Barclays PLC FY 2014 Results

Fixed Income Analyst and Investor Conference Call (edited transcript)

Question 1 – Greg Case, Morgan Stanley

Hi, guys. I understand you're not really talking very much about ring-fencing at this point in time, but I was wondering if you could give us a feel on how you're thinking about the lead time for this given that, I think, it's 2019 for implementation. How long do you think you're going to need to work with the business to get it into shape for ring-fencing? Do you think that's a two or three-year thing or do you think you've got less time to do that? And also on your Pillar 2A buffer I was wondering if you had any thoughts around the trajectory of that and whether or not you'll anticipate that going up or coming down. I appreciate, again, that you're probably quite limited on what you can say there. Finally on the leverage buffer, or whether or not you are going to disclose in future, do you have an aspiration for a buffer you want to run over your leverage minimums or are you still waiting for things to bed down there? Thanks.

Answer – Tushar Morzaria

Thanks, Greg. Why don't I answer your question on ring-fencing and then I'll hand over to Dan, who can talk a bit more about Pillar 2A and buffers above our leverage requirements. So, ring-fencing – there's not a whole load I can say on that. Dan mentioned that we submitted our plan for both US and UK ring-fencing plans to the regulators and we're in close dialogue with them. We'll probably talk to the market in a little bit more detail to the specifics around that plan later on in the year, probably in the second half once we've gone through the regulatory conversations. In terms of timing, we'll aim to implement this as quickly as we can. We would expect, sitting here now, to target to be operating under a ring-fence regime probably in 2018, but in ample time in advance of the 1st January 2019 implementation at least in the UK, but we'll probably talk more about that as we get through the conversations with regulators so we can share some specifics with you. Dan, do you want to cover the other two points?

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Answer – Dan Hodge

Certainly. Let me start with Pillar 2A and what we think directionally around that. So, I'll just start by repeating what I said earlier because I think it's helpful for clarification that the increase that we saw was materially because of the way that Pillar 2A is computed as an add-on – As RWAs came down, then the Pillar 2A as a percentage of RWA went up. As you'd expect, the composition of 2A is confidential between us and the PRA, so we're not permitted to go into detail on the various parts, so I'll just make some more general qualitative comments instead. Pillar 2A covers particularly operational risk, concentration risk, pension risk, and interest rate risk in the banking book. We do look at each of these individually and take actions that we believe de-risk them. Over time we hope that these efforts to de-risk and simplify the bank are reflected in lower Pillar 2 add-ons. I think we'd also make the point that some of these may be moving to Pillar 1 as well, and then you have an even greater level of transparency over how they're calculated.

To your final question around the leverage buffer – I think we see this in a similar way to the capital ratio buffer. When we think about what is going to be the end state for leverage, we look at the regulatory target, which is the 3% minimum plus the 70bps that we have for the G-SIFI buffer plus whatever else might come in in terms of counter-cyclical, and then we apply a prudential buffer above that. In terms of how we size that, you can see that we're aiming in the short term for at least 30bps and we have said we'll get to at least 4%, so it could easily be higher in future. We do a calibration exercise around that in the same way as we do for the prudential buffer for the capital ratio. So we look at what are the sources of volatility that we would see in both the numerator and the denominator over a given period of time, and that's how we arrive at the level.

Question 2 – Robert Smalley, UBS

Thanks very much and thanks very much for doing the call. A couple of questions on slide 11 and then a couple more if I could. The NSFR ratio now at a little over 100% (102%) and earlier in the presentation you say that wholesale funding is £171bn. £75bn of that matures in less than one year. There's a lot of regulation out there and you're trying to triangulate through all

of it. Is the NSFR where your goal is just to be at the minimum because of the conflicting nature of the rest of regulation or is this something that you want to build up as well, and what do you think the proper average-weighted maturity is for your wholesale funding?

Secondly, with the increase in the LCR, are you running any kind of different type of basis risk than you were a couple of years ago given the amount of high-quality assets that you have and the funding? A potential mismatch there – what is it? How are you working on that?

And finally just a little bit more detail. £10bn-£15bn across the public markets in senior and subordinated debt this year – any breakdown you want to give between senior and subordinated?

