Barclays PLC

Response to Basel Consultative Proposals on Capital Adequacy

Thursday May 31st, 2001

BARCLAYS

Structure of Response

Barclays response broadly follows the same order that topics appear in the consultative paper, with detailed comments provided against each of the following themes. Queries in respect of the paper should be directed to Bill Hayward (tel +44 020 7699 4306, email bill.hayward@barclays.co.uk) or Alan Hilton (tel +44 020 7699 email alan.hilton@barclays.co.uk) of Group Credit Risk in the first instance.

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1 Executive Summary

The draft new capital adequacy framework and its accompanying documentation constitute a very detailed set of proposals with something to say about every aspect of how banks originate, measure and manage risk. This is quite fitting. Since the original Accord of 1988, every aspect of risk management in banking has changed and it is inevitable that regulators, as custodians of the financial system, should seek to leverage this transformation in banks' own methods. But instigating such wide-ranging, once and for all, change to the regulatory framework brings its own risks. In particular, the measurement of risks under Pillar I needs to be as sensitive and flexibly formulated as possible – while supervisory review and market discipline need to be formulated so as to reinforce, rather than supplement Pillar I - because insensitive measures will distort both management decisions and market behaviour.

Detailed comments are provided in the body of the response. However these comments can be categorised into the following key themes, which we ask the Committee to continue to bear in mind as they contemplate the production of the more detailed rules.

1.1 Individual firm vs. market impact

Any approach to regulatory capital allocation will focus on what is known and easily understood and hence measured by regulated businesses. This approach may fail to recognise impacts at the systemic level where greater market liquidity and level playing fields may be equally as important as capital within individual firms. An "average amount of capital" is not a helpful concept as an overcapitalised firm does not offset an undercapitalised firm. An appropriate balance between legitimate concerns over the safety of an individual firm and the macro environment within which all firms operate must be found.

1.2 Changing nature of of market place leading to a dynamic and consultative process

The world is dynamic. Banking as an industry is undergoing a period of rapid change, in some cases altering the substance of what would recently have been considered as sacrosanct. This development will not stop with further rationalisation and globalisation set to continue. Increased competition from non traditional banking sources will drive the evolution that is required. This makes it all the more difficult to create a rule book that can cover every eventuality.

For this reason, we advocate ongoing and formal review of the regulatory capital framework. Specifically we propose a forum to review the relationship that Banks have with their Supervisors, and the workings of the framework.

1.3 Cost/benefit, pragmatism in implementation

There needs to be scope for "learning by doing" that allows banks to continue to develop risk management capabilities in a way that is sensible. The danger of an extensive rule book is that it creates a layer of undue complexity that merely adds to the cost of doing business without any commensurate step up in risk management control and understanding. The rules must reflect the materiality of risk being controlled and its market environment.

1.4 Principles and output not prescription and input

The basic criteria of the proposals should be "Does the approach adequately address where capital is needed". This involves a sufficiently detailed understanding of all of the risks being run by an institution, rather than trying to describe them by rote. Inevitably this will differ from firm to firm but should reflect the underlying asset and business mix in terms of range of customers, products, geography and so on.

Whilst a certain level of qualifying criteria should be an entry ticket to doing business, bank management must be responsible for managing their businesses.

Failure to satisfy this point will mean the proposals will fail one of the core criteria, the use test. Experience shows that only where you have the process embedded as part of day to day existence can you achieve the most effective results. This means the supervisors working "alongside" not "in addition to" risk managers within the organisation.

1.5 Increased liquidity and better capital management

Capital should act as a buffer against levels of uncertainty. Importantly the way banks manage capital is becoming increasing sophisticated; the saleability of assets, expected future income, new types of contingent capital are all areas of development which add to the safety of individual banks and the system.

Firms now understand better the nature of the risks they are running far better than at any time during their corporate history and design their "capital" accordingly.

1.6 Impact on banks vs. non banks

One of the fundamental changes we see in the industry concerns the role of banks where, increasingly, they are becoming dis-intermediators of risk with other non bank institutions happy to take on levels of credit (and other) risks traditionally not part of their purview.

Clearly the intention is to create as much flexibility and transparency within the capital regime as is possible. However, as the rules currently stand they are not the same for all and the concern is that this drives business away from traditional holders of risk and outside the sphere of influence of the regulators.

1.7 Are the incentives compatible with the effort

Recognising that more work remains to be done concerning overall calibration levels, the framework should ensure that those banks that invest in developing their risk management systems and processes are sufficiently rewarded to make this viable from a regulatory standpoint. At this stage, it is unclear whether this is the case.

1.8 Timeframe

We support the G10 banking federations call for further consultation period on these issues given there are still a number of moving parts that need to be resolved. The consultation period should not be closed until we have had an opportunity to review all the proposals. This is of particular relevance to the parallel EU process that, unless the nature of legislation is sufficiently flexible, will struggle to achieve co-incidental introduction – critical if we are to achieve the aspired for level playing field and not to work with different regulatory rules in different parts of the world.

Where there is no theoretical basis for capital calculation, it is better to be explicit that a blunt charge is being used to be refined but with a commitment to a timetable for refinement.

The timetable for completion of the Quantitative Impact Study is such that the results and learning from that exercise need to be fed in, in particular the number of assumptions that have had to be made where the rules are not yet sufficiently well defined. Use of these assumptions causes huge swings in the results confirming the need for the rules to be sufficiently well defined. We will include comments with our QIS feedback.

1.9 Conclusion

The ultimate goal of regulators is a strong and secure global banking system. This will be best served if the three Pillars of the new Accord are genuinely mutually reinforcing, and no more. We remain committed to working with the regulators to develop the proposals to find the right answers to these challenges.

2 Main points of concern

2.1 Calibration

Fundamentally, the capital Accord should be about ensuring that the amount of capital banks hold at least reflects the risk they run, to an acceptable tolerance or confidence level. This, of course, is the aim of the proposals within the first Pillar of the Accord. We applaud regulatory willingness to adopt internal ratings methodologies within the formulation of capital needs.

However, the January proposals left much to be done in terms of:

- The overall level of calibration, which we view as too conservative.
- The treatment of several asset classes, such as retail exposures and project finance, where we would welcome further consultation.
- Areas, such as Repo business, market liquidity lines and short-term facilities where the current proposals could be potentially very damaging.

2.2 Moving from the standard to advanced internal ratings based approach

It is unclear from the results of the Quantitative Impact Study whether there are sufficient incentives within the current proposals to encourage banks to move from the Standardised to the Foundation IRB, or from Foundation IRB to Advanced status. This is without factoring in the cost of upgrading systems and processes to standards commensurate with those required by the regulator.

Specifically, we would recommend that banks whose systems and controls are deemed sufficiently robust, should be able to immediately adopt the Advanced method without being subject to the proposed constraint that the resultant requirements should not be less that 80% of those generated under the Foundation IRB approach. This constraint does not provide banks with the appropriate incentives to invest the resource immediately to establish more advanced risk sensitive capital models. Where the regulators are not satisfied with the control environment adopted by an institution, a graduated approach applying penalties that reflect any such reservations should be applied.

2.3 Level Playing Field Issues

The Accord should level the competitive playing field rather than distort it. Here we still have concerns about national variations in the implementation of Pillar II within the EU, and the applications of the new Accord in Europe as opposed to the rest of the world, especially the impact on EU bank owned versus non-EU non-bank investment management business.

The proposals on operational risk should differentiate between process-driven and traditional asset managers. Process-driven investors present lower operational risk and should therefore be subject to lower capital requirements. We question whether assets under management (AUM) provides a useful indicator of operational risk, given it is weakly correlated with operating losses. If AUM is nevertheless used as the indicator, we propose a sliding scale with a cap for process-driven asset managers.

2.4 Treatment of the SME asset class

Small and medium size businesses are clearly a different proposition from large corporate and retail customers as described in the proposals. Our strong preference is have this important customer grouping recognised as a separate asset class in their right, reflecting the distinct nature of the risks involved. However, we recognise that time may be against development of a separate asset class at this stage in the development of the proposals and we therefore advocate that SMEs be regarded as retail reflecting the re-engineering of credit processes underway across the industry utilising techniques more traditionally associated with retail businesses.

2.5 Pillar III

Market discipline has an important role to play in reinforcing capital regulation and other supervisory efforts. For banks that operate in open and transparent markets, increased disclosure about capital structure and capital adequacy, the risks faced and how they are managed should result in lower capital ratios and a lighter regulatory touch. However, these objectives can only be achieved through disclosures that are relevant and understandable to the users of financial statements. Therefore, we support the Basel Committee's decision to work with the IASB. Setting disclosure requirements in an International Financial Reporting Standard will not only ensure that users, preparers, auditors and regulators reach a consensus about appropriate disclosure, it also will help ensure that the disclosure requirements are kept up to date as the markets develop and will assist in enforcement, particularly within the EU when listed companies are required to prepare their financial statements in accordance with international standards.

2.6 External models

We need clarification as to the extent a bank may place reliance on external default models (e.g. KMV Credit Monitor and Creditmetrics). We are concerned that the inability to rely upon such external sources will inhibit banks ability to develop models quickly and have a detrimental impact upon the quality of data available. Hence we would welcome confirmation that banks may use such models to qualify for the Internal Ratings Based approach. This will accelerate banks ability to qualify for the more sophisticated approach, as well as promoting best practice.

2.7 Validation

The proposals require Banks to undertake their own model validation and it is suggested that there should be five years of historical data to validate internal models. We suggest that greater consistency and higher standards may be achieved if, under Pillar II, the Regulators provide the quality assurance and set out the rules and principles for validating PD, EAD and Severity of Loss models. We also believe that it is essential that a close dialogue is established between the Industry and Regulators to address the issue of volatility of capital which will inevitably arise when greater risk sensitivity is introduced.

2.8 Recognising diversification

We believe that the proposals should provide for the future recognition of portfolio models that take account of portfolio diversification, by reduced capital requirements. A number of leading banks already use or are developing such models as a vital component of prudent portfolio management and there should be an incentive for banks to develop or buy, and implement, such models, by giving regulatory relief (where merited).

2.9 'W' factor

The proposals incorporate the concept of a 'w' factor to take account of residual risks. The application of such a factor is not justified and we believe that such residual risks should be addressed within the context of operational risk. The potential impact will be to discriminate against certain types of risk mitigants, and thus distort market pricing and development, and reduce liquidity.

We are concerned that, as the proposals are currently framed, the use of credit risk mitigation techniques will, in general, result in additional regulatory capital being retained within the Banking system, whereas the economic impact has been to spread the risks and thereby reduce systemic risk.

2.10 Trading book repos

The application of the proposed banking book treatment of collateral to trading book repos will result, as a result of the 'w' factor and haircuts, in a material increase in regulatory capital required to support these transactions. We believe that the proposed levels of capital are disproportionate to the levels of risk inherent within such transactions and are of such a magnitude as to have a significant adverse impact upon the availability of liquidity within the securities markets. This matter requires further consideration and consultation with the industry.

2.11 Securitisations

We consider the application of a 20% conversion factor overstates the risk of liquidity commitments to multi-seller conduits. We suggest that the appropriate conversion factor should be one that reflects the true probability of a draw under the liquidity commitments as supported by statistical evidence (with an appropriate prudential buffer), rather than one that is arbitrary.

2.12 Further consultation

We consider it necessary that further consultation takes place on those elements of the proposal that are at an early stage of development. This includes Project Finance and securitisation (synthetics and application of the IRB approach), retail and operational risk.

3 Introduction and general comments

The general direction and aims of the new Accord are very welcome. Philosophically, it is more risk sensitive than the 1988 Accord and aims to recognise and encourage actions by banks that genuinely mitigate risks. It constitutes an official recognition as best practice, of many of the techniques and philosophies the Barclays Group has been developing in recent years. Proposals that encourage better understanding and control of the myriad of risk issues affecting financial institutions are welcome and the new environment has the potential to lift the level of risk management across the industry. It calls for strong internal governance processes and the independent internal challenge and review of risk models - both of which are high on our internal agenda. It should also be a catalyst for more banks to develop rating models and mitigation techniques, with positive implications for the development of secondary markets. However, the Barclays Group has considerable concerns as to the impact that this sea change in regulatory influence over the industry might have both on strategic decision-making and day to day banking activity.

3.1 Potential impact upon investment decisions

We are concerned that there is potential to stifle internal and cross border industry consolidation, even though this makes sense on economic grounds. In particular, a bank that has achieved “advanced” status under the IRB approach will be hesitant in increasing its scope and influence into areas that are relatively undeveloped where the price is too high in terms of regulatory capital impact. Similarly businesses may seek to divest satellite operations where the cost of compliance with IRB standards is considered uneconomic or not feasible, or where the rules do not align themselves with the underlying economic considerations. Also, the parent company may seek short-term advantage by “floating”, or otherwise forcing offshore, in order to arbitrage the regulatory rules.

The approach should allow banks to use an approach appropriate to the markets it operates in. If the standard approach is suitably claibrated this will mean consolidated capital at the Group level will by definition be at least as much as under IRB. (This is not the same as cherry picking.)

3.2 Non compliance through practicality

Whilst well intentioned, one of the real dangers from the proposals as structured is that they are overly complex and prescriptive and deviate from banks own internal risk management control processes.

