

Attachment



# Discussion on Proposed Volcker Rule

November 2011

# Introduction

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- The proposed rule represents a coordination of the regulatory challenges and the need to limit negative market impacts.
- The proposal issued on October 11, 2011 contains a number of principles that we support, including but not limited to:
  - ▶ Preserving banks' role in client facilitation activities, such as market making and underwriting
  - ▶ Recognizing the differences among liquid and illiquid asset classes
  - ▶ Emphasizing risk-based compliance monitoring
  - ▶ Acknowledging the marketplace's use of a portfolio-based approach for mitigating risk
  - ▶ Emphasizing internal monitoring in coordination with regulators
- At the same time, several provisions of the proposed rule may result in negative market impact in certain asset classes and adverse economic consequences for US investors and issuers.
- Today's discussion will focus on improvements to five elements of the proposed restrictions on proprietary trading:
  - A) Exemption for trading in government obligations
  - B) Criteria for permitted market making activities
  - C) Framework for monitoring permitted hedging activities
  - D) Impact of restrictions on non-US activities
  - E) Quantitative metrics

# Exemption for US government obligations should be expanded to include futures on US Treasuries

## Rationale for expanding exemption to US Treasury futures

- **Safety and Soundness**
  - Treasury futures play an important role in the market liquidity and price discovery of the Treasury cash market, such that the two products are intrinsically linked<sup>1</sup>. When people say the Treasury market is the most liquid in the world, they are referring to the combination of US Treasury cash instruments, and Treasury futures
    - Futures account for over 55% of overall Treasury volume, and comprise over 75% of volume in long-dated maturities
    - Failure to exempt Treasury futures will distort price discovery and reduce liquidity in the Treasury cash market
    - An exemption for Treasury futures is necessary in order to give effect to the intent behind statutory exemption for US Treasury cash instruments
- **No incremental risk to banking entities**
  - The return profile of trading a cash Treasury is almost identical to trading a Treasury future, so there is no additional risk being created by exempting futures
    - On the contrary, failure to exempt Treasury futures would require banks to take extra risk as a result of being unable to trade the futures commensurate with the cash instrument
- **Consistent with existing exemptions**
  - Exempting Treasury futures is consistent with existing exemptions for US government debt and repurchase contracts, as Treasury futures mirror the characteristics of those two instruments in a single instrument
- **Hedging exemption is inadequate**
  - Existing hedging exemption would adversely affect how Treasury futures are used in connection with the Treasury auctions to allow primary dealers to participate in auctions at aggressive levels
  - Dealers may be reluctant to participate as they currently do if ambiguity exists around the use of futures as a method for distributing risk over time – resulting in reduced Treasury liquidity and/or wider spreads

1. Brandt, M.W., K. A. Kavajecz, and S. E. Underwood (2007). "Price Discovery in the Treasury Futures Market," *Journal of Futures Markets* 27, 1021-51.

# Some market making criteria will damage markets without advancing the purpose of the rule

## Current Requirements for Permitted Market Making Activities

1. Internal compliance program must be established
2. Trading desk holds itself out as being willing to buy and sell on a regular or continuous basis
3. Activities should be designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties
4. The banking entity has all of the appropriate dealer registrations to transact in that activity
5. Activity is designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to asset appreciation or hedging
6. Compensation arrangements of market-making personnel are not designed to reward proprietary risk-taking
7. Activity must be consistent with the commentary, provided in Appendix B of the proposal, that speaks to the principles distinguishing market making from prohibited proprietary trading

## Recommendations

- Requirements should account for principal trading and derivative trading markets, including:
  - Assumption of principal risk, a fundamental aspect of making markets, may result in asset appreciation as markets move
  - Unpredictable time horizons in which customer demand materializes
- Regulations should account for the fact that two-sided markets do not exist for all instruments, particularly those in more illiquid markets