Answer – Dan Hodge

Let me start with NSFR. As you rightly observed, the wholesale funding levels are coming down. However, the NSFR has gone up and that's because the amount of required stable funding has come down with the reduction in scale of our Non-Core operations. There were also some changes to the methodology which also explain the increase we saw over the course of the year. In terms of where we expect to take that, I wouldn't give any guidance other than the fact that we want to remain above 100%. It's very important to us that we stay above that level. Even though we're not required to actually get there by 2018, we think it's just very prudential funding and liquidity management to be at those sorts of levels. In terms of what the perfect weighted average maturity should be – I don't think there is any perfect number you'd look at and say, it has to be X years, frankly. It's really a product of what is the right mix of liabilities and so we're partly driven by the market in terms of where's the right place to be and as we have TLAC in mind, the transition through structure reform will also influence the maturities that we select. So, I don't think there's any magic single answer to that. We actually quite like a broad set of liabilities to avoid cliff risks as well. That's another point that I'd make around that.

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In terms of the LCR, again, what has driven the increase in the LCR? As I said earlier, we want to make sure that we are prudently positioned for a likely downgrade in our short and long-term ratings as sovereign support is removed later in the year. You shouldn't take that as a sign that we're always going to be operating at over 120% LCR. Again, the only future guidance I'd really give on that is that we will be prudent. We'll make sure, having got above 100%, that we will remain above 100%. We're not going to take advantage of the transitional phase-in that we're entitled to in the UK where we only need 80% compliance from October this year. The other point I'd make in terms of those increases in the LCR – this that it is really just talking about notionals of liquidity we have to hold against the quantum of the (outflow) stresses that we model. It doesn't actually talk at all about the amount of basis risk we're taking and that hasn't gone up. You can't read anything into the underlying interest rate risk that we're managing from the LCR figures. We're very careful in terms of the amount of basis risks that we take and there are all sorts of risk limits around it as well in the organisation that we are required to manage, too, and we haven't materially changed our appetite around that over the last few years.

Answer – Steven Penketh

In respect to the issuance plans, if you look at what we did last year, you saw the balance there between senior unsecured and capital c.£8bn in public markets, c.£5bn of senior unsecured in the private markets, and then c.£1bn worth of T2. We also did the LM exchanges Dan referenced earlier on in AT1. It's fair to say that of the £10bn-£15bn that we expect to issue this year, you can expect the lion's share of that to be in senior unsecured term debt mainly because the refinancing profile for senior unsecured term debt is naturally shorter-dated than the capital profile, but at the same time, the fact that we have succeeded and outperformed effectively on the leverage side means that the pressure to issue AT1 has come off significantly. As far as T2 capital is concerned, again, with the rules in TLAC stating that regulatory capital held in material subsidiaries being in scope for TLAC, I think there's also pressure taken off that issuance item as well. It's in a steady state, very similar to last year, and I wouldn't expect any surprises on the balance between senior and capital.

Question 3 – Corinne Cunningham, Autonomous

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Quick question about TLAC and as you increasingly position yourself for that by issuing more out of the holding company, have you made any estimates as to how you think this might flow through into net interest margins and earnings?

Answer – Tushar Morzaria

Yes. Why don't I hand over to Steve? I guess your real question is what the potential cost of TLAC will be on a funding basis. Steve, why don't you go there?

Answer – Steven Penketh

I think given the construct of TLAC counting senior unsecured term debt and regulatory capital, I think a bank that has had reasonably large wholesale funding presence in the market is actually in a pretty good position compared to those that have not. I think that what we would say as far as the additional cost is concerned, because we are actually refinancing as opposed to incremental issuance, we wouldn't expect that to have a dramatic impact on the overall cost base of the bank and therefore not have a dramatic impact on the net interest margin position of the bank.

Additional question – Corinne Cunningham

So, no overall uplift in cost that you're prepared to hazard a guess at the moment?

Answer – Steven Penketh

The way we see things at the moment and the way we've positioned ourselves, we don't see at the moment a significant increase in cost there. No.

Question 4 – Gildas Surry, BNP Paribas

I've got a question on slide 9 on the transition through to the HoldCo. It's about the way the coupon in the terms of the internal capital and debt could be set. Would you leave that to the OpCo and have you thought about the discussion that you will have in setting those terms?