As a result, the likelihood of non-compliance is increased simply because the rules are so detailed they cannot possibly feature as an integral part of day to day decision making. Instead of effort being applied toward improving risk management processes and control, energy would be diverted toward creation of a bureaucracy simply to record exposures in a different way. The risk must be that the industry becomes so inwardly focused and ends up creating teams of compliance officers while the real underlying objective of improved risk management and improving and maintaining the stability of the banking industry becomes lost. Where the rules closely align with underlying internal economic measures of risk the chance of success is greatly enhanced.

Cost benefit must be taken into consideration.

3.3 Boundary issues between credit risk and operational risk

Historically, many instances of what is now being regarded as operational risk have been categorised as credit risk. Obvious examples would include first party fraud and documentation failure. But more generally, in increasing their use of ratings and scorecards within credit origination, banks are achieving better standards of credit risk management at the expense of potentially higher “model” risk. We believe this process is in a constant state of flux and may differ in intensity between seemingly very similar banks, according to their use of internal ratings and standards of internal governance.

This leads us to two conclusions:

- “Operational” risk within credit processes should be built into the credit risk weightings, so as not to invalidate most historic data held by banks and regulators should strive hard not to double count this risk.

- The emphasis on high validation standards and strong independent internal review within the proposals is entirely justified and should be a key determinant of the amount of extra capital banks are required to hold under Pillar II.

3.4 Threat to solo consolidation

In our response to the first consultation paper in March last year, we expressed concerns about the possibility of some existing arrangements and good practices, permitted under the EC legislation, being withdrawn for the benefit of political expediency. In particular, we understand that the EU Commission is under pressure from certain quarters to withdraw the solo-consolidation technique available to banks in the European Member States under the Consolidated Supervision Directive.

We believe that the regulators should have the flexibility to apply the capital adequacy standards at both the consolidated and solus level. However, in applying the requirements at the solus level it is vital that banks continue to have access to the solo consolidation treatment permitted under the EC Consolidated Supervision Directive. The FSA recognises that the aim of solo-consolidation is to include only those subsidiaries that have a close relationship to the parent. The criteria for solo-consolidation is such that it should be possible to wind up a solo-consolidated subsidiary rapidly and repatriate the net assets to support depositors with the parent. The solo-consolidated subsidiaries are not therefore a potential source of weakness to the parent. For this important reason, we believe that solo-consolidation should be retained.

3.5 Materiality

In principle, we support the idea of all material businesses having a similar degree of sophistication in their approach to risk management. But the question of materiality is a big issue to Barclays,

which has a diverse set of businesses, some in territories where the level of sophistication is not as advanced as in the UK/US. We believe banks should be given a realistic timetable to migrate. We also believe that some business units should be exempt if it is not practical or feasible to implement an IRB approach, provided the bank can satisfy the regulator that risks in those units are well controlled and managed and that there is no intent to arbitrage the rules.

3.6 Cost/benefit not proven

It is naïve to think that risk systems and general ledgers can simply be aligned without some major overhauls that will distract from customer service, significantly increase overheads and ultimately result in increased cost for the consumer. This cannot be right.

The proposed approach to materiality does not take into account the inherent complexity of a global organisation where it is impractical to apply the same standards of risk management across all business units. The approach assumes a single internal risk system, with little scope for banks to incorporate risk management techniques relevant to local market conditions. We can envisage a number of difficulties. Principally, it needs to be recognised that for many asset classes or businesses, the same level of historic data is simply not available. Allied to this, not all markets are at the same stage of development, and it is inappropriate to assume the same level of sophistication in all circumstances. Otherwise well-established and well-run operations, such as our African operations, would struggle to provide the necessary historic data capture.

Systems related costs will rise, changing the economics of bank investment strategies and potentially leading to a more fragmented and less secure banking system. Excessive prescriptiveness of the process will have a similarly damaging effect.

We would prefer to see the proposals revised so that appropriate levels of risk management is encouraged with the time and effort commensurate with the level of risks run by the organisation as a whole. This should follow the “use test” philosophy that we wholeheartedly support but without adding additional cost and potentially detrimental impact on customer service.

3.7 Increased complexity in banks’ management of capital

Banks manage their capital needs subject to a binding regulatory capital constraint, which, under the terms of the 1988 Accord, is largely a function of flows in and out of their asset base. The proposed new Accord poses a considerably greater challenge to capital managers because changes in the credit quality of the stock of assets on the books will also give rise to different capital needs from one period to the next.

This issue has been discussed largely in the context of “pro-cyclicality” but the more simple point to be made is that the new Accord introduces a new and potentially significant element of uncertainty into capital planning. It would not be surprising if many banks sought to avoid this challenge by opting for the standardised approach. In the main, this underlines the need for appropriate calibration of the risk weights under the IRB approaches. But the fact that banks operating in the same market will have different drivers and degrees of urgency to their capital planning warrants further consideration by the regulatory community.

4 Risk weights for corporate exposures

4.1 Overview

The overall calibration of risk weights is very conservative. We are aware from separate dialogue with Basel working groups that the weights include substantial buffers (50%) to allow for measurement error in all banks' models and increased pro-cyclicality of capital requirements. This, we feel, undermines the credibility of the weightings. In the case of measurement error, it is understandable that the Basel Committee should wish to build adequate safeguards into assumptions and capital calibration. But this should equally be in the interest of bank's risk managers and senior management. In other words, banks should be prudent and conservative in their own right in their use of models. Excessive allowances for error in the weightings may discourage conservatism by banks and may also stifle innovation in predictive modelling.

With regard to the cyclical issues surrounding credit modelling, it is self-defeating to deal with this issue by inflating the risk weights because this merely amplifies any implied increase in capital requirements during periods of economic weakness. We believe that a better solution is to incentivise banks to undertake adequate stress-testing of their capital needs to ensure that the buffer they carry above regulatory minima is sufficient to absorb cyclically-driven rises over an appropriate time horizon.

Additionally, the weights have been calibrated to cover Expected Loss and Unexpected Loss to counter the concern that the inclusion of General Provision as Tier two capital is double counting. Banks that have assessed the impact have found that the capital benefits in moving from standard to IRB approaches are not clear. This was not the intention.

4.2 Banks must do more than this; Standard weights will never capture all risks

Mapping from probability of default (PD) to capital weights is a credible approach and a significant advance over the 1988 Accord, albeit that we think the current calibration is too conservative. Even so, a PD to capital mapping could only ever approximate the risks within a bank's credit portfolio. Accurate modelling of capital requires a differentiated approach to correlation, as opposed to the blanket assumptions embedded in the current risk function. This is what sophisticated banks are now doing with the deployment of portfolio credit models and it would be a backward step if the Basel process discouraged or deflected banks from this course. It would be potentially very harmful if an inaccurate weighting calibration were hard-coded into the Basel rules. This is even more of a risk in the parallel EU process and it is our view that weightings will need to be reviewed more frequently in future. We particularly feel that regulators should hold open the option of approving the use of credit portfolio models at some point in the future so as to encourage further endeavour in this field.

4.3 Maturity adjustment

We feel that the Accord is right to incorporate maturity adjustments in the advanced IRB approach. Both the DM and MTM approaches are valid in concept. We would like to see more detail on how they have been deduced. That said we favour the MTM approach because it is more in line with Value Based Management.

4.4 Granularity Adjustment

We welcome the acknowledgement in the Accord of the need to address single name risk concentrations via regulatory capital rather than solely through Pillar II. Indeed, the baseline risk weights themselves are derived directly from Merton/Vasicek's model, which explicitly assumes that all loans are infinitely small compared to the portfolio as a whole and that the portfolio is homogeneous. We therefore welcome the proposal to adjust regulatory capital upwards for those portfolios that contain more single concentration risk than the average portfolio and to lower capital for portfolios which contain fewer single name concentrations. We also agree with the Accord when it states that not to include a granularity adjustment will unduly favour large corporate lending over SME lending. However, the extent to which this matters depends on where SME assets are classified within the final Accord. Finally, we feel that the committee should release further details on how the granularity formula is arrived at (the Accord references a document that is not available in the public domain) and that the explanation of the approach can and should be simplified.

5 Minimum requirements for corporate exposures

Paragraphs 235-421 set out the minimum requirements for the rating of corporate exposures. While many of the points made appear reasonable, our main concern is that taken as a whole they create an over-engineered regulatory regime around the use of internal ratings.

If unchecked, the impact could be detrimental in at least three ways. First, the more rigid regulators are over model compliance standards, the less likely it is such models will underpin other processes such as pricing. As such, they will fail the use test also stipulated by Basel. Second, there is a danger that too much of our effort is devoted to regulatory compliance, to the detriment of true risk management. Third, to the extent that we expend our time and effort on tasks that add little to effective risk management, we raise costs and damage customer service.

Instead, we suggest that a balanced approach to rating governance is apposite, with banks required to demonstrate their rating process is fit for purpose and has checks, balances and controls which reflect the materiality of the exposures covered by the ratings. We believe this flexibility is all the more necessary as rating systems and banks' use of them continues to evolve.

The concern here is that this conflicts with the use test. Logically it is not possible to both have level of prescription and use test. The choice is between prescription and standardisation but dual system or principles and use test with acceptance of variability.

5.1 Criteria to ensure meaningful differentiation of risk

We support the need for transparency and clarity over the nature and purpose of rating systems. Rating systems should distinguish borrower-specific and transactional factors. We also recognise the need for separate categorisation of non-performing loans, since such a status usually transcends any factors that drive the rating of performing accounts.

5.2 Completeness and integrity of rating assignments

Over very large portfolios, it is questionable whether every borrower needs to be rated before a loan is originated. Rigid interpretation of such rules might stand in the way of normal banking transactions. The need for independent review of all ratings is also questionable - especially where there is limited scope for judgmental input to ratings. While endorsing the need for ratings generally to be up-to-date, requirements over the frequency of update should also be subject to the materiality of the exposure.

5.3 Oversight of the rating system and processes

Banks have an ever-increasing reliance on credit models and scorecards within the measurement and management of credit risk and we accept the need for a commensurate control and governance process. Rigorous documentation and validation are key to such a process and we also identify closely with the roles outlined for an independent credit review unit, and internal audit,

both of which accord closely with the governance process for credit models now employed within the Barclays Group. But here again, the question of materiality needs to be raised. Independent review should take place to an extent sufficient to protect the integrity of internal ratings, rather than to a scale that amounts to duplication of effort. We see internal review as being primarily about the robustness of rating methodologies supplemented by adequate safeguards to protect against systematically incorrect assignment of ratings.

5.4 Reference definition of default

We accept the need for benchmark reference standards, so that regulators might make comparisons between institutions and ensure consistency within the capital framework. However, along with many others in the industry, we see some of the reference criteria listed as being “measures of impairment” rather than outright default. There is a risk of damaging sensitive relationships within the rescue/turnaround culture should this definition, and subsequent capital penalty, apply.

- Under the second criterion, default will be registered for turnaround cases where we extend or reschedule repayments (via postponement of principal/interest or additionally re-ageing a retail facility). This strict definition would lead to an impact on PD calculation and validation (as historic recognition of default will be inconsistent with the new definition).

- The third criterion is extremely wide, where default is deemed to have occurred if obligor is past 90 days on any credit obligation. Banks can only monitor default on facilities granted by them, rather than on all trading liabilities. For example, where a local authority takes more than 90 days to pay an invoice they would “technically” be in default.

5.5 Minimum requirements for the PD estimation

With regard to the make-up of ratings themselves we accept the need for well founded methodologies which err on the side of conservatism. This is in the interest of banks and their shareholders since ratings now underpin many aspects of the credit process beyond capital allocation. However, we caution against over-prescription by regulators in laying down standards; in many instances internal ratings are a device to summarise the key factors relevant to credit assessment, rather than a distillation of “all available information”. With this in mind, we suggest regulatory oversight should focus mainly on the output, validation and governance surrounding ratings, rather than their inputs.

5.6 Data collection and IT systems

It is difficult to argue with the proposals at a high level. Banks should store key data on their clients and have robust management information. This is good practice. However, there is the question of length of data history which, if taken literally, could lead to a significant industry in producing and maintaining data, for little added benefit. There needs to be greater flexibility and/or a better clarification of what the regulators are trying to achieve so better proposals can be put in place.

We think the "use" test is critical in respect of data, rather than rules that are overly prescriptive. The latter could lead to the maintenance of two rating systems to meet regulators and banks' own internal requirements. The paper talks about ratings being "through the cycle" but this does not recognise shorter-term outcome periods or large ticket assets where pricing is based on the current situation taking into account maturity, not "through the cycle".

5.7 Ratings history

To have a complete rating history on a client is impractical, particularly for long standing customers where customer relationships predate data requirements gathering procedures. A target of (say) five years data is reasonable as this typically links with the data required for model build/validation.

5.8 Defaults by rating

Generally, it is normal model validation practice to retain a history of defaults by rating category. However, we would note that difficulty arises with Sovereigns, Banks and Large Corporates where defaults are sparse. In these cases there is a need for more industry-led data sharing for use by all participating banks, or recognition of different techniques.

5.9 The retention of data on borrower characteristics for retrospective allocation of obligors to grades

In principal this makes sense, as seeing movement of client ratings over long time periods is important information, primarily for transition matrices. However, taken to extremes, this could prevent banks from introducing a more powerful rating model because the history of certain variables is unavailable.