## Suggested Modifications to Requirements

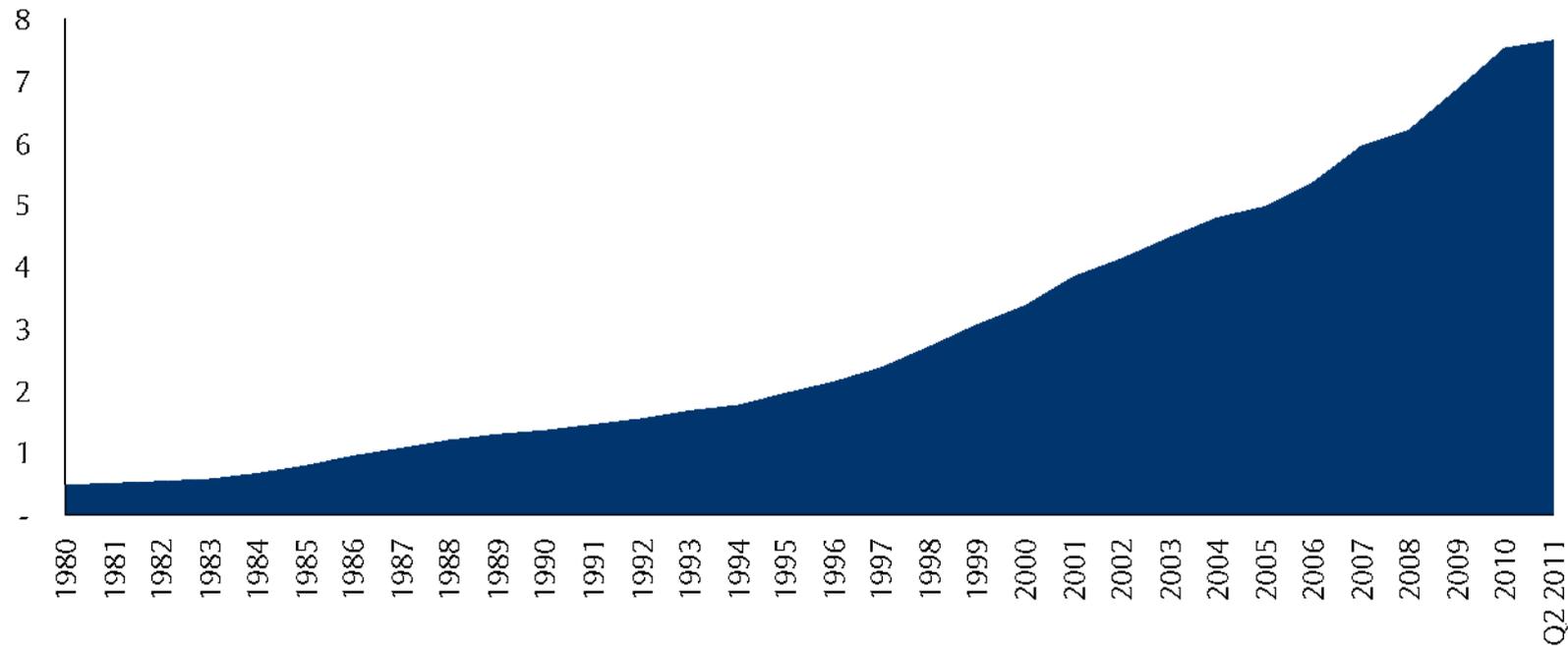
2. Trading desk holds itself out as being willing to buy and sell on a regular and continuous basis to the extent two sided markets are made in a given instrument
3. Activities should be designed not to exceed the reasonably expected ~~near-term~~ demands of clients, customers or counterparties
5. Activity is designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income attributable to satisfying reasonably expected customer demand not attributable to asset appreciation or hedging

Agencies should be careful to not disrupt the credit markets, which has been a significant funding source for corporates and has over \$7 TN outstanding

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Outstanding US corporate bond market debt outstanding (\$ TN)

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Source: SIFMA

# Hedging requirements should not discourage market making or risk mitigation

## Current Requirements for Permitted Hedging

1. The hedging trade is made in accordance with internal compliance program

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2. The trade hedges one or more specific risks arising in connection with individual or aggregate positions

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3. The hedge reasonably correlates to the risk it is intending to mitigate

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4. The hedge does not give rise to significant incremental exposures that are not also hedged

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5. The hedge is monitored on ongoing basis to confirm (i) compliance with the policy, (ii) maintenance of reasonable correlation, and (iii) mitigation of any significant subsequent exposure arising from the hedge

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6. Compensation arrangements of person performing the risk-mitigating hedging activities are designed not to reward proprietary risk-taking

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7. Additional documentation requirements for hedges established at a different level than the underlying transaction