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Answer – Steven Penketh

If you're lending down on an arms-length basis, effectively you would be primarily charging the operating company arms-length term funding, which is what you actually raise at the holding company. So, mirrored means mirrored. Whatever the cost of the funding is at the holding company, to the extent it's lent down on a back-to-back basis to the operating company, you would expect it to actually have a similar price , term, payment profile, etc.

Additional question - Gildas Surry

And if we think in terms of hedges for interest rate risk – if you issue a fixed coupon debt, how do you plan to hedge this out? Will the hedge be passed through to the operating company?

Answer – Dan Hodge

I think the idea is to try and minimise interest rate risk at every level of the company. At the moment, if you look at the HoldCo, it's a very clean entity. We wouldn't want to start driving unnecessary interest rate risk through the holding company in the same way that you wouldn't want to start creating unnecessary basis risk at the operating company level.

Additional question - Gildas Surry

Do you think that you would keep collateral at the HoldCo and eventually post it or receive some collateral as well from the OpCo in order to neutralise the risk?

Answer – Dan Hodge

We're not necessarily contemplating a collateralisation of any arrangements that are needed at this stage. If you think about it, there wouldn't need to be any derivatives directly between the HoldCo and the OpCo anyway if HoldCo were down-streaming a position in exactly the same basis whether it be fixed or floating. This situation hasn't yet arisen and we're not sure it necessarily would arrive. If we were we wouldn't start complicating HoldCo by having to flow lots of collateral arrangements through it.

Additional question - Gildas Surry

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Yes, of course. It will go against the concept of a cleaner HoldCo, but if we think in terms of the rate cycle – in ten years' time when rates will be higher, potentially there could be a imbalance between the HoldCo and the OpCo if there is no collateral being posted between the two.

Answer – Tushar Morzaria

Yes. We think of it much more as the HoldCo as a pass through entity at this stage. I think Dan is right. We wouldn't expect significant collateral arrangements between the two to manage the interest rate risk by just having the HoldCo as a "clean" entity and just passing through external debt through to the OpCo with similar if not identical coupon levels and maturities.

Additional question - Gildas Surry

Thank you. And if I may ask on the ring-fencing – even if you can't really disclose much at the moment, you mentioned diversification. Just to give us an idea of the number of subsidiaries at the moment at the OpCo there's about six or seven entities that provide diversification. How many subsidiaries are you thinking of for the HoldCo with the ring-fence bank and the non-ring-fence bank below it, please? Is it more two or three or six or seven?

Answer – Dan Hodge

At the moment we'd just say there's going to be at least three. We've talked about having a service company, we've talked about having the ring-fence bank, and also you've got the non-ring-fence bank. We're not at a stage to disclose any more details of whether it's more than three, but we'll say a minimum of three at this stage.

Additional question - Gildas Surry

Thank you. And my last question, please, is on the TLACproposal of 2.5% of RWAs for senior unsecured. It gives flexibility for issuers. Do you approach this the same way? Would you make use of it by issuing, in effect, some additional senior from the OpCo that would potentially contribute to TLAC?

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Answer – Steven Penketh

The TLAC rules, as Dan mentioned earlier, are obviously yet to be fully finalised. I think as a UK company and having been asked to move to the single point of entry model where you have the majority of your term funding and your capital coming out from the holding company, that is our primary focus at the moment. The 2.5% RWAs at the OpCo, I think, is a red herring in the context of the overall structural shift that we see for our debt stack and our capital stack going forward.

Question 5 – Carlo Mareels, RBC

My question is first on RWAs. Of course in 2014 there has been a very significant reduction in RWAs from £442bn to £402bn. There is a little bit of scope left of course going forward for further RWA reductions in the Non-Core. Once that is behind us, what is your view or do you have any colour in relation to what your RWA inflation could be even if you don't change any of the actual risk-taking? Just on a static approach, what could the impact be especially in the investment bank of RWA inflation?

That's the first question and then I have a second question on single point of entry. I understand that single point of entry within the UK is the preferred way of the PRA, but what about the foreign operations? Is it conceivable that there is a single point of entry for a resolution entity in the United States or in the African bank? Do we need to look at those as separate points of entry or is it all under the single point of entry of the UK holding company?