5.10 Measurement of exposure requirements for off-balance sheet items

We are concerned that the proposals for treatment of off-balance sheet items are not fully developed. For example, the CEE treatment of uncommitted facilities hinges on whether their documentation declares them to be "unconditionally cancellable" with the CEE ranging between 0% and 75% depending on this detail. This conflicts with our own approach to EAD estimation, which is informed by experience and judgement. Our concern is that the assumption in this instance would be better based on market behaviour rather than documentation. Otherwise, the treatment of EAD could be influenced greatly by fine details in documentation and would be a potent incentive against migration from the foundation to the advanced IRB approaches.

5.11 Treatment of "all monies" charges

The current proposals suggest security must cover discrete product exposures. This is in contradiction to the current UK model of taking an all monies charges to cover the whole of a customer's facilities (examples include standard charges on land and guarantees). This will be a major issue for many banks particularly with SME exposures. We believe that national legal precedents should be acknowledged and allowance for local regulators to agree a treatment for calculation and disclosure of these types of facilities.

6 Risk weights for retail exposures

The draft proposals make it clear that the Basel Committee's thinking on retail exposures is less developed than it is for the corporate asset class. We are grateful for the opportunity to comment at this formative stage.

Barclays supports the idea of separate treatment of retail assets within the capital weighting system. There are two compelling fundamental reasons for lower capital weightings for retail exposure: granularity and asset correlation. While the former is self-evident, the latter is also demonstrable from the performance of retail lending institutions: personal sector defaults and charge-offs occur year-in, year-out. And while there is a cyclical element to provisions, this is less significant than for corporate lending.

A third reason for lower retail risk weights arises through the calibration of the weights themselves within the proposed framework. The inclusion of expected as well as unexpected loss within the calibration bears down particularly harshly on retail operations because:

- Expected losses are invariably factored into margins in this segment. The validation of the margin is much easier and more reliable in the unsecured retail market because of the pay as you go nature of the business.

- With the possible exception of residential mortgages, it is much less likely that an institution might book income ahead of provisions in this market than is the case for (say) corporate lending.

We support the principle that risk weights should be fundamentally lower for retail exposures and endorse a benchmark retail weighting of half the corporate weight for an equivalent level of default risk as appropriate as a first pass solution. But further, we think that regulators should have the facility to apply further downward adjustments to capital requirements to allow for the beneficial impact of margin income. The extent of such adjustments, and the conditions surrounding their use, would be for regulators to apply under Pillar II of the Accord.

7 Minimum requirements for retail exposures and validation standards

It is clear that both before and after the publication of the proposals, the Basel Committee has identified a wide variation in the industry's approach to risk management in the retail sector. One interpretation of this range of practice might reasonably be that there is much change in store for the industry in the years ahead, resulting in a much clearer consensus on what is, and is not, best practice in risk management. Conversely, time may show that there are several different ways to achieve the same level of effectiveness. Under the circumstances, we feel it would be unwise for regulators to impose excessive standardisation on the industry at this stage.

7.1 The nature of probability of default (PD) estimates

The probability of default estimates being based around "a conservative view of the long run average for the grade in question", may not be appropriate for Retail. Many retail credit products have very short average lives and that the product dynamics can change significantly over five years either because of changes in the market place or origination policy. This makes data from just a few years ago potentially of limited value to today's risk assessment. In some respects the proposals could restrict risk management improvements through the requirement to use too much backward looking data and run the risk that regulatory capital models would fail the "use" test, being inappropriate for other business uses. An alternative approach would have banks providing supporting evidence by way of relevant data and analysis for the assumptions used in the calibration of scorecards. The scorecards themselves would have to pass through an appropriate governance process prior to implementation, to ensure adequate documentation, independent review and senior management sign-off.

Backtesting is easier and more robust in this market.

7.2 The Proposed Definition of Default is not appropriate for Retail Portfolios

It is clear to us that definitions of default for retail exposures often vary both within and between institutions. Such differences are often arbitrary from the risk perspective, reflecting differences in the way products and services have developed to satisfy a range of customer and institutional needs.

The default definition referring to "past due more than 90 days" is not appropriate for all retail portfolios. Barclays (along with the rest of the industry) does not consider this an event of default in itself where we believe that we can work with the customer to overcome their period of financial difficulty and subsequently maintain a profitable customer relationship. (We can demonstrate that a significant number of accounts will roll back to an up-to-date state from 90 days delinquency.)

- Furthermore, we actively use renegotiated repayment programmes, including negotiations on fees and interest, as a tool with our "solutions toolkit" for customers in difficulty. It is welcomed by customers and provides us with flexibility to deal with each case on it's own merits.

- The default definition refers to being past due on any credit obligation, this needs clarification as data may be in one part of the bank but not another; or the customer may have defaulted on obligations with one lender or product while meeting those to another (e.g. still paying

mortgage and in default on credit card).

- The raising of specific provision being classed as default needs clarification in respect of accounts in arrears, where it is accepted practice to raise a “portfolio specific” provision.

- We would not always regard re-ageing as default as this is not something we can easily identify from current data.

Reference definitions of default may be useful insofar as they help regulators understand how individual institutions own approach to the issue maps, or relates, to a reference standard. This would help to achieve consistency in capital standards across the industry. However, we believe it would be unnecessary, costly and probably of little benefit to impose further standardisation on the industry at this time.

7.3 Segmentation

Given the unique nature of having flexibility to dynamically adjust the reward elements of the portfolio (both interest and fees) there may be a case for specific treatment, potentially via a credit conversion factor, for credit card or other actively managed portfolios. This contrasts fixed rate loan portfolios where changes to loss characteristics cannot easily be offset by changing pricing dynamics.

Risk to repricing should be an explicit consideration.

7.4 Seasoning effects

It appears that there is a view that a buffer be added to capital requirements to account for the effect of increasing risk due to implicit seasoning. Within credit card portfolios there is a seasoning effect whereby the capital requirement is likely to be higher initially than over the term. This is because risk is generically higher for new customers. If a buffer is to be considered to cover seasoning risk growth then a similar “haircut” should be considered due to the opposite effect.

7.5 Customer level ratings and one rating per customer

Barclays acknowledges the potential of customer-level ratings. Indeed, as an institution that provides a range of retail products to a large retail customer base, we believe ourselves to be well placed compared to many others in the industry to implement customer level strategies. However, in the retail sector, account level scoring solutions remain highly predictive and many institutions, ourselves included, use ratings based on account-level data that are then enhanced by customer level data where this is available and is deemed to add value. We suggest that there is merit in retaining the flexibility to use these account level scores, given the differing levels of risk on separate product types.

7.6 Rating history

The proposals also suggests that there should be comprehensive data collection including full rating history since the inception of the relationship – if interpreted literally this would be problematic as some of our customer relationships are very old and began before data required to calculate a rating was stored.

7.7 Retail accreditation and validation

Regulators will face something of a conundrum when setting validation standards for retail models and scorecards. The Basel papers frequently refer to, or call for, long run data series to validate models and assumptions. On the other hand, they also want models to pass the "use test". In practice however, retail scorecard builders make frequent adjustments to their models, believing this to be necessary in order to keep up with rapidly changing customer behaviour in the retail marketplace. In other words, it is widely believed that scorecards need frequent modification in order to remain predictive and useful. Validation needs to be suitably defined in order to accommodate this practice.

7.8 Method of model building and standards of documentation

We suggest regulators enter into discussion with the industry to develop standard documentation describing key aspects of rating model construction and validation, including:

- The data and methods used in the scorecard building process.
- Statistical information as to the power of variables in the model and the overall scorecard.
- The reasons why final models differ from the output of the model building exercise.

Of course, there are many areas where institutions are unable to employ elaborate model-building techniques; banks should be able to identify these instances and satisfy their regulator that their approach in such situations is suitably prudent.

7.9 Operational implementation

Implementation should take place within a sound control and governance framework. Institutions should be able to demonstrate that models have been reviewed and authorised for use by senior management. Implementation should include an audit/review process to ensure the model is correctly coded into IT systems. Subsequent amendments should be subject to a change control process.

Whilst it is possible to develop retail models around a measure of bankruptcy, this is not a particularly useful tool for managing the business. Model development is much more around the stages of delinquency rather than this final state that only affects a relatively small proportion of the population.

7.10 Ongoing validation

There should be formal management review of the effectiveness of models and components in light of changing market and operational circumstances. Validation should include separate reviews of the discriminatory power and calibration of PD models. There should be verification of outcomes versus prediction for each PD model in use. We believe there is scope for the development of standardised documentation and a basket of metrics such as power curves and gini coefficients. Institutions should also monitor overall default performance to verify models are calibrated to the appropriate underlying default assumption. Overall the validation and disclosure processes should be such that regulators are able to satisfy themselves that banks with similar default experience have similar PD/LGD calibrations.

7.11 Relevant not necessarily time banded

The requirement for assumptions concerning loss given default and default probability to be based on conservative, long run, averages seems to deny that circumstances might change and processes, such as collections and recoveries, might become more efficient. Otherwise, there is again the prospect of two sets of rating methodologies: one for regulatory purposes, the other more business tuned, for pricing etc. With regard to the components of LGD, the emphasis should be on the statistical validity and relevance of data samples rather than longevity. Banks should be able to satisfy their regulators that PD and LGD measures are consistent with one another and that appropriate adjustments have been made to data influenced by cyclical factors. We think that regulators should also look favourably on initiatives that share validation data between institutions.

The use of long run data to base models on may give less powerful and less accurate results than those currently used. Within the retail arena a typical approach would use a sample of customer applications or accounts over a six month period, with outcomes observed over one to two years. Resultant scorecards / models will be in use for around three years before constant monitoring indicates redevelopment is required. In this way we capture more recent portfolio / industry influences and are able to provide models on more recently launched products. We suggest that for modelling purposes the requirement for long run data clause is amended, although we have no explicit objection to providing underlying data for that length of time where available. In addition, we believe that a revised clause is also required to allow for the most accurate modelling of risk components on new products or territories.

7.12 Use of ratings in daily risk management process (the Use test)

This conflicts with the requirement for ratings to be a conservative long run average. Within the retail environment with short product life cycles it is important for the models supporting credit management to reflect recent data and accurately estimate behaviour over the next year.

8 Small and medium enterprises (SME)

8.1 The case for special treatment

Within the modelling framework regulators have used to derive the credit risk weightings, separate treatment of SMEs from Corporates is warranted in order to achieve the right answer. In other words, the asset correlation assumptions modelled to derive the corporate capital weights are much higher than those normally used in modelling SME risks.

In addition, there are other features of SME customers that distinguish them from large corporates:

- They are unlikely to be publicly quoted or rated, so banks will generally rely on different credit appraisal solutions.
- They are not normally multi-banked, so their bankers can see the whole picture in terms of banking transactions. This makes account behaviour scoring a viable proposition for SMEs.
- They have more straightforward banking needs and product usage.

In our view the majority of SMEs do not fit within the Corporate class. Given the significant work involved in defining regulations and minimum requirements for a new class at this late stage, we believe that SMEs should be incorporated under Small Business within Retail. Failing this, Barclays supports the ISDA proposal that SME assets which cannot be treated as retail should nevertheless be differentiated from larger corporate claims.

Given the political sensitivities surrounding the delivery of banking services to this sector, currently subject to a Competition Commission Investigation in the UK, we believe the classification as Corporate would discourage rather than encourage competition given the level of capital required and costs associated with compliance.

8.2 Definition of SMEs

Both the Department of Trade and Industry and the European Commission have objective criteria to define Small and Medium Enterprises (SMEs). The problem with these measures is that they do not correspond directly to information which banks will regularly collect from all customers.

We suggest that a workable definition from a UK perspective is customers with a combined debit turnover across all accounts of less than £25 million per year.

- National regulators would set their own threshold compatible with an international reference standard.
- Definition to be adjusted periodically to reflect inflation.

9 Other Credit Risk Asset Classes

9.1 Banks and large companies

The question of ratings for large companies and banks needs to be addressed differently to middle market corporates, particularly in terms of model building and validation. In the large corporate market, the data is not available to build statistically valid models using good/bad samples, as is common for middle market corporates.

Scarce default data rules out statistically derived scorecards and makes annual validation of limited value - but this is made up for by Rating Agency information and market scrutiny, with a greater level of relevant information in the public domain. We think the question of suitability of ratings should rest on banks being able to satisfy regulators that their approach maps to sensible default probabilities (via external rating comparisons where available), is objective and unbiased, and subject to appropriate oversight and governance. We would also like to see clear guidelines on bank's use of third party rating systems within the IRB framework.

9.2 Sovereigns

For Sovereign exposures under the Standard approach, at national discretion, a lower risk weight may be applied to exposure to Sovereigns denominated and funded in the domestic currency[1].

Under the IRB approach there must be ongoing monitoring of economic and political developments and "the political dimension must include the possibility that a Sovereign might be unable or unwilling to repay its obligations, or may not have access to foreign currency". Moreover Sovereign rating must be performed by specialists and by an independent unit from the front office. There is further comment on the need for banks to separately assess the different loss characteristics of domestic and foreign currency lending to sovereigns under the LGD requirements implying CTR should be adjusted for under LGD not PD.

9.3 Country Transfer Risk

The Accord is not clear in respect of the definition of Country Transfer Risk ("CTR") or how it is incorporated into the capital allocation process. Surprisingly the Accord is more detailed under the Standard than the IRB Approach and more specifically for Sovereigns.

