FCE Bank plc Response to the Basel Committee on Banking Supervision

Institution Submitting Response

FCE Bank plc (FCE) is an institution authorised under the Banking Act 1987, based in the United Kingdom and supervised by the Financial Services Authority. FCE's ultimate parent company is Ford Motor Company in the United States and hence its primary business is in automotive financing for Ford (and affiliated companies), franchised dealers, fleet/business and retail customers. Operating under various trading styles (e.g. Ford Credit, Jaguar Financial Services, Land Rover Financial Services and Mazda Bank), FCE services 20 markets around Europe via 18 2BCD branches, plus 17 subsidiary companies.

The assets of FCE are approximately £13billion (Euro21billion).

General Comments on the New Capital Accord

The new Accord is considered to be a positive step in establishing greater differentiation between the regulatory capital requirements of high and low risk institutions. However, the sheer complexity of the new Accord does create significant concerns, including:

Compliance Costs

Complying with the new Accord will probably require substantial incremental investment, especially in relation to credit risk and operational risk systems/resources. Ongoing compliance costs will be increased in various areas, including risk management and disclosure.

Competitive Neutrality

The variations in current legislative and regulatory frameworks around Europe (and globally) already result in a playing field that is far from level. It is possible that the new Accord might serve to accentuate some of the unevenness of the playing field, due to the substantial differences in the resources, skills and approaches of the regulators around Europe. Inevitably, the more complex the set of rules, the more open they become to interpretation and/or enforcement according to local priorities. This could lead to capital flows and business operations migrating to jurisdictions that are considered to be more favourable in the manner of implementation of the Accord.

In addition, many aspects of the new Accord appear to favour large banks. This could result in the Accord proving to be anti-competitive when fully implemented, placing smaller/medium sized institutions at a competitive disadvantage, discouraging new market entrants or even, inadvertently, providing incentives for authorised institutions to switch into unregulated sectors.

Shifts in the Economic Cycle

Whilst the recognition of different levels of risk in banks via the amount of regulatory capital is desirable, this is a measure that will need to be used with extremely good supervisory judgement if the accentuation of economic downturns is to be avoided. For example, if the economic cycle moved into a mildly recessionary direction, there could be a trend for banks to significantly harden credit decisioning in order to avoid upward revisions to regulatory capital. This in turn would reduce corporate funding capacity and could precipitate a deepening and/or lengthening of the economic downturn.

Data Definitions/Standards

The new Accord incorporates data definitions/standards that are primarily geared to banking institutions involved in unsecured lending, whereas there is significant variation by industry sector. Consequently, within the Internal Ratings-Based (IRB) approach in Pillar 1, the definition of loss given default (LGD) does not sufficiently take into account of the security held with asset-backed financing. Similarly, provisioning policies for banks operating in different sectors will reflect the level of security held, with the result that not all banks commence provisioning at 90 days' delinquency.

Disclosure Requirements

Whilst it is recognised that reasonable levels of public disclosure are appropriate to meet the needs of shareholders, investors and regulators, the requirements within Pillar 3 of the Accord appear to be over-exhaustive. Not only do the requirements cover areas that are commercially sensitive but they also risk putting complex data into the public domain that, on a stand-alone basis, could be open to significant misinterpretation.

Implementation Issues

Although the outline timetable for implementation of the new Accord in 2004 is included within the proposals, there are crucial points that need to be covered before this could be considered as achievable. For instance, how will institutions transition from existing regulatory capital requirements to those required under the new Accord; if all organisations had to change at a set point in time, this could create massive turbulence in the capital markets. Hence, the implementation plan will need to incorporate some form of transitional approach so that the migration (upwards or downwards) can proceed in an orderly fashion. Similarly, the systems implications for IRB and operational risk will necessitate sufficient lead time to avoid over-concentration on Basel-related development at the expense of customer/shareholder priorities.

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Response to Consultative Document: 'The Standardised Approach to Credit Risk'

Comments are referenced relative to the indexing within the Consultative Document.

A. The Risk Weights in the Standardised Approach

A.1. INDIVIDUAL CLAIMS

A.1(i) Para's 10/19
Sovereign risk weights
The Committee's proposals would appear reasonable. (Note: The Committee = the Basel Committee)

A.1(ii) Para's 20/21
Risk weights for Non-Central Government Public Sector Entities (PSE's).
FCE holds a de minimis level of deposits from PSE's, with no anticipated increase. In some markets FCE does provide financing to PSE's. The principles relating to the risk weighting outlined in para's 20/21 would appear reasonable.