Answer – Dan Hodge

Thanks for the questions, Carlo. In terms of RWA inflation I would say there's a lot less immediate changes now than there were on the initial adoption of CRD IV, but there are clearly some in the short term and the long term. In the short term I think we're likely to see some increases of operational risk as some of the conduct and litigation events in the industry get incorporated in the model. In the longer term, the key changes we see will be from interest rate risk on the banking book, the trading book review, the securitisation framework, and the standardised approach to credit risk. All of these are in various stages of development. We're

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not expecting implementation for a few years still. It is just too early to determine the outcome. The Basel committee have stated in several consultations that the objective of this isn't to increase the overall level of capital requirements. It's not to say it won't be the case, but it really is too early to determine the outcome. On the IB, which I think is your specific question, there's two points I'd make here- we need to focus here on both time and ability to take management actions. Firstly the changes are unlikely to be imposed without warning. We'll have time to reflect changes and optimise our business model to ensure returns and potential stability aren't compromised. We actually have a very strong history of managing regulatory change particularly in the investment bank. You can see from some of our past disclosures that our management actions have reduced the eventual impact of Basel 2.5, which is the trading book rules, and then Basel 3 by over £50bn. We clearly, proactively, change our business mix and dispose of assets in businesses where regulatory change no longer renders them attractive. We're very confident that we could continue to do that on a go-forward basis. I'll hand over to Steve on the single point of entry question.

Answer – Steven Penketh

On the single point of entry question, you would have seen from the TLAC term sheet that material subsidiaries should actually have 75% to 90%, I think is the current proposal on the table on a bid-offer basis, of internal TLAC. So they would have the ability to also raise additional capital in the marketplace locally, as well, if they wish. Fundamentally, most of the UK groups, certainly looking at Barclays, would expect it to be the single point of entry model where the majority of the funding and the capital comes from the holding company and then downstream for the multiple layers of subsidiary companies beneath it. I think that the question of local capital having been brought on-side is helpful in the context of some of your financing operations such as BAGL in the instance of Barclays, but I think that it's fundamentally going to be a question of down-streaming from the holding company.

Question 6 – Lee Street, Citigroup

Good afternoon and thank you for the call and thank you for all of the additional disclosure. Just on the down-streaming -the whole downstream will probably need to be subordinated) –

would you expect to change the form of the HoldCo senior that you've currently down-streamed as OpCo senior into something that is TLAC eligible? That's both the paper you've got in issue now and, potentially, if you issue some more that's downstream as OpCo senior.

My second question would be on the management buffer – you're equal to or less than 150bps. Could you give us any details on the circumstance under which you think it might fall below 150 bps and what you think your tolerance might be for it to fall below 150 bps?

Finally, referencing your comments you made about S&P and sovereign support removal – if you were to lose all sovereign support and get no LGF uplift so you went to BBB+, are you able to quantify what that might mean for your derivative business and derivative exposures? I'm thinking collateral posting, lost accounts – is there anything you can give us?

Answer – Steven Penketh

I think it's quite clear if you look at the TLAC term sheet that in order to qualify as TLAC you actually need to downstream on a basis that makes you subordinate to excluded liabilities in the operating company. The expectation is that once you get through the transition the way we structured it at the moment, that's something which would happen. I think that the point that we would raise is that if we can actually keep this safe harbour in transition, you get to a stage when that eventually happens, because you've refinanced the bulk of your senior unsecured term funding that is outstanding at the OpCo at the moment – you've actually also mitigated that potential structural subordination in the end state, too. Dan has obviously made some very good caveats here which are important to note, which is we can look at the market, identify risks, and mitigate them to the best of our ability today, but there are still some headwinds out there or some uncertainties out there: for example, the MREL proposition that's coming in on the 1st January 2016 that also has an overriding power to introduce contractual subordination too which could actually require us to change our approach. All we can do is be as transparent as we possibly can be with the disclosure that we're giving, articulate precisely how we are trying to mitigate risks for investors, and then carry on with the engagement with the regulatory authorities to ensure that transitional timelines do actually provide the requisite relief.