For exposures to banks under the Standard approach the Sovereign approach is extended, (i.e. at national discretion a lower risk weight may be applied to exposure to Sovereigns denominated and funded in the domestic currency). However, this is limited to exposures with an original maturity of 3 months or less subject to both a risk weight category that is one less favourable to that assigned to the Sovereign and a risk weight floor of 20%. There is no stated favourable treatment for corporate or retail exposures but no unrated corporate exposure may be given a risk weight

[1] Where this discretion applies, other national supervisory authorities may allow their banks to treat the same exposures to this Sovereign (or Central Bank) in the same way.

preferential to that of the Sovereign; the sovereign “floor” for rated corporate exposures proposed in the June 1999 Consultative Paper has been withdrawn.

There is little specific comment under the IRB approach. For corporate and bank exposures, only one rating is allowed for each borrower, effectively meaning that we cannot continue with separate ratings for domestic local currency and foreign currency facilities. However, the assumption could be made that CTR adjustments can be made through the “separate and distinct dimension, which takes into account transaction specific factors”. Some guidance may be taken from the requirement to include “the risk characteristics of the country it is operating in and the impact on the borrowers ability to repay, (including transfer risk) where the borrower is located in another country and may not be able to obtain foreign currency to service its debt obligations”. However, this does not cover the category of in-border foreign currency loans which presents a problem in that it implies CTR should be incorporated into the rating. Further, if there are in-border, domestic currency, loans (say in Hong Kong to a Hong Kong counterparty) and cross-border loans (say from London to a Hong Kong counterparty) we are prohibited from having different ratings.

Are corporate/bank and Sovereign exposure different

The principal issue is the different treatment between corporate/bank and Sovereign exposures. CTR is adjusted for in corporate/bank exposures through the facility characteristics; only one grade is allowed for each borrower. Sovereigns can have two grades; a domestic currency (if funded in same currency) and a foreign currency grade. We would argue that the Sovereign approach should be extended to corporate/bank exposures, otherwise two different grading and LGD approaches need to be in place.

The logic to restricting the adjustment to the risk weighting for banks exposures of less than three months is not reported. We would argue for this to be extended to all corporate/bank exposures.

There is no comment at all on retail exposures.

As proposed the Accord would necessitate changes to our methodologies and systems, leading to two sets of records, one for internal management purposes and one for regulatory purposes. The economic sense of this is not clear. Whilst based on the same risk assessment criteria, CTR adjustments are not applied in the same way. The danger therefore is that the process is unnecessarily complicated. We would argue that it is more important to demonstrate control in a way that is consistent and transparent to all concerned.

Does it give the right result and incentives?

The impact on Banks generally is not clear without carrying out research into how the adjustments would be made. It is not consistent with the rating agencies’ approach, which provide different ratings for domestic and foreign currency ratings for all borrower types and do not provide facility adjustments.

It is also not clear what the impact will be on capital. Arguably there should be little difference to the credit impact. The main impact will be implementing the Accord in its present form with the different approaches to corporates/banks and Sovereigns.

In addition, if Euros are domestic currency for Germany and Italy, we may be at a disadvantage in that we will not be raising the same proportion of our liabilities in Euro's. So lending to an Italian Bank in Euro's, the German bank could (should) have an advantage as that would be domestic currency loans funded in domestic currency and (in the absence of adopting the Euro) we may not have the same ability to lend Euro's if this is repeated across "Euroland".

What are our recommendations?

Whilst the approach to country risk for Sovereigns is reasonable, there are issues with the approach for other counterparty types.

It seems appropriate to have a consistent approach to country risk. There are two main issues; PD and LGD. Default can be caused by a country event or a credit event, the probabilities and LGD's of which are expected to be different under each default type.

The Sovereign approach is a sensible way of addressing this, although it would be more appropriate to start with a lower PD, based upon Sovereigns exposures denominated and funded in the domestic currency, with an adjustment upwards if Country Risk is an additional risk. This approach seems suitable for the Standard approach and should be extended to all counterparty types; there is no logic for restricting it in the way proposed.

In the IRB Advanced approach the expected differences in LGD based upon each form of default should be calculated. There will need to be two different regulatory capital calculations; one using the PD and LGD because of a credit default and one using the PD and LD because of a country default. The total regulatory capital for each exposure will be the sum of these two calculations (less any correlation). This approach should be extended to all other exposure types.

9.4 Equity Exposures

Two key approaches for treatment of these exposures are proposed, although further work and feedback is required. The first is a PD/LGD approach and the other based on market risk/stress testing.

Proposals need to differentiate between positions held for rescheduling and strategic equity holdings. Positions held for rescheduling should probably be at "fair value", though not necessarily at full mark to market. Strategic equity holdings should be at cost or lower of cost and market.

9.5 Project and asset finance

We consider it important that the capital treatment be tailored to meet the particular characteristics of Project Asset Finance and therefore welcome the Committees intention to give this matter further consideration. Barclays has contributed to the BBA working group on Project Finance designed to provide a consolidated industry view on the characteristics of good risk management

and is supportive of the response provided by them, the response below restates and summarises that position.

Definition

We agree with the definition provided by the Committee, subject to:

- "Loans" should be replaced by "financing transactions" to reflect the different forms of financing adopted.
- Include "The performance of the project is, typically, monitored against projections on a regular basis" to reflect the way in which such projects are managed.
- Clarify what is intended by the phrase "warrant the debt service". This should not constitute a reference to a form of guarantee. Rather, risks of the financing would be mitigated not only by charges over the relevant assets and/or cashflows but also by the robustness and commerciality of the contracts which detail the project.

Projects are structured against cash-flow and are generally subject to frequent review of progress against projections and forecasts, via coverage ratios, performance targets and other covenants. From these, the probability of a problem is identified and an assessment made of the likely loss. This may, and often will, result in a restructuring of the project or of its financing, rather than be reflected in crystallisation of the position and lead to a work-out.

In addition, default may, and frequently is, called as a result of a covenant breach, which may reflect the failure to provide information on the due date. Usually, this does not reflect an increased probability of loss. The concept of default is therefore very different from that used in the corporate lending field.

We note that only certain types of asset financing fall within the scope of the definition and where this is the case will be subject to the appropriate regulatory treatment. In particular we are concerned to ensure that this would encompass for instance aircraft asset finance.

Differences to Corporate Grading

In general, project financings are rated on the basis of a definition of project default, that is necessarily different from that used for the corporate book.

The rating process is derived from an assessment of a number of elements. These range from objective, quantitative elements such as cashflow and debt service coverage, including assessments of the robustness of those projections, to assessment of such risk factors as: technology; supply contract; demand (off-take) contract; completion risk; operating risk; country risk; environmental risk. Most of these are subjective and reflect the various parties to the contract as well as the legislative framework and jurisdiction in which disputes will be resolved. In sum, the grading ascribed will largely reflect experienced judgement. The important factor to bear in mind is that, as a result of the regular reviews to which projects are subject, all of these factors are probably being reviewed on a rolling basis, the trigger for action being a material change to the loss expectation which has been assessed. Given the unique nature of projects, however, this likelihood of loss cannot be validated with any accuracy.

To answer the Committee's specific questions:

- Rating grades are assessed from a basis of objective and subjective elements to reflect the bank's existing loan grade structure.
- Assessments are primarily aimed at assessing cash-flows and their vulnerability.
- The orientation of the system is to a two-dimensional (EL and LGD) approach.
- The nature of projects means that they are subject to more frequent review than the generality of corporate lending.

Further work required

It is difficult to see how project and asset financings can be readily incorporated into the IRB methodology, which is essentially geared to portfolios, rather than to assessment of individual loans or projects. We believe that experience shows, certainly in certain markets, that projects have an extremely good loss record. We would welcome the opportunity to work with the Committee in seeing whether there are criteria that can be used to identify projects that deserve relatively favourable treatment. Having said this, we would not wish regulatory treatment to influence the structure of project financings.

We are also aware of the data being provided by the Finance and Leasing Association with respect to other forms of asset finance. We would welcome working with the FLA and Committee on developing a risk-sensitive approach for asset finance.

However, there is real concern that national differences in what is superficially a subjective based approach will lead to distortions of the aspired for level playing field in respect of this risk.

9.6 Trade Finance

Short term activity

The proposals for the treatment of short-term bank exposures within the standardised approach severely penalises existing trade finance arrangements. At present, the majority of trade finance exposures are weighted at 20%, with only facilities over twelve months to non-OECD banks weighted at 100%.

Under the new proposals, the short term, lower quality bank exposures are likely to attract a higher risk weight at either 50% or 100% depending upon actual grading/rating. This will also flow through to the IRB approach, as these non-OECD banks are likely to have poorer ratings.

The consequential impact on trade facilities using bank limits (particularly short term) is likely to be significant. This is predominantly caused by trade deals being more common with the lower graded countries/banks, where this type of assistance is vital to the trading system. However, there appears to be little evidence to suggest the inherent risks within these deals has increased.

Medium term activity

We seek clarification that ECA covered business would be treated as an exposure to an AAA sovereign.

10 Credit risk mitigation

10.1 Banking book considerations

Under the foundation approach, there is little weight afforded to increased security in terms of resulting LGD - 140% secured through to 30% secured only equates to a narrow LGD differential of between 40% and 50%. This is not sensible and it could actually act as a disincentive to have extra security to mitigate the credit risk. We suggest widening the LGD band to reflect the difference in the risk between differing secured levels.

Personal guarantees are not included on the list of eligible guarantees, a significant class amongst the security offered in support of SME facilities. We believe that personal guarantees should be included to the extent of supporting security, which would be treated in the same way as other collateral.

We question the proposal for internal re-valuations of property to occur annually and professional valuations every three years or upon renewal, default or refinance (a "maturity event"). From our experience non-professional valuations have proved to be of little value due to the expertise required and we do not allow this internally anymore. Also undertaking a professional valuation at a "maturity event" or for reducing term loans is an unnecessary cost. We will be undertaking these valuations on the majority of assets that will not default. This is not in the interest of our customers.

Our proposal is to remove the need for annual non-professional valuations totally and remove the need for threeyear professional valuation for all performing agreements, moving to an exception-based process. To cover against potential volatility in asset values we can use stress testing on the portfolio.

On the question of ensuring collateral is adequately insured, our own experience proves that no significant losses have been incurred from removing this costly and highly administrative procedure, which we did a number of years ago. We believe this requirement should be removed.

We welcome the recognition of a wider range of eligible collateral and the greater recognition generally of risk mitigation techniques. We see regulatory recognition of risk mitigation as an important step towards the greater development of such techniques, and the potential for greater liquidity in markets that facilitate risk mitigation.

It is as important to influence and motivate appropriate risk mitigation techniques, as it is to measure the risks that are to be mitigated. Thus it is important to review the proposals in terms of their likely impact on markets and the behaviour of participants, and where unintended consequences arise, to reassess the proposals.

The Barclays Group has participated in a number of industry and trade association initiatives to consult with Regulators and the Committee, and in general the responses submitted by these bodies accord with Barclays' thinking on this subject.

10.2 Developing the market/impact on portfolio management

Risk mitigation techniques fall broadly into two main categories.

Risk mitigation that is undertaken upon origination. This generally takes the form of structuring and collateral and appropriate pricing. We are encouraged that structuring and collateral will be recognised through their impact on the LGD calculations of internal models used in the advanced IRB approach. We also recognise that pricing is not something that can be easily brought into a regulatory regime for wholesale portfolios, although it is a different matter for retail, and this is raised elsewhere in our response.

Secondly risk mitigation occurs through post origination activity, increasingly in the context of portfolio management. There it is disappointing to note that a number of the proposals have the effect of disallowing, or only partially recognising, for regulatory capital calculations actions which effectively mitigate the full economic risk. This has the additional effect of potentially impacting the liquidity and price transparency of the markets where such mitigation takes place.

We consider that prudent portfolio management is an essential element in the stability of the international banking system. Accordingly loan portfolio managers should have the widest array of credit risk mitigation techniques available to them in order to optimise portfolio management. The Committee should facilitate this choice and promote the development of sound portfolio management techniques by:

- Recognising as broad a range of credit risk mitigation techniques as possible.
- Allowing the regulatory capital relief afforded such instruments to reflect the economic impact to a bank in terms of the reduction of risk.
- Ensuring equality of regulatory capital treatment between the different techniques.

In this way portfolio managers will have the greatest choice of robust credit risk mitigation techniques available to them, without artificially distorting their selection of the best technique for a particular portfolio or management purpose.

In this regard we believe that, used appropriately, there are a range of techniques that all constitute effective and prudent credit risk mitigation techniques. Therefore, their use should be encouraged, as part of the efficient portfolio management process and to the fullest extent practicable should be subject to equality of capital treatment. These include collateral, guarantees, credit derivatives, asset and synthetic securitisations (where all material risk is transferred) and participations.

Accordingly, we ask that the Committee develop the Accord to ensure the minimum asymmetry of regulatory capital treatment between these credit risk mitigation techniques and to recognise their beneficial contribution to prudent risk management equally.

Whilst we welcome the Committee's proposal to provide a choice of approaches and balances between simplicity and sensitivity, we believe that the focus on economic substance and risk treatment should result in a more homogenous treatment of credit risk mitigation techniques than exists in the current proposal. The excessive demarcation between the forms of mitigation used is inimical to the desirable focus of the new framework on economic substance and risk.