A.1(iii) Paras 22/23
Risk weights for multilateral development banks (MDB's).
FCE holds deposits from MDB's and would support the proposal to retain the 0% risk weighting for MDB's that meet the Committee's criteria.

A.1(iv) Paras 24/25
Risk weights for banks.
Option 1 would be neutral versus FCE's current position and hence is considered reasonable and the preferred Option.

A.1(iv) Para 26
Risk weights for banks.
Option 2 would have an adverse impact on a significant proportion of FCE's funding and would appear to disproportionately favour larger banks which could have an anti-competitive effect in the market place. This issue also arises due to being the 'captive' finance company/bank, hence FCE's credit assessment is directly linked to its manufacturing parent. However, FCE is required to meet all the regulatory obligations related to being a bank (which provides increased protection for depositors and investors) but is assessed in the same manner as an ordinary 'corporate' for risk weighting purposes.

A.1(v) Paras 31/32
Risk weights for securities firms.
FCE does not currently have exposures to securities firms but the Committee's proposals would appear reasonable.

A.1(vi) Paras 33/39
Risk weights for corporates.
This would not generally be applicable to FCE. However, the proposals would appear to potentially provide well-rated corporates with similar funding cost benefits as banks but without comparable regulatory obligations/costs. This situation could lead to corporates gaining excessive competitive advantage in the market place and/or some banks revoking their authorisation to concentrate on unregulated activities.

A.1(vii) Para 40
Risk weights for retail assets.
As mentioned above, FCE primarily finances automotive products for dealers, businesses and retail customers. Virtually all our financing agreements are asset-backed with a product that has predictable levels of depreciation and a variety of disposal channels. Consequently, FCE strongly supports the eligibility of asset-backed retail financing for risk weighting benefits. However, the potential limitation of risk weights only to institutions applying the Internal Ratings-Based (IRB) Approach (as opposed to including institutions applying the Standardised Approach or the Foundation IRB Approach) would again appear to provide larger institutions with excessive competitive advantage which is not supported by asset quality.
FCE would be prepared to liaise with the Committee or the FSA to provide additional background on this extremely important issue.

A.1(viii) Para 41
Risk weights of claims secured against residential property.
FCE is not currently operating in the residential property lending market but considers the Committee's proposals reasonable.

A.1(ix) Para 42
Risk weights of claims secured on commercial real estate.
FCE does provide loans on commercial real estate in several, but not all, European markets and does not agree with the Committee's proposals to place a 100% risk weight. The experience over many years has been comparable to residential loans, i.e. when commercial property disposals arising from customer defaults on real estate loans result in the generation of sufficient funds to clear the debt (in most cases). Consequently, FCE would support common treatment of risk weights (50%) for residential property and commercial real estate.

A.1(x) Para's 43/44
Higher risk categories
Provisioning policies to account for unexpected losses vary by institution and business sectors. FCE operates in asset-backed financing, which provides a significant mitigant against unexpected losses and portfolio performance provides statistical data to determine appropriate provisioning. For this reason, provisioning is not automatically undertaken by FCE at the point that an account is 90 days' delinquent; conversely, if account performance is considered to be sufficiently high risk, provisioning will happen at an earlier stage. Hence, FCE would strongly object to a standardisation of all accounts being provisioned at 90 days' delinquency.

A.1(xi) Para's 46
Other assets – securitisation
It is not clear from the Committee's detailed proposals, which express concerns re capital adequacy and liquidity strains on an unwind, are directed towards revolving <u>credits</u> (e.g. credit cards or auto wholesale loans, where there is an ongoing obligation to fund) or just revolving <u>structures</u> (where there are ongoing sales but the receivables may be revolving or term assets). Consequently, FCE is deferring comment on this section until the Committee is able to provide additional clarification.

Please note that FCE considers that securitisation has become an important, imbedded component of the capital markets and consequently would anticipate the Committee's final proposals will ensure the stability and continuity of an active securitisation market.

A.1(xii) Para's 47/50
Off-balance sheet items
The Committee's proposals would appear reasonable.

A.1(xiii) Para's 51/52
Maturity
The Committee's proposals would appear reasonable.

<u>A.2. EXTERNAL CREDIT ASSESSMENTS</u>

A.2(i) Para's 54/55
The recognition process
FCE uses credit reports to assist in the underwriting of corporate counterparties. However, these reports are normally supplemented by internal credit evaluation processes.

A.2(ii) Para's 56/62
Eligibility criteria
The Committee's proposals would appear reasonable.