## Recommendations

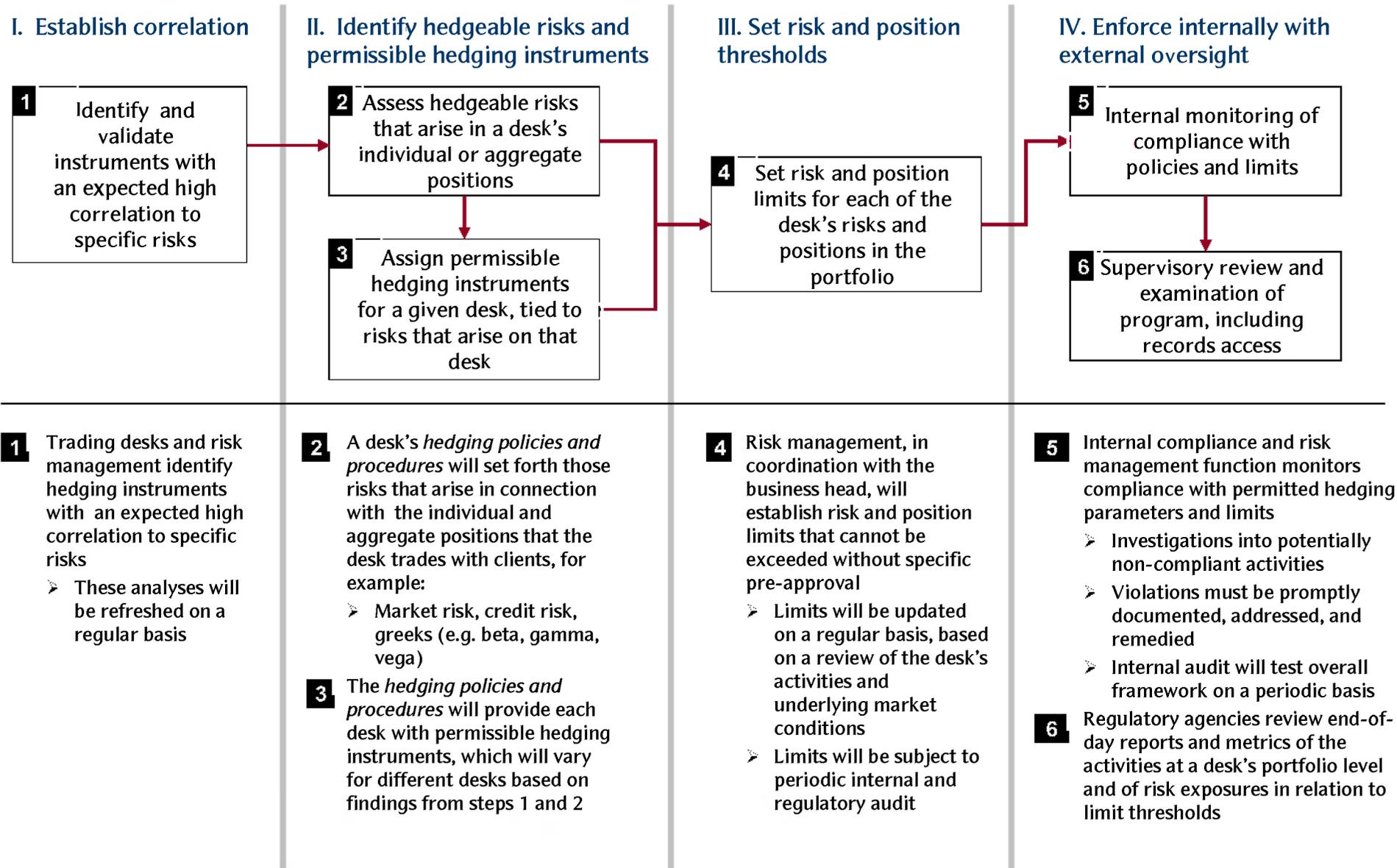
- Requirements should allow banks to leverage existing effective risk-monitoring procedures, focusing on:
  - › Trading within risk and position limits
  - › End of day monitoring
- Approach should be consistent with market making compliance framework:
  - › Be cost-effective to implement and not place undue burden on regulatory examiners
  - › Require a manageable amount of data that allows examiners to supervise activities effectively



## Suggested Modifications to Requirements

2. The trade is reasonably expected to hedges one or more specific risks that is expected to arise in connection with individual or aggregate positions
3. The hedge is reasonably expected to correlates to the risk it is intending to mitigate
4. The hedge does not give rise to significant incremental exposures that are not also hedged within the desk's pre-established risk limits
5. The ~~hedge~~ risk exposure of the desk is monitored on an ongoing basis to confirm:
  - Compliance with the policy
  - Maintenance of reasonably expected correlation
  - Mitigation of any significant subsequent exposure arising from the hedge