10.3 Credit derivatives and guarantees

Given that the Committee prescribes specific conditions for the recognition of guarantees and credit derivatives, it seems to us inappropriate to distinguish between types of guarantor/premium providers and then seek to add a further hurdle in the form of the "W" factor.

10.4 W factor

We remain unclear as to the justification for applying a ‘W’ factor. Further, the application of the ‘W’ factor provides no incentive for banks to reduce risks as the factor is fixed and takes no account of the extent risk is inherent within individual transactions. Also, the proposed approach discriminates between different types of transaction that appear to incorporate similar risks. For example a government repo attracts a nil “w” factor unlike a transaction documented under a CSA that is collateralised by government securities. We believe that the proposal should be withdrawn. As our position is reflected in the BBA/ISDA/LIBA submission we do not elaborate here.

10.5 Diversification

We consider diversification to be a vital component of prudent portfolio management and note with regret that the new framework does not yet give due recognition to the manifestly beneficial effects of diversification. Whilst the Accord proposes disincentives for excessive risk concentrations under the rules on granularity and/or sanctions imposed under Pillar II, we had hoped to see a greater use of positive incentives for banks to diversify their risk profiles. Whilst the consultation document discusses this in the context of guarantees and credit derivatives the inhibiting effect of the development of credit risk models is a significant shortcoming in the current version of the new framework. Accordingly, we would encourage the Committee to allow the recognition of diversification to be included in the new framework so that banks may continue to work with regulators to explore ways to recognise the beneficial effect of diversification and double default correlation on the banking system (i.e. two name risk with low correlation is better than single name risk).

10.6 Joint default

In particular, we regret the absence of recognition of "double default correlation" and believe that the resultant charges will be excessive for the risks incurred. Whilst there will be difficulties associated with producing an approach that is both prudent and simple, the lack of recognition of double default effect is a major disincentive for banks to develop efficient portfolio credit risk models.

10.7 Trading book treatment of securities financing transactions

We are concerned as to the proposed trading book treatment of securities financing transactions.

Whilst not explicitly addressed in the consultation paper it is understood that the proposed treatment of collateral is intended to apply to both banking and trading book transactions. This would encompass repurchase and securities loan transactions booked in the trading book and used as a source of funding and for hedging dealer exposures.

The application of the proposed haircuts and 'W' factor would result in significantly higher capital costs for these transactions than under existing rules. We believe that the proposed capital requirements would be inconsistent with the low levels of risk associated with these types of transactions.

Historically, these types of transactions have been reliable and resilient. This market incorporates a high degree of market discipline, sophisticated market participants and systems, robust and well tested legal documentation and sound legal foundation. Losses, as a consequence, have been insignificant. Further, these transactions are predominantly of a short-term nature, often overnight, which further reduces the risk inherent within such transactions.

Further, the increased capital charges, of the size proposed, are likely to result in a reduction in dealer activity leading to reduced liquidity in the securities markets. The proposals would result in participants, both lenders and borrowers, being required to put up additional collateral and incur additional capital requirements, generating additional costs that would have to be covered when undertaking these types of transaction. The proposed treatment of government repo is insufficient to address this problem. A wider concept of qualifying transaction is required to address this.

Given the serious implications arising from the application of the proposals we consider that the treatment of Trading Book repos requires further consideration and consultation beyond the 31 May deadline.

We believe that the concept of qualifying transactions should be enlarged to incorporate transactions that satisfy certain conditions such as:

- Daily marking to market of contracts to determine net exposures.
- Daily re-margining to reset the collateral and eliminate any net exposures. To qualify as eligible collateral it should be possible to liquidate within 4 business days.
- Involve securities that are settled in a settlement system that customary settles securities.
- Application of a legally enforceable Master Agreement, such as the Bond Market Association and International Securities Market Association Global Master Repurchase Agreement or an equivalent agreement or equivalent agreement.

The agreements should incorporate the following features:-

- Provide the non defaulting party with the right to close out all transactions under the Agreement upon an event of default.

- Allow for prompt liquidation of collateral upon an event of default.

- Provide the non defaulting party with the right to determine, in good faith, the valuation of the securities and collateral, even where there is no generally recognised market quotation available.

- Provide for the netting of gains and losses on transactions closed out under a Master Agreement so that a single net amount is owed by one party to the other.

- Legally enforceable, under applicable law, including in event of the bankruptcy of a counterparty.

In addition the bank should demonstrate that it has appropriate controls in place. Clearly, regulators could under Pillar II apply additional capital charges should they have concerns regarding the operating standards applied by the bank.

For such transactions the proposed levels of collateral haircuts appear unduly high, instead no haircuts should be applied but the net exposure to the counterparty would attract a capital weighting. This approach is similar to that currently adopted within the trading book under the FSA's rules.

We recognise that this constitutes an interim approach and ultimately would involve moving towards a VAR based approach to determine the amount of collateral to be lodged, any short fall attracting a capital charge. But such an approach would have to be tailored to these types of transactions and hence would require time to develop.

Points concerning transactions that do not constitute qualifying transactions:

- For reasons explained elsewhere we believe it is inappropriate to apply the 'w' factor.

- The proposed holding periods of ten days should be reduced to a lower level approximately four days to reflect the characteristics of the transaction. Ideally the holding period should be tailored to the individual characteristics of the individual types of repo.

- Clarification is required as to the netting of repo. When applying estimates of haircuts netting should be permitted on a portfolio basis.

11 Securitisation

11.1 General

We regard securitisation as a valuable tool for managing risk consequently we are concerned that the capital regime should reflect the risks inherent within such transactions.

We note that certain aspects of the treatment of securitisations including synthetic securitisations and the IRB approach are at an early stage of development. We are concerned that these fundamental issues should be subject to further formal consultation once the Committee's proposals are sufficiently advanced.

11.2 Multi seller conduits

We commend to you in this regard two comment letters prepared by an international group of banks (the "Commenting Banks") that are active participants in the asset-backed securitisation and asset-backed commercial paper ("ABCP") markets. The first letter comments on the application of the proposed standardised approach as set forth in the Consultative Paper; the second focuses on appropriate capital requirements for securitisation and on the application of an internal ratings based ("IRB") approach.

We continue to support the Committee's goal of modifying capital requirements to better reflect the relative risk associated with various assets. In particular, we continue to support the adoption of a workable IRB approach to be implemented in the same timeframe as an external ratings-based approach. However, we are greatly concerned that as the proposals now stand, the IRB approach will not be available to the vast majority of banks experienced in the ABCP market.

Having said that, it is our strong concern that the current December deadline for finalising the revised Accord is overly aggressive. More specifically, we believe the proposals with regard to the IRB approach and methodology are not fully developed. We believe it necessary to allow concerned parties adequate time to vet concrete proposals.

We are concerned that the Committee's expectations as to the amount of capital that would be prescribed for securitisation positions using either the standardised approach or an IRB approach will substantially exceed the amount justified by the credit risk inherent in these positions. With regard to this point, we refer you to the BMA Comment letter.

Because of the importance of the ABCP market and potential ramifications posed by revisions to the Accord, we strongly urge the Committee to revise its timeframe to allow sufficient time for a formal comment period on a fully developed IRB approach for securitisation which will be available to the vast majority of banks experienced in the ABCP market and properly incentivise banks to move from the standardised approach to seek IRB approval.

We, along with the Commenting Banks, seek clarification on a number of areas addressed in the Consultative Paper as they apply to banks' securitisation activities, particularly their exposures to Multi-Seller Conduits, as well as offer the following comments.

11.3 Treatment of credit enhancement

While we appreciate the Committee's inclusion of an approach for calculating the applicable risk weight for programme credit enhancement by reference to the related underlying asset pools, we seek clarification on the following aspects of this proposal that:

- As implied in the Consultative Paper, seller-provided and other transaction-level enhancement constitute a first-loss position.
- A bank may look to the risk weighting of the underlying asset pool when determining the risk weight for a position held in an un-rated asset-backed security.
- When determining the risk weight for an unrated asset pool, a bank may look to the weighted-average risk weight of the underlying obligors rather than the highest risk weight.
- Unrated pools with corporate obligors should be assigned a 100% risk weight.
- An IRB approach will be available for unrated programme credit enhancement positions.

Generally, we believe that an IRB approach should be applicable to all unrated securitisation positions, first-loss credit enhancement positions, second-loss positions and liquidity commitments. We further believe that an IRB approach should be available to a bank in all circumstances, regardless of the role in which the bank is providing a credit enhancement position.

11.4 Treatment of liquidity commitments

We support the continuation of the current method of calculating required capital for liquidity commitments that apply the conversion factor to the risk-weighted off-balance-sheet item and seek clarification that this is the Committee's intent.

We also support the use of an IRB approach in determining the risk weight for the off-balance-sheet item when calculating the required capital for liquidity commitments.

We believe that it is imperative that risk weights for liquidity commitments under any IRB approach be calibrated to reflect the structural features that reduce the risk of these commitments.

However, having said that, with regard to pool specific liquidity commitments, in the absence of an appropriate IRB approach, we believe an approach that incorporates a look-through to the structure of the transaction is appropriate. The structure of a transaction most often results in "deemed" ratings of the various tranches, as opposed to "hard" ratings, from a qualified rating agency. These deemed ratings reflect transaction specific enhancement, as well as the credit and investment policies of the individual conduit which will dictate the degree of structuring required to allow an individual transaction to be included in a conduit without jeopardising the conduit's overall rating.

If the Committee were agreeable to the above consideration, we would propose that the "deemed" rating form the basis for the risk weighting of the item and the conversion factor be applied to that weighting. For example, in the situation a draw on liquidity would result in the liquidity provider assuming exposure at the senior-most level of the structure - which is often deemed to be rated single A or better the basis for the risk weighting of that liquidity would be single A or possibly better. We ask the Committee to bear in mind that the liquidity provider would fund against a borrowing base that excludes defaulted assets.

11.5 Conversion factor

We believe that the assignment of a 20% conversion factor for commitments of one year or less overstates the risk of liquidity commitments to Multi-Seller Conduits. Statistics compiled by the Commenting Banks and presented in their Comment No 1 support this position and suggest a much lower conversion factor would be appropriate. We suggest the appropriate conversion factor is one that reflects the true probability of draw under liquidity commitments as supported by statistical evidence rather than one that is arbitrarily set. Some other reasons supporting a lower conversion factor are discussed below:

The structure and purpose of these commitments reduce substantially the risk that there will be a draw in a particular transaction. Specifically, the asset-quality tests built into liquidity commitments and the structural components of the related underlying securitisation transactions serve to protect commitments from funding against non-performing assets. Thus, the risk of exposure of a commitment is effectively reduced to the extent that the underlying assets default. Said another way, as defaults on a receivables pool increase, the availability under the committed facility decreases giving such commitments an element of "cancelability."

Liquidity commitments are unlikely to be drawn in the ordinary course, as they are backup funding sources for the highly stable ABCP market, which is the primary funding source for Multi-Seller Conduit transactions. Because the ABCP market has historically been very stable, even during the turbulence of late 1998 and the Y2K uncertainties of year-end 1999, the likelihood of draws under an outstanding liquidity commitment to address market disruptions is minimal. We are not aware of any draws on liquidity commitments to Multi-Seller Conduits in late 1998 due to market disruption or general inability to access the ABCP market despite the fact that some highly rated corporate borrowers were unable to access the corporate commercial paper market.

Even when commercial paper rates spike, liquidity commitments are not generally susceptible to draws for economic reasons because it is the conduit administrator, not the customer, who determines when to draw on liquidity commitments in Accordance with the terms of a transaction. Because increased commercial paper costs are generally passed through to the customer, the conduit administrator, who is also typically a liquidity provider, does not have the same incentive that a customer would have to fund through the liquidity commitment. In fact, the economics of funding under a liquidity facility are generally unattractive to customers since drawn pricing is set at levels to discourage usage.

Multi-Seller Conduit transactions have structural features designed to allow an administering bank to maintain the stability of a receivables pool and mitigate the effect of defaults. These structural features include frequent pool reporting requirements, amortisation triggers for revolving facilities that permit the liquidation of a receivables pool once it fails to meet specified performance requirements, audit mechanisms that allow an administering bank to inspect its customer's operations and ensure proper servicing of the receivables pool and, when warranted, the ability of

an administrator to take control of payment systems to provide for direct payments to the Multi-Seller Conduit, thus, mitigating bankruptcy and fraud risk.

11.6 General comments

First, we also believe that the presence of asset quality tests in liquidity commitments sufficiently safeguard these commitments from being used as credit enhancement and therefore believe that further criteria for a commitment to be treated as liquidity as proposed by the Committee would be inappropriate.

Second, while we agree with the proposition that there must be a “clean break” between an originator and securitised assets before an originating bank can remove these assets from the calculation of its risk-based capital ratio, we agree with the comments on this issue set forth in Section 2.1 of the BMA Comment seeking clarification on several points in the Accord’s “clean break” requirements.

11.7 Traditional securitisation

We believe that the approach applied to determine the capital requirements should be based upon the amount of risk retained, rather than the role played by a bank as originator or investor.