A.3. THE IMPLEMENTATION PROCESS

A.3(i) Para's 63/65
The mapping process
The Committee's proposals would appear reasonable.

A.3(ii) Para's 66/68
Multiple assessments
The Committee's proposals would appear reasonable.

A.3(iii) Para's 69/75
Issuer versus issue assessment
The Committee's proposals would appear reasonable.

B. Credit Risk Mitigation in the Standardised Approach

B.1. INTRODUCTION

B.1 Para's 76/87
Introduction
The systems implications of the Committee's proposals are yet to be fully evaluated and hence comment on this section is not ready for submission. The requirement for data retention periods is not specified within the proposals and this would need to be known to fully determine the potential impact systems structure.

In addition, the points made above in relation to risk weights on retail financing which is asset-backed would be applicable to the various approaches that the Committee is proposing and not just the advanced IRB approach.

B.2. Collateral

B.2(i) Paras 91/106
Minimum conditions
FCE would assume that these proposals do not create any increase in obligations beyond the current FSA requirements.

The blanket obligation in paragraph 100 to re-value marketable securities on a minimum frequency of daily would appear onerous for some circumstances, hence it is suggested that the paragraph is revised to incorporate some flexibility in application.

B.2(ii) Para's 107/109
The methodologies
FCE would assume that this proposal does not create any increase in obligations beyond the current FSA requirements.

B.2(iii) Para's 110/114
Eligible collateral
The Committee's proposals would appear reasonable on the basis that 'cash on deposit with the leading bank' referred to in Para 111 is retained.

B.2(iv) Para's 115/162
The comprehensive approach
This approach is complex and the applicability to an institution such as FCE has yet to be fully evaluated. At this stage the main concern would be that if the application, and related benefits, was limited to a small number of very large institutions then it could negatively impact on the competitiveness of medium sized institutions.

B.2(v) Para's 163/173
The simple approach
Within para 167, the requirement is for the collateral to be pledged for the life of the exposure. However, in practice the exact matching of individual exposures to collateral is not realistic and is achieved via a portfolio approach. Consequently, it is recommended that this paragraph is revised to reflect the acceptability of this practice.
Within para 170 (a), collateralised claims are only eligible for risk weights of less than 20% if both the exposure and the collateral are denominated in the same currency. This precludes the possibility to incorporate an appropriate 'cushion', in conjunction with appropriate monitoring practices, within collateral assessment to take account of exchange rate fluctuation. It is recommended that this paragraph is revised to include this facility.

B.3. Netting

B.3(i) Para's 174/177
On-balance sheet netting
The Committee's proposals would appear reasonable.

B.3(ii) Para 178
Off-balance sheet netting/PFE's
The Committee's proposals would appear reasonable.

B.4. Guarantees and Credit Derivatives

B.4(i) Para's 179/182
Introduction
The Committee's proposals would appear reasonable.

B.4(ii) Para's 182/193
Minimum conditions
The Committee's proposals would appear reasonable.

B.4(iii) Para 194
Operational requirements for guarantees
The Committee's proposals would appear reasonable.

B.4(iv) Para's 195/198
Operational requirements for credit derivatives
The Committee's proposals would appear reasonable.

B.4(v) Para 199
Range of eligible guarantors/protection providers
The Committee's proposals would appear reasonable.

B.4(vi) Para's 200/214
Risk weights
The Committee's proposals would appear reasonable.

B.4(vii) Para 215
Sovereign guarantees
The Committee's proposals would appear reasonable.

B.4(viii) Para's 216/218
The level of w
The Committee's proposals would appear reasonable.

B.5. Maturity Mismatches

B.5(i) Para 219
Definition of maturity
The Committee's proposals would appear reasonable

B.5(ii) Para's 221/222
Risk weights for maturity mismatches
The Committee's proposals would appear reasonable

B.6. Currency Mismatches

B.6 Para's 223/225
The Committee's proposals would appear reasonable

B.6(i) Para 226
Collateral
The Committee's proposals would appear reasonable

B.6(ii) Para 227
On-balance sheet netting
The Committee's proposals would appear reasonable

B.6(iii) Para 228
Guarantees/credit derivatives
The Committee's proposals would appear reasonable

B.7. Disclosure Requirements

B.7(i) Para's 229/230
Collateral/on-balance sheet netting
The Committee's proposals would appear reasonable

B.7(ii) Para's 231/232
Guarantees/credit derivatives
The Committee's proposals would appear reasonable