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Additional question – Lee Street

I guess that's fair enough. I'm still a little bit confused on why bother with the transition in some ways and not just go straight to the downstream stuff, but I do appreciate it's still a proposal and things are up in the air.

Answer – Dan Hodge

Thanks for the other questions, Lee. Let me address those now in turn. Firstly, looking at the management buffer. So I'll talk a little bit about actually how we calibrate this. Clearly, the buffer is there to absorb volatility in both the RWAs and capital line. We know there's some lumpy P&L items, also, in the reserve line – things like AFS, pensions. Obviously, on the RWA side, there is some level of pro-cyclicality. But the most important thing about the buffer is we need to manage against distribution restrictions. That's really the key here, I think, for equity and fixed income investors alike.

If we look at the absolute buffer, at the moment, it represents about £13bn above the AT1 CoCo trigger level and 540bps above the T2 CoCo trigger level. Obviously that buffer is growing over time, to that trigger point. The buffer to the MDA restrictions is also the £13bn, were they to be applied, and obviously we know they're not coming in formally until 1 January 2016. The MDA we take incredibly seriously because we realise the severity of falling inside those regulatory buffers, the fact that it is the hardwired requirement to start turning off distributions means we really do not want to get into a situation where we are eating through that buffer. We already have conservative overlays for fines and litigations in our plan against unexpected P&L charges, so hopefully there'll be some upside if those headwinds are lower than expected. If the buffer wasn't sufficient itself, we would take necessary management actions to avoid mandatory distribution restrictions. On the specific point of 150 bps, that's where we come out on a current assessment of risk, but we do frequently recalibrate that. So if we felt that circumstances changed and we didn't think that was sufficient, we would look to recalibrate.

The second point around what happens with derivative outflows on a downgrade to BBB+. So the point I first want to make there is actually there's some information in the Annual Report in

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the Liquidity Risk section, around the contractual outflows we'd expect to see. And actually, where it would hit first is on a downgrade to an A2/P2 level, which obviously is a notch before you get to BBB+. I think derivatives are somewhere in the region of £8bn outflows from falling to A2/P2, and there's about another £6bn or so of other contractual outflows that we would expect. On top of that, we'd also expect to see some behavioural outflows from those investors, who aren't necessarily contractually prohibited from lending to us or dealing with us at those levels, but may decide to move away in any event.

The important thing around this is that we actually anticipated this in our funding plan already, so when I talk about pre-positioning for downgrade, I'm actually looking specifically at these contractual outflows and assumptions of behavioural outflows and pre-funding them ahead of time because, to reiterate the points I made earlier, we don't want to get into a situation where we start spending the buffer, and by that I mean we don't want to get into a situation where we're falling below 100%.

Answer – Steven Penketh

And I'd add to that it's substantially pre-funded, so it's not just that exact amount. We're very more than substantially pre-funding it, to keep our liquidity position very robust.

Question 7 – Suzanne Buchta, Bank of America Merrill Lynch

You mentioned that you have about £35bn in structured notes that will be coming due over the coming years and you will be rebalancing towards instruments more likely to count towards TLAC. Do you have a sense or an estimate of what percentage reduction you might do in structured notes? And a second question is, in the event that structured notes are approved for TLAC, does that change your response?

Answer – Steven Penketh

Structured notes as a product tend to be a bigger-volume proposition when spreads tend to be very high. We've obviously had a compressed spread environment for quite some time now, so in many senses the roll-off of the structured note profile for many institutions is to be expected. Ultimately what we are doing when we look at the structured note line from a

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treasury perspective is actually looking at it from a funding perspective and to the extent that we actually now see greater value in TLAC build as a holding company, then the natural roll-off of the structured note profile is not problematic. In many senses it actually fits quite neatly into our overall transition plan. So I don't think that the decrease in structured note issuance is driven primarily or fundamentally just from regulators. I think the interesting proposition that you mention is if they suddenly count for TLAC purposes – our expectation is that they would not. At the moment there's a much broader definition for MREL which does potentially capture structured notes and so there will be some regulatory value there perhaps, but I think on those two particular points we'll just wait for the updated policy statement to come out from the regulators and then react accordingly.

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