With regard to the treatment of investing banks we are concerned that the proposed treatment of asset backed securities are not consistent with corporates subject to the same credit rating. We are unclear as to the justification for such an approach. We believe that they should be subject to the same treatment. Otherwise distortions will be created between ABS and corporate issues. Also this would result in investors expecting to maintain their return which would increase the costs involved in securitising assets creating a disincentive for banks to establish such structures. This would be inappropriate given the importance of securitisation as a means of diversifying risk.

11.8 Synthetic securitisations

Whilst the guidlines issued in November 1999 by the US Office of the Comptroller of the Currency and the Federal Reserve provide a basis for developing a treatment of synthetic securitisations, such an approval should be designed to align the capital charges to the risks underlining each tranche.

Given the early stage of development of the proposals in this area, it is important that the committees proposals, once they are sufficiently advanced are subject to full consultation.

11.9 Pillar III market discipline

We are concerned that the proposed disclosure requirements constitute an excessive burden to produce and may not meet the needs of the users of the accounts. We believe that the Pillar III

disclosures require additional consideration to ensure that relevant information is to be provided to the users of the information. Therefore we support the Basel Committee's decision to work with the IASB to establish more appropriate disclosure requirements.

12 Trading book issues

12.1 Definition of the trading book

We welcome the proposed amendment to the definition of the financial instruments that may be included within the trading book. This is particularly important as it raises the possibility of including actively traded loans within the trading book and hence, as is appropriate applying equality of treatment between traded bonds and loans. This should encourage the development of a more liquid loan market which would also contribute towards a more stable banking system. We are unclear as to what is meant by the term ‘hedged completely’.

12.2 Trading book capital treatment for specific risk under the standardised methodology

The revision of specific risk weightings linking them with the new standardised approach requires further consideration. We are unclear why it is confined to governments and consider that it should be subject to wider application.

12.3 Specific Risk capital charges for positions hedged by credit derivatives

We believe that the proposals to limit the extent to which offset would be recognised through the use of credit derivatives that incorporate restrictive payout provisions requires further consideration having regard to the different types of instruments applied by the industry. We are unclear as to the basis for limiting the offset to 80%.

12.4 Counterparty risk

We are concerned that the standardised and IRB approaches being developed for the banking book should not be adopted for the trading book without having due regard to the characteristics of the trading book. In particular trading book transactions tend to be short term in nature. An example is the application of banking book charges to trading book repo and stock lending transactions, which is addressed in section ten of this submission.

13 Operational risk

The general direction of the proposals with the attempt to introduce a risk based charge for operational risk is welcomed. There are however a number of key issues and concerns with the current proposals.

13.1 Definitional/ scope issues

There is insufficient clarity and completeness around the definition of the operational risk charge, which raises the following issues:

- The boundaries of operational, credit and market risk have not been defined. This will lead to potential uncertainty, inconsistency, double counting of risk and arbitraging of losses between the risk types. These boundaries must be clearly defined and the definitions of risk must be mutually exclusive. It may be necessary for pragmatic reasons to decide on a definition of credit risk that includes all losses associated with lending process. Whilst this would inevitably include some operational risk losses, it would allow a banks historic credit risk data to be used within the Advanced credit risk approaches.

- The definition of direct and indirect losses is not a helpful distinction as it leads to ambiguity and potentially inclusion of inappropriate risk losses. A more helpful perspective will be to use operational losses, which have led directly from operational risk events and have been booked to the Profit and Loss Account (above an appropriately large loss threshold).

The proposals state that regulatory capital should be held against certain expected losses, since operational risk provisions are infrequently made unlike credit risk. This is inappropriate for the following reasons:

- The key purpose of regulatory capital is to protect the depositor against large, sudden, unexpected losses, which lead to a rapid deterioration in a bank’s solvency.

- Operational risk losses are not subject to the economic cycle in the same way as e.g. credit risk losses. Expected operational risk losses are consequently more stable (and predictable) than credit risk losses. Expected operational risk losses consequently are implicitly (if not explicitly) priced into the product/service charge and expected losses are therefore met by the P&L Account.

13.2 Level of the charge and calibration issues

As the stated aim of the regulators is to maintain the present overall level of regulatory capital in the system, the reduction resulting from the new credit and market risk regulatory capital proposals should determine the level of the overall operational risk charge.

The proposals presently set the operational risk charge as 20 % of the overall regulatory capital level. It is understood that this 20% figure is based on a regulatory questionnaire undertaken in 2000 by a limited number of banks, which asked how much economic capital was internally allocated to “other risks”. The data returned is believed to have included a variety of risks not

included under the "operational risk" definition of the present proposals in particular business risk. The 20% figure is therefore based on an incorrect starting point.

Furthermore the present level of the charge suggested for the Basic Indicator Approach (30% of Gross Revenue) is considered too high. A recent IIF survey reveals that of the participating banks, 20% of MRC equates to a significantly lower level of Gross Revenue.

If the requirement is for a buffer, lets agree an interim buffer and progress to an operational risk charge when we have done the work to know it is robust.

13.3 Level playing field issues

- It is important that Pillar II is implemented in a transparent and consistent manner across the various jurisdictions.

- Similarly, differing coverage of regulatory capital charge in EU vs. non EU states (See Level Playing Fields below).

- Insurance services and other non banking activities must be excluded from the Basel regulatory charge to ensure a level playing field with non-bank competitors providing the same services.

13.4 Risk sensitivity issues

In order to improve risk sensitivity <u>all</u> Options should include the following:

- A qualitative adjustment to the charge (both positive and negative), which is based on objective criteria for sound operational risk management. This will drive good risk management and will look at the control environment, which is a more risk sensitive and forward looking indicator of risk than expected losses.

- Include a non-linear factor to scale the level of charge to the level of Gross Revenue. The present assumed linear relationship of size to risk is considered to be wrong and penalises the growth in Banks of all sizes.

- The proposals include the principle of a "floor" below which capital cannot fall. The proposals should similarly include the principle of a "ceiling" limiting the upper limit of a charge. Historical losses could be used to benchmark the maximum level of experienced loss across the Industry.

- Risk mitigation should be taken into account in the level of the charge. There are a number of challenges to recognising insurance at present that the insurance and banking industry will need to work together on. The proposals should however include greater encouragement to support this development.

13.5 Option 2

The risk sensitivity from this option comes from the different risk rates of the Business lines. Consequently a more granular level of business activity should be used.

Gross Revenue should be the common exposure indicator as there is no additional risk sensitivity to be gained from a crude sizing indicator. Gross Revenue would provide the advantages of ease of collection, consistency, auditability, and a common metric across the various Options.

A subjective adjustment, a non-linear scalar and risk mitigation should also be added to this option (see above).

13.6 Option 3

This is presently an incomplete and unproven option, which has questionable theoretical foundations.

The option is based on the assumption that internal loss data (primarily expected losses) can be supplemented by external industry data to measure the level of unexpected loss and hence regulatory capital required. The relationship of expected loss to unexpected loss is open to question and cannot be determined until sufficient quality industry data has been collected and tested.

There are a number of other concerns:

- Loss data is backward looking and not necessarily predictive of future losses.
- The risk profile index methodology is not presently clear or complete.
- There are various issues around how industry loss data will be collected, including confidentiality and anonymity. The present industry data base consortia are unlikely to provide sufficient quantity or consistency of data to meet Option 3 requirements.
- The present shortfalls in this Option will not be appropriately remedied within the existing timescales and further time will be required for data collection and testing before this Option can be judged as a reliable (or otherwise) method for calculating regulatory capital.

The proposals include loss types, but the usefulness of loss types in measuring risk is considered doubtful. Risk events are presently under consideration by Industry groups as a more useful categorisation. Near misses should not be included in the charge as there is no objective way of consistently identifying and measuring such losses across the industry.

13.7 Timing issues

There is insufficient time remaining for the regulators and Industry to complete the proposals within existing timescales. In particular the IMA approach (Option 3) has a number of outstanding challenges, which industry groups and the regulators are now focussed on. For example, it is not clear how loss data is to be compiled in a way that will satisfy the regulators.

In order to deliver a more risk sensitive advanced approach it will be necessary to extend the development and implementation time for the IMA approach. The proposals (and EU Directive) should be sufficiently flexible to allow for continuing development of a more advanced approach over the next 18-24 months. Similarly the development of an Option 4 approach should be built into the regulation (and EU Directive) to allow for continuing development and implementation of more risk sensitive approaches as the operational risk discipline matures rather than by having to restart the regulatory/legislative process from scratch.

If the existing timescales are kept (sign off to the proposals by the end of 2001) the alternatives will be to either scale back on an advanced approach or deliver a rushed and potentially flawed methodology, which the Industry will have to live with.

A “phased development approach” for Option 3 and 4 would also allow time for the industry to consider whether the development of alternative advanced approaches would provide greater risk sensitivity.

13.8 Qualitative criteria

Further definition around these criteria will be necessary for them to be meaningful. The Sound Practices Paper will hopefully provide this clarity once developed.

13.9 Pillar III market discipline

We support the disclosure of information that is necessary to enable users of financial statements understand the results and financial position of the company. Therefore, we support the disclosure of risk management techniques employed and the regulatory risk capital charge used by a bank. We have concerns that the disclosure of operational loss data could result in lengthy lists of relatively small items. This would prove counter productive since key information could be lost in the detail. Therefore, we suggest that consideration is given to targeting disclosures on significant operational losses and to ensuring that the disclosure is relevant and understandable. This point is further developed under section 17 below.

14 Impact on asset managers: case study - Barclays Global Investors

The following case study has been undertaken by BGI[2] and relates to the proposals on operational risk as they affect asset managers.

14.1 Recognise low risk of process-driven investment

Asset managers are far from homogeneous. In terms of operational risk, the key difference is between process-driven and traditional investors. This difference should be reflected in different capital requirements.

Process-driven investing, whether indexed or active, is quantitative and systematic. It uses models and well-defined procedures to produce consistent results. Rather than relying on a fund manager's discretion or a trader's intuition, process-driven investing uses procedures that have been rigorously tested before being put into use. Once approved, the process is applied repeatedly and consistently. As a result error rates and operational risk are low.

Setting lower capital requirements for operational risk for process-driven investors would reward those asset managers who adopt a highly risk-controlled approach to investing.

14.2 Carry out more research

The science of operational risk is immature. We would welcome the opportunity to work with the Committee and local regulators to carry out further research to identify accurate risk indicators.

The Committee has proposed using assets under management (AUM) for the standardised approach. This choice appears to have been driven by simplicity rather than utility. We assume it is based on an assumption that AUM is an accurate indicator of operational risk. But this is not the case. We have internal and external evidence to show that AUM has little relationship to operational risk.

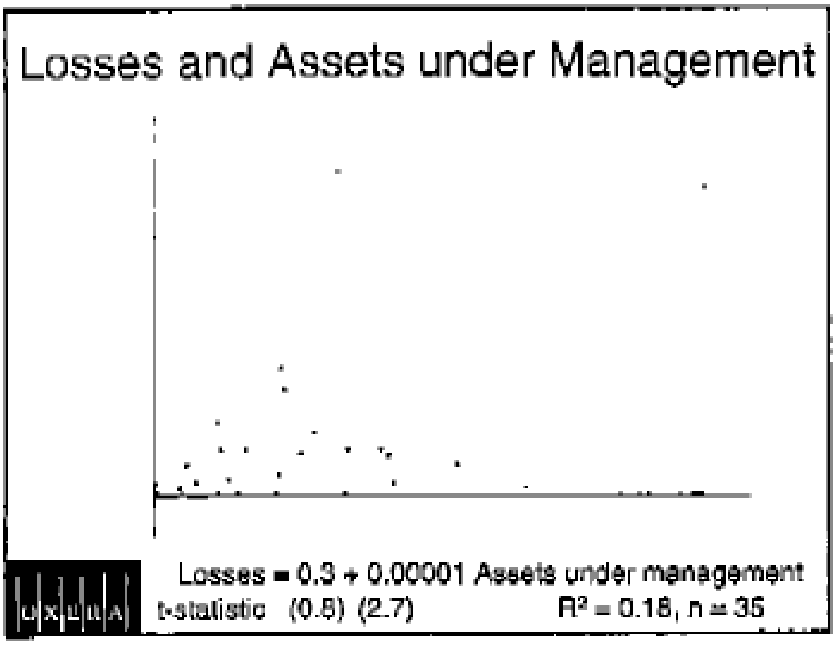
Barclays Global Investors' internal evidence shows that our losses from operating errors have remained roughly constant while our assets under management have grown substantially each year. This reflects our investment in systems, people and process as we have grown.

BGI has also worked closely with various industry trade associations and in particular supports the RMA submission on stocklending.

[2] Barclays Global Investors is one of the world's largest investment managers and the world's largest provider of process-driven investment strategies. These include indexing, quantitative active and asset allocation strategies. We manage more than $800 billion in assets for over 1,900 clients in 37 countries around the world. We also run more than 1,500 funds and track over 200 indices globally.

The external evidence is from OXERA[3], which found little relationship between AUM and operating losses for its sample of European asset managers. (See below.) It follows that AUM should be replaced as a risk indicator. More research is required to find a replacement.

AUM – a weak proxy for operating risk across managers



Source: OXERA

14.3 Reduce the basic indicator

The proposed level of charge is disproportionate to the level of risk for the asset management industry. Therefore for example, at the flat rate of 30% of gross revenue Barclays Global Investors would be required to set aside more than three times our current capital requirements and more than 100 years of operating losses. The costs would have to be passed to clients, putting up the cost of pension funds, mutual funds and other forms of investing. It is not clear that our clients would benefit in terms of reduced risk. The likelihood is that clients will switch to lower charge entities not covered within the rules and will be afforded no protection.