# Illustrative framework for monitoring compliance with hedging exemption



## Narrow interpretation of the “solely outside of the United States” exemption and failure to exempt non-US sovereign debt invite negative consequences

Discourages international lending activity in the US

- Proposed foreign exemption discourages non-US banks from establishing a lending presence in the US because Volcker would apply to activities undertaken off-shore with US persons

Invites reciprocity from international regulators

- Non-US sovereign debt does not benefit from the exemptions provided to US Treasuries and liquidity is compromised in both US and off-shore markets
- Application is unduly invasive and operates in excess of equivalent existing home country regulatory regimes
- Offshore banks that offer liquidity in non US sovereign debt to US persons will be subject to additional Volcker compliance protocols offering no apparent public policy benefit

Disrupts US access to international markets

- To offshore banks, US persons present a less favorable customer profile than equivalent non-US person customers, for whom providing services will not trigger Volcker compliance framework.
- US asset managers and corporates seeking risk management and hedging products in non-US local markets are disadvantaged relative to domestic participants
  - Implementation costs resulting from overseas Volcker compliance will likely be reflected in the pricing quoted to these clients
  - International banks subject to the Volcker restrictions may stop transacting with US counterparties from their non-US offices altogether to avoid imposition of the Volcker market making compliance framework

## Quantitative market making metrics should be reduced to those that are most effective at tracking compliance with the permissible activities

Market Making Surveillance Metrics		
REPORTING CATEGORY	SUGGESTED METRICS FOR INCLUSION	SUGGESTED METRICS FOR EXCLUSION
Risk Management	<ul style="list-style-type: none"> <li>▪ Risk and Position Limits               <ul style="list-style-type: none"> <li>▸ Define acceptable levels of risk relative to specific market and size of client franchise</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ VaR / Stress VaR – Does not reveal intent, varies by franchise size, horizontal comparison limited; subset of risk limits</li> <li>▪ VaR Exceedance – Does not reveal intent, only accuracy of model</li> <li>▪ Risk Factor Sensitivities – Does not reveal intent, varies by franchise size; subset of risk limits</li> </ul>
Source-of-Revenue	<ul style="list-style-type: none"> <li>▪ Comprehensive P&amp;L Attribution               <ul style="list-style-type: none"> <li>▸ Define expected levels of portfolio P&amp;L relative to specific market, market performance and size of client franchise</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ Comprehensive P&amp;L - Redundant</li> <li>▪ Portfolio P&amp;L - Redundant</li> <li>▪ Fee Income and Expense – Redundant; relevant only to demonstrate existence of client revenue</li> <li>▪ Spread P&amp;L – Redundant; relevant only to demonstrate existence of client revenue</li> </ul>
Revenue-Relative-to-Risk	<ul style="list-style-type: none"> <li>▪ Skewness of Portfolio P&amp;L and Kurtosis of Portfolio P&amp;L               <ul style="list-style-type: none"> <li>▸ Define expected levels relative to specific market, market performance</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ Volatility of Comprehensive P&amp;L and Volatility of Portfolio P&amp;L – Redundant and less descriptive than skewness and kurtosis</li> <li>▪ Comprehensive P&amp;L to Volatility Ratio and Portfolio P&amp;L to Volatility Ratio – Redundant and less descriptive than skewness and kurtosis</li> <li>▪ Unprofitable Trading Days Based on Comprehensive and Portfolio P&amp;L – Creates lower liquidity in volatile markets</li> </ul>
Customer-Facing	<ul style="list-style-type: none"> <li>▪ Inventory Risk Turnover               <ul style="list-style-type: none"> <li>▸ Define expected levels relative to specific market; may be low where required to warehouse risk</li> </ul> </li> <li>▪ Customer-Facing Trade Ratio               <ul style="list-style-type: none"> <li>▸ Modify to Ratio of Risk Metric rather than # of trades</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ Spread P&amp;L – Redundant with Comprehensive P&amp;L Attribution</li> <li>▪ Inventory Aging -- Redundant with Inventory Risk Turnover</li> </ul>
Payment of Fees, Commissions and Spreads		<ul style="list-style-type: none"> <li>▪ Pay-to-Receive Spread Ratio – Does not meaningfully reveal intent</li> </ul>