14.4 Introduce a cap

Assuming the standardised indicator continues to be based on AUM (despite the lack of correlation with operational risk), the Committee should adopt a sliding scale and a cap.

The scale could work in various ways. This could be set based upon a sliding scale dependant upon size but with a lower level for process-driven investors than for others.

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[3] Risk and Regulation in European Asset Management: is there a role for Capital Requirements? By Professor Julian Franks and Professor Colin Mayer and Oxford Economic Research Associates Ltd, commissioned by the European asset management association, January 2001. OXERA is an independent UK-based firm of consultants, providing economic advice to business, industry and Government.

Without a cap, the standardised approach risks being just as disproportionate as the basic indicator. Even at a basic level of say US$50m the cap would represent 25 years of operating losses.

Depending upon the level of sophistication sought, the cap could be set at a flat rate or based upon a log scale or some other basis reflecting industry experience of loss. We would be pleased to work with the Committee on the development of an appropriate basis.

14.5 Exclude protected assets

Asset managers do not usually hold clients' assets themselves; the assets are custodied separately. This means that if an asset manager fails, its clients' assets are secure. As a result the risks presented by asset managers are both different from and far less than those presented by banks.

Where custody is outsourced to a separate entity, the assets involved should be excluded from the calculation for capital requirements. This would avoid double counting.

As well as separate custody, asset management clients enjoy a number of other protections. For example, many funds have trustees who have fiduciary responsibilities to investors. Some funds have separate boards that also offer independent protection for clients. Yet others employ independent actuaries. Assets subject to these kinds of protection should also be excluded from the calculation for operational risk capital.

Further, asset managers already make a number of reports on their internal controls (and operational risk). These reports include SAS 70 in the US and FRAG 21 in the UK. These reports are signed off by external auditors. In addition some regulators already make risk assessments of regulated firms. It is not clear that the proposals would add value to these assessments.

14.6 Consider competitive effects

If implemented, the proposals would put banking-owned asset managers at a disadvantage to non banking-owned firms. (The EU proposals would additionally put EU asset managers at a disadvantage to non-EU asset managers.) We believe this is an unintended consequence of the Committee's proposals. (It could lead to some asset managers moving their operations outside the EU with a consequential economic loss to EU financial centres.)

The proposals represent a particularly acute danger to indexation, which is bringing large benefits in terms of low-priced, low-risk investments to investors throughout the world, whether through pension funds, mutual funds or other vehicles. Given the low fees indexers charge, any cost differential is crucial. Note that many of the largest indexers in the world are not owned by banks (and are based outside the EU). The competitive effects would result in an uneven playing field.

15 Interest rate risk in the banking book

Overall, we support the approach, but with some reservations:

- In Pillar II, we are concerned that the supervisory review process may become onerous. We would need to agree with the FSA the type and frequency of the supervisory information they would look for.

- Also under Pillar II, national supervisors may differ in the extent to which they use their discretion to use a lower threshold for imposing capital requirement on banks. This may prejudice the aim of having a level playing field.

- Under Pillar III, we feel that the proposed disclosures err towards excessive detail. Moreover, It is not clear what will be the required frequency for interest rate risk disclosures – we would recommend that annual frequency, or at least no more than half yearly, is acceptable for banks whose risk profile is low and stable. Our main concern, however, is to ensure consistency between the increasing number of disclosure standards issued by regulatory and accounting bodies. We welcome, and support, the Basel Committee's intention to promote such consistency.

15.1 Effect on banks

Since the approach is based on banks' internal systems, there is scope for banks to incorporate new risk management techniques. Banks with existing processes for managing interest rate risk in their banking books should have no problem in implementing the approach. However, they will need to review the extent to which their existing practices:

- Enable them to calculate the impact of the standardised interest rate shock.

- Comply with the 15 principles.

- Satisfy the disclosure requirements.

15.2 Does it give the right result and incentives?

The approach supports good risk management practices. In particular, it provides an incentive for banks to have adequate risk management policies and procedures for the measurement, monitoring and control of risk. It will also result in a capital charge for banks with material amounts of interest rate risk in their banking books.

However, the scope for national supervisors to use differing thresholds for making a capital charge may compromise the level playing field in respect of this risk.

Barclays policy is that market risk is concentrated in Barclays Capital, with little risk being taken in the banking businesses. We believe that the outlier test (i.e. the sensitivity to the standardised shocks) will produce the right result in relation to this policy.

16 Environmental risk

16.1 Nature of liability is unclear

In the section regarding the operational requirements surrounding Loss Given Default and Exposure at Default for Commercial Real Estate to be eligible each of a number of requirements must be met, including:

- The bank should monitor and manage the risk of environmental liability arising in respect of the collateral, such as the presence of toxic material on a property.

What this doesn't detail is the nature of the liability. This may be the liability to the operator/owner to pay the costs of restoring the site. If the cost were to outweigh the value attached to the land as security, this would extinguish the security value, though this would effectively cap the extent of the liability.

If however, the liability is intended to extend to the bank incurring the liability if it were to become mortgagee in possession, the liability facing the bank could exceed both the previously assumed value of the land, and could exceed the level of exposure marked to the customer in question. Clearly this scenario is the more onerous as the magnitude of the liability cannot be quantified.

16.2 The case for independent specialists

We envisage no problem in implementing the approach within the UK where we have a procedure for screening environmental status of commercial land offered as security. The Barclays procedure calls for commercial land being offered as security, where a value in excess of £100k is anticipated, to have a Land Use Questionnaire (LUQ) form completed by the valuer at the same time as the land is valued for security purposes.

These LUQs are then forwarded to our central Environmental Risk Management Unit where the responses are assessed to determine whether there are any environmental concerns associated with the site in question. In the majority of cases this initial questionnaire is sufficient to provide adequate comfort. In the remaining cases further enquiry will be required, with information either from the current owner/occupier, or from specialist investigation. With the benefit of these findings, the valuer will be asked to reflect these environmental considerations in the valuation, or if the land cannot be regarded as “approved” security, a nil valuation will be recorded on the security records.

The cost/benefit analysis of developing the same standards globally across all Barclays operations is questionable where levels of materiality must be considered.

16.3 Level playing field concerns

The approach supports good risk management practices for the monitoring and control of environmental risk and recognises a proactive control environment as adopted within Barclays.

However, scope exists for a more reactive approach, relying upon the lending manager to consider whether there may be environmental degradation of any given property. If the lending manager has concerns they would be likely to commission a specialist environmental report, though this approach lacks consistency between lending managers, and represents a source of conflict of interests between business development and risk management objectives.

National supervisors may use different thresholds for determining the adequacy of compliance. This may compromise the level playing field in respect of this risk. Incentives should be given where Banks are able to demonstrate a robust and independent control mechanism.

17 Pillar II

17.1 Can Regulators achieve consistency?

We see the approach put forward as a positive step that we would encourage since it is based on close liaison between banks and their regulators, developing mutual understanding of markets and the environment in which they operate. The approach closely resembles the existing supervisory process employed by the FSA, which in our view works very well. In principle therefore we support the proposals put forward.

Timely and effective supervisory intervention are key to the long term stability of the industry and in principle is a good thing. However, the scope for national supervisors to use differing thresholds and differing interpretations is a source of competitive concern. Whilst this approach is well developed in the US and the UK, it is less well developed elsewhere and there must be a real risk that banks in these two jurisdictions could be penalised whilst regulators elsewhere are learning to use the flexibility available to them under Pillar II.

There is also a growing concern that where a definitive outcome is not possible under Pillar I the tendency is to assume the outcome is best left to Pillar II. An example of this is the potential for arbitrage by some firms constantly rolling forward short-term exposures, thereby achieving favourable capital treatment. The BBA has in its response suggested that the regulators should look for evidence of abuse under Pillar II and apply commensurate sanctions – akin to the three-strike approach for securitisation. This would avoid the need to create multiple conditions around the definition and treatment of short-term facilities, which could merely obstruct banks' ability to do business and increase costs.

In summary, therefore it is important that Pillar II is implemented in a transparent and consistent manner across the various jurisdictions. In particular, clear principles should be established under which the supervisors in each jurisdiction would be required to operate when exercising their powers under Pillar II. We support the view put forward by the BBA that supervisors should be required to disclose national policy in this regard.

18 Pillar III Market Discipline – appropriate disclosure

18.1 Summary of approach

The framework of the new Accord contains three complementary Pillars to banking supervision which seek to balance capital regulation, supervisory review and market discipline. Market discipline will work effectively if market participants have access to relevant, reliable and timely information which enables them to make decisions which foster a stable and efficient financial system. This information includes disclosures about the bank's capital, policy and practices with regard to exposures to credit risk market risk, interest rate risk and operational risk and capital adequacy.

18.2 Evaluation of approach

We agree that market discipline has the potential to reinforce capital regulation and other supervisory efforts. We also agree that more rigorous capital requirements and supervision will be necessary for those banks, such as unlisted banks or banks listed on exchanges with poor or illiquid markets, where market discipline would be less effective. An appropriate level of timely disclosure must be beneficial for well run institutions, investors and depositors and the capital markets generally provided that the information disclosed is useful to shareholders and other market participants. However, we have concerns that the proposed disclosures may not achieve this and could place a disproportionate burden on banks as well as users of financial information. The quantity and detail of the disclosures and their focus on regulatory capital requirements may have little relevance to users of the financial statements. The information needs of users, particularly shareholders and their representatives, who are the main users of published financial statements, must be paramount in developing relevant disclosures that will meet the objectives of Pillar III.

The paper does not establish whether the Basel Committee has consulted potential users of the information to ascertain whether and how they would use the information. We believe that users, including potential counterparties, will have difficulty making valid comparisons between different banks since they will have different approaches to determining regulatory capital and will use different models. This difficulty is compounded by the fact that the availability of information will not be consistent between different jurisdictions and between listed and unlisted banks. It will be important to ensure a level playing field in transparency, but it is difficult to see how the Basel Committee can achieve this given the differences in listing in different jurisdictions. However, provided that a bank uses a consistent approach each year, it may be possible for users to draw conclusions about an individual bank over time. We strongly recommend that the Basel Committee hold discussions with potential user groups to determine their requirements. The Basel Committee should also not underestimate the need for market participants to develop an understanding of the information that will be disclosed in future. It will be in the interests of the banks, as well as the supervisors, to ensure that the disclosures are comprehensible to users.

In addition to the information requirements of users, other considerations must be taken into account to develop an effective framework for transparency. Practically, since the disclosures are likely to contain price sensitive information, they must be made within the context of the published financial statements. This has important implications for how the disclosure should be developed as well as for its frequency and the audit or other assurance to be provided on it.

Therefore, we consider that the only way in which the Pillar III proposals can be implemented effectively is by the Basel Committee working with the IASB, particularly the Steering Committee charged with revising IAS 30. This will ensure that both parties produce mutually consistent disclosure requirements.

18.3 Scope for future developments

Overly rigid and detailed disclosure into the methodologies and the results of internal models can serve to discourage improvements to methodologies since banks may be reluctant to disclose the reasons for and affect of the change in methodology even it results in a clear improvement. While the policies and practices with regard to risks should be disclosed, care should be taken to ensure that the detailed requirements do not serve to impede future development.

The disclosure requirements should be able to readily adapt to developments in financial reporting generally and to the needs of the market.

Unless the Basel Committee intends to have an ongoing committee reviewing disclosure, detailed disclosure requirements developed by Basel will be less able to do this than standards produced by the IASB, which can be subject, if necessary, to interpretation by the Standing Interpretations Committee (SIC).

18.4 Practical issues

There are concerns about the quantity and level of detail of the proposed disclosures as well as their frequency and enforcement. These concerns can best be addressed within the context of international accounting standards and reinforce the need for the Basel Committee to work with the IASB and the auditing profession.

There will be considerable costs to preparers in providing the information and to users in understanding and forming judgements. In addition to ensuring that the information is relevant, a cost and benefit analysis should be performed to ensure that the proposals are cost effective. Accounting standards are developed in consultation with preparers, users, auditors and regulators and this system will best be able to balance cost effectiveness.

In some areas the proposals duplicate disclosure already required by current accounting practices or are similar but not identical to existing disclosures. The Basel Committee should use existing practice as much as possible and only require additional disclosure where this is considered necessary to implement Pillar III.

While we support the same annual report being used for reporting to shareholders as well as for regulatory purposes, it should be recognised that financial accounting requirements and regulatory requirements may not be identical. The disclosures should include provision for the statutory reserves to be reconciled to the regulatory capital.

The issue of providing information more frequently than at the year-end needs further consideration. Even for internationally active banks, it should be unnecessary to disclose relatively

static information, such as the structure of the risk management functions and strategies for managing and controlling risk. In addition to determining core and supplementary disclosures, Basel, in conjunction with the IASB, should identify what types of disclosure should be given more frequently. The implications of more frequent reporting and of electronic reporting also need further consideration to ensure that the proposals fit with financial reporting systems in different jurisdictions.

While the supervisors can no doubt use “moral suasion” to enforce disclosure, by far the best method of enforcement would be to rely on the methods of enforcement used in different countries for compliance with accounting standards. This further strengthens the argument for the Basel Committee to work with the IASB so that, for example, the EU enforcement mechanisms that are being developed for 2005 can help ensure consistent practice.

Greater consideration needs to be given to the audit implications of the additional disclosure with regard to both the types and frequency of the proposed disclosures. Basel and the IAS 30 Steering Committee must hold discussions with auditors’ representatives, including IFAC, to consider what forms of assurance can best be provided on the disclosures.

Electronic reporting is at an early stage. It would be preferable to await developments so that the proposals for more frequent electronic reporting can be put in the context of future financial reporting developments

18.5 Impact on banking industry

The need to make disclosures about risk management policies and practices should encourage better standards of risk management.

Provided that commercially sensitive information is not disclosed and that there is a level playing field with regard to the quantity and frequency of disclosure, the proposals are unlikely to distort competition.

Unless users information needs are met and they are able to understand and properly analyse the information presented, there is the risk that the disclosure may be mistrusted risking reduced rather than greater confidence in the banking sector.

18.6 Impact on Barclays

Potentially material depending upon the level of flexibility allowed. We also have concerns that the disclosure requirements are too intrusive and not particularly relevant for certain of our businesses. The level of risk management control and autonomy of the risk management function are important mitigants that recognise effective risk management is more than just a statistical process.

It is more important to ensure appropriate disclosure, in line with evolving and improving internal risk management practices and compliant with International Accounting standards, is developed. This would better meet the objectives of Pillar III than disclosures that are fixed at a particular time and based on a fixed methodology.

18.7 Impact on Regulators

We are mindful of the fact that in some jurisdictions the increased regulatory burden created by Pillar III will place an undue burden on regulators and will create a strain in resource allocation to make the judgements needed. We are aware of a number of initiatives in this area but are happy to contribute to the process.

19 Level playing field concerns

19.1 Within the EU

As noted above under Pillar II comments, the supervisory review approach is well developed in the UK but not in the rest of the EU. Moreover, supervisors elsewhere in the EU claim they do not have legislative authority to impose capital requirements above the minimum. Every opportunity should be taken to ensure that supervisory review should be backed by commitment and legal authority to impose capital requirements above the minimum in other EU Member States whenever the risks warrant it because failure to do so would maintain a serious competitive distortion within Europe.

19.2 Timing issues

There is a risk that implementation of the new Basel Accord can be achieved sooner outside the EU than within the EU because of the time it may take to complete the adoption and implementation of the necessary EU Directive (or Directives).

Non EU regulators will then have the opportunity to apply the new Basel rules before those in the EU. This has the potential to cause competitive distortions between regulatory regimes during the period after Basel is implemented but before the EU Directive is.

19.3 Flexibility issues

The nature of the traditional EU legislative approach has been relatively slow and inflexible. Proposals put forward by the Lamfalussy Wise Men's Group (with specific reference to securities markets but of relevance here: the development of a capacity to enable "technical" implementing measures to be updated rapidly without going through the complete process required for primary legislation) should go some way to addressing this but exactly when or how these proposals will be adopted is not yet clear because of a serious dispute/power struggle between the European Parliament on the one hand and the Commission and Council of Ministers on the other. There is, therefore, the possibility that EU legislation will be less quick and flexible when it comes to accommodating changes in market/industry/accounting practice when compared with non-EU approaches. Therefore, this second time lag effect could also be a source of continuing/recurrent uneven treatment of similar institutions based in different jurisdictions.

19.4 Coverage issues

The EU Directive will apply to all financial institutions (credit institutions, investment banks and asset managers) where Basel only applies to banks. Therefore within the EU some institutions such as asset management firms and securities houses will be covered and will be subject to capital charges thus putting them at a disadvantage when compared to their non-EU non-bank

competitors. (Of particular concern are investment banks and non-bank asset managers in the USA who will not suffer a charge.)

19.5 Application issues

The complexity of the proposals and the extent of reliance that is to be placed on national supervisors mean that while there will be one set of rules, inevitably how the game is played will be different. This is important where financial institutions are competing cross border as this will inhibit and distort natural supply and demand principles. In particular where a local regulator is unduly protective the situation will arise that the same transaction will attract different capital treatment.

The principal areas that have the potential to lead to such distortion are:

- Interest Rate Risk in the Banking Book – different supervisory thresholds.
- Environmental Risk – different criteria.
- Disclosure – critical for an open market treatment.
- Project Finance – different interpretation of which assets and the basis of measurement.
- Credit Risk.
- Operational Risk – proposals largely undeveloped and remain subjective, inconsistent application of a Supervisory Review between Regulators.
- Materiality – markets are different size.

Also, within the UK the supervisor/regulator has the power to require the holding of capital in excess of the minimum 8% whereas this power does not exist elsewhere. Without other regulators having such a power UK institutions may be placed at a disadvantage if they are obliged to hold above the minimum where comparable institutions elsewhere are not.

20 Appendix I Issues arising from Quantitative Impact Study (QIS)

Note – in view of the timing of this exercise the QIS results and learning have not fully factored in. We will provide separate comment with our QIS submission.

20.1 Credit risk

Based on the submissions thus far and the queries that have been raised over the past few weeks, the following issues have emerged which have implications for systems development and business processes.

- There have been numerous queries on definitions for retail exposures and the way amounts should be reported, for example derivatives, stock borrowing, and repo products. Hence, detailed instructions will be essential.

- The application of collateral and netting agreements to derivative products suggests that a significant increase in regulatory capital could result compared with the current capital requirements.

- The approach should reflect the way charges are taken and not oblige changes for limited or unclear benefit. With respect to Unsecured Retail lending a “low” capital requirement is produced under the standard approach compared to the IRB calculation that is against our expectations. This is due to internal LGD estimates to take into account the potential for default on un-drawn exposures. However, for the standard approach the capital requirement is based purely on drawn exposure, i.e. no LGD measure. Should the standard approach include a proportion for undrawn exposures?

- In completing the Retail Unsecured Lending portion of the book, a number of differences between the internal methodology and Basel rules have transpired with the internal methodology being applied.

- There are instances where it has not been possible to complete all sections of the return where we do not have a detailed database of loss statistics, and what data exists may be spread across a number of systems. Consequently, adoption of the IRB approach has significant implications in terms of data capture, internal processes and systems development, as well as cost.

- Segments of the Barclays portfolio will not be included in the consolidated QIS return as either methodologies are being developed or information is not available at sufficiently granular level to calculate items such as EAD, PD, LGD for IRB approaches. In other cases, portfolio level estimates, for example, for EAD have been used, as it is not possible to undertake calculations at a more granular level.

20.2 Operational risk

- Part A of the QIS has already highlighted challenges in mapping a Business against standard businesslines

- Part B of the QIS has only just been issued, but already it is clear that the level of detail being requested far exceeds the realistic capabilities to provide the data.

- It is believed this will be a common concern across the industry.

21 Appendix II Working Groups where Barclays have been represented

General Issues

BBA Risk & Regulatory Capital Advisory Panel
ISDA Capital Accord Steering Committee
FSA Capital Accord Advisory Panel
IIF Capital Accord Steering Committee

Credit Risk

BBA/ISDA Credit Risk Panel
BBA/ISDA Overall Calibration
BBA/ISDA Retail Credit Risk
BBA/ISDA Credit Risk Operational Requirements
BBA/ISDA Securitisation
BBA/ISDA Project Finance Committee
BBA/ISDA Risk Managers Association on Stock Lending
BBA/ISDA Credit Risk Mitigation
LMA

Operational Risk

BBA/ISDA Operational risk

Pillar II

Supervision and Compliance

Pillar III

Financial Reporting Advisory Panel

22 Appendix III Additional points for clarification

Pillar I : Standardised approach

- **Claims on Sovereigns, Banks and Corporates (23,32,35)** : Why are unrated credits weighted at 100% when B- and below at 150%?

- **Claims on Public Sector Entities (27)** : Definition of PSEs required. Is this the same as the current list providing weightings for UK PSEs?

- **Claims on Banks (29)** : Two options are proposed for regulators. Clarification is required as to which option is intended to be used. Option 2 is preferable as it recognises the short term nature of these facilities although 3 months is a reduction on current effective short term definition which is 12 months (see lobby point on Trade Finance).

- **Physical collateral (37)** : Residential property is weighted at 50% whereas commercial property is 100% (or 50% in exceptional circumstances). How do we treat mixed commercial and residential property (i.e. a retail unit with a residential flat above)?

- **Physical collateral (38)** : Definition is required of “exceptional circumstances” that need to be in place before commercial real estate can receive a preferential weighting for those portions below 50% LTV.

- **Physical collateral (38)** : The term “Mortgage Lending Value – MLV” is not used within the UK. Do the FSA view “Open Market Value – OMV” as an acceptable proxy for MLV within the UK?

- **Credit Risk Mitigation (77)** : Definition required of “main index” and “recognised exchange” for equities to qualify as eligible collateral.

- **Risk Weights (131)** : Definition required of the materiality thresholds below which no payment would be made under a guarantee / credit protection, in the event of loss.

Pillar I : IRB – Rules for corporate exposures

- **Collateral haircuts (206)** : Definition of a “core market participant” required, for whom a zero haircut may be applied.

- **Measurement of Corporate exposures (230)** : Guidance required on how exposure is measured for lease and lease purchase transactions within Asset Finance.

- **Meaningful differentiation of risk (242)** : Confirmation that the requirement for only 30% of gross exposures to fall within a particular grade will be applied across the book rather than at industry specific or lower levels. At low levels, our grade differentiation may not be spread to this extent.

- **Oversight of the ratings system (249)** : Internal reporting including the comparison of actual versus expected loss adds little value on a monthly basis due to month on month volatility of actual defaults. This should be reduced to at least quarterly.

- **Oversight of the ratings system (251)** : Certain information contained within KMV Credit Monitor is withheld to protect the intellectual capital invested. Will the FSA accept the use of these market-leading tools?

- **Oversight of the ratings system (251.3)** : KMV Credit Monitor reflects market expectation on performance and is therefore not cyclically neutral. Will this impact on the FSA acceptance of their model?

- **Oversight of the ratings system (254)** : If the FSA require an external audit of our rating assignment process and estimation of loss characteristics, is this to be undertaken by external auditors?

- **Criteria and orientation of rating system (265.4)** : There is a need to amend the definition of "audited financial statements" to reflect the UK proposed Accounting framework changes to when a full audit is required (intention is for full audit to only apply if T/O > £4.8m and NTAs over £2.4m).

- **Eligible real estate collateral (312)** : Definitions required as to what constitutes Small and Medium sized corporate entities and additionally, are larger entities excluded from pledging this type of collateral?

- **Commercial real estate (313.1)** : The definition within the document appears to exclude bridging finance and property investment. Is this the intention and if so, are they likely to fit within Project Finance?

- **Commercial real estate (313.2)** : The definition within the document would appear to exclude operational property (e.g. hotels, nursing homes, pubs, restaurants, golf courses) where the performance of the business does have a material effect on the value of the property. Is the intention for us to then value on vacant possession as opposed to assessment of Open Market Value (OMV) as a fully equipped operational entity?

- **Commercial real estate (314)** : Definitions of "raw land" and "income producing / investment CRE" are required.

- **Residential Real Estate (315)** : The definitions appear to encourage lending secured by directors/owners RRE as opposed to business assets in certain circumstances (operating businesses, property investment). Is this the intention, as it appears to be an unsatisfactory precedent?

- **Operating requirements for collateral (317)** : Confirmation that the requirement for a process of timely collateral realisation does not impact on the appropriate recovery strategy agreed, which may mean a longer-term view is taken given property market conditions and trends.

- **Operating requirements for collateral (320)** : Clarification regarding the treatment of pari - passu security in multi-banked situations as no recognition is granted for second or subsequent charges.

- **Operating requirements for collateral (321.1 & 321.2 & Disclosure 655)** : Is there a requirement to implement policies setting out maximum LTV proportions for all lendings? Customers and facilities have different risk characteristics and so a one size fits all approach, as implied, would not be appropriate across the portfolio.

- **Minimum requirements for EAD estimation (381 & Retail 469)** : It is unclear whether subjective and judgmental analysis for EAD estimation is required in addition to the use of a statistical model?

Pillar I : IRB – Rules for retail exposures

- **Segmentation by vintage (447)** : The proposal is to segment by vintage (the time that the transaction was put on books) with a maximum length of vintage period of 12 months. Clarification is required on the treatment of longer-term facilities. Additionally, the use of segmenting facilities this way as a material indicator of risk is unclear.

- **Additional segmentation techniques (448)** : Clarification should be sought as to the tangible capital benefit of using additional retail segments detailed.

- **Exposures within a segment (451)** : Definition required of “no single risk segment should include an undue concentration of banks total retail exposure”. Is this 30% as per Corporate (as detailed in 242)?

- **Estimation of EAD & PD/LGD or EL (463)** : Confirmation required that overdrafts and Sales Financing facilities would be included within this definition of “products with uncertain future exposures”.

Pillar III : Market discipline

- **Supplementary disclosures (650c6)** : The disclosure of averaged days overdue is unlikely to be meaningful because it would be calculated across a wide spectrum of customers and facilities.

- **Quantitative disclosures (652c2)** : Definition is required of “fully worked out” with respect to losses.

- **Recommended quantitative disclosures (658.2)** : Definition is required for “annual recovery amounts from collateralised transactions”.