LLOYDS TSB GROUP PLC

RESPONSE TO THE CONSULTATIVE DOCUMENT

ON

THE NEW BASEL CAPITAL ACCORD

ISSUED BY THE BASEL COMMITTEE
ON BANKING SUPERVISION

31st May 2001

This paper contains specific points, which are mostly cross referenced to particular paragraphs within the Accord and a number of more general remarks, where the focus of the remark will be made clear in the content.

INTRODUCTION

Lloyds TSB recognises the extent of the work undertaken and welcomes the proposals as being directionally correct, since a bank's regulatory capital requirements should reflect its risk profile.

Some elements of the proposals do not however, in our view achieve the objectives of the Committee, and we believe that these should be adjusted accordingly.

The proposals have a strong capital markets flavour and a consequence of this is a lesser degree of attention on Retail; which consequently requires considerable further development. This is of particular importance to banks with a retail focus, and we welcome the continuing discussion with the FSA on this subject and the additional work proposed by the IIF.

We believe that it is essential that we should have the opportunity to review interim papers prior to the publication of the Accord on those areas where further work clearly needs to be done, namely:

1. RETAIL EXPOSURES
2. OPERATIONAL RISK
3. PROJECT FINANCE
4. EQUITY HOLDINGS
5. PILLAR 3
6. IRB APPROACH TO SECURITISATION

While the deadline for response to the Consultation Paper is 31st May, Lloyds TSB will continue to work with the Basel Committee and the Industry in order to attempt to formulate practical solutions to the remaining issues.

On a general note, there is a need for quite considerable flexibility going forward, as regards detailed calibration and configuration. In addition to the absence of formal proposals in certain areas, a number of factors limit the effectiveness of the consultation that has taken place; the short consultation period, relative complexity of proposals, volume of concerns raised, potential impact on banks/markets/consumers of even small errors in calibration or configuration and lack of testing/transparency. These go together to create an environment where consultation as concluded here cannot deliver what is required in terms of review, testing and improvement of the New Accord. We strongly believe, therefore, that the process must continue.

We are also concerned at two issues for competitive equality arising out of the proposals. Firstly, the process for approval and implementation of the revised Accord within the European Community is protracted and lacking in flexibility, when compared to the process in the USA, and we are concerned lest European based banks are placed at a competitive disadvantage as a result.

Secondly, the financial services industry is experiencing a period of rapid change, accompanied by the development of non-bank competitors. It is essential, in order to achieve the aims of the Accord, that the lack of regulation of non-bank institutions

does not cause a significant shift in the supply of retail financial services to organisations outside the regulatory framework.

SCOPE OF APPLICATION (para 18.)

Paragraph 18 states that “Deduction of investments in deconsolidated entities will be 50% from tier 1 and 50% from tier 2.” It is not clear whether this is intended to mean

(1) 50% of investments will be deducted in arriving at tier 1 capital; or

(2) 50% of investments will be deducted from tier 1 capital as currently calculated, for the purpose of calculating the tier 1 ratio. (This meaning was supported orally by an FSA representative at the initial presentation on Basel 2.)

(1) above would be a major change from the current position where investments in deconsolidated entities are deducted from the total of tier 1 and tier 2 capital. It is difficult to see the relevance of this change to the overall thrust of the proposals, in terms of improving the quality of banking supervision, and it could have a major impact on the capital structure of some institutions.

A hypothetical bancassurer making full use of the current rules could have its capital substantially affected as follows:

	Current	Proposal (1)	Proposal (2)
Core tier 1	170	170	170
Innovative tier 1 - restricted to 15% of total tier 1	30	12	30
Deductions from tier 1 (Proposal (1))		(100)*	
Total tier 1	200	82	200
Deductions from tier 1 (Proposal (2))			(100)*
			100
Upper tier 2	100	100	100
Lower tier 2 - restricted to 50% of tier 1	100	41	100
Deductions from tier 2		(100)*	(100)*
Total tier 2 - restricted to 100% of tier 1	200	41	100
Deductions	(200)*	-	-
Net capital	200	123	200
Risk assets	2,000	2,000	2,000
Tier 1 ratio	10.0%	4.1%	5.0%
Total ratio	10.0%	6.2%	10.0%

* *deductions for a deconsolidated entity such as a life company*

The reduction of the total ratio from 10.0% to 6.2% arises because of (a) the restriction of innovative tier 1 to 15% of total tier 1; (b) the restriction of lower tier 2 to 50% of tier 1; and (c) potentially the restriction of total tier 2 to 100% of tier 1. Furthermore, the FSA requirement for a tier 1 ratio of 6% before the issuance of

innovative tier 1 would present a further obstacle until further core tier 1 has been raised.

There is no suggestion in the paper that investments in life companies should not be financed in part by tier 2 capital. This is acceptable for banking business and should continue to be so for life businesses, which are increasingly gearing up their own balance sheets.

(2) above would resolve the lack of comparability of tier 1 capital ratios between pure banks and bancassurers. In the example above this would give a tier 1 ratio of (200-100)/2000 = 5.0%.

The proposal in its current form should be clarified along the lines of (2) or withdrawn.

CREDIT RISK ISSUES

Calibration of Internal Ratings Based Approach

Lloyds TSB is concerned that the current proposals will lead to an excessive capital requirement. We support the arguments detailed at length in the BBA and IIF responses, but would summarise our position as follows:

Absolute Calibration

The insertion of uplift factors relating to measurement error and an assumed lack of loss-absorbing capital are in our view not required. It means that the risk sensitive nature of the proposals is devalued. While we recognise that a degree of prudence is desirable, this would be better handled under Pillar 2. This would also help to avoid the risk of amplifying cyclical effects. In any event we see no reason why prudently managed banks should be anything other than conservative in their calibration of credit risk.

Moreover, the proposals are conservative in a number of areas, and this further reduces the need for an additional capital allocation. Examples of this are:

1. Calibration of the risk components (PD/LGD/EAD)
2. Calibration to EL and UL
3. Through the cycle definition of PD
4. No recognition of risk diversification

In view of this conservatism, we do not support the uplift factors referred to above. There are similar issues regarding Operational risk, outlined below.

Relative Calibration

While the Quantitative Impact Study will serve to help to clarify matters, there appears at present to be insufficient incentive to move from the Standardised to the Foundation Internal Ratings Based Approach (FIRBA). Current calibration in fact may dissuade progression to the FIRBA. Similar arguments apply for progression to

the Advanced (including retail) Internal Ratings Based Approach (AIRBA). This is highlighted clearly in the IIF and BBA documents.

Whilst there are many benefits to be derived from more sophisticated risk management systems/data, a targeted reduction of only 2-3% in the level of regulatory capital under the FIRBA as compared to the Standardised Approach, does not constitute a significant incentive to incur the costs involved in such a progression.

Calibration to EL/UL

This approach seems particularly harsh in respect of retail portfolios, where EL may be high, but stable and is covered through product pricing, business income and specific provisions.

We recognise however that national accounting regimes differ and that a common regulatory solution based upon a calibration to UL may not be workable.

Although the conceptual basis for establishing regulatory capital based on EL and UL may not be correct, we do recognise the need to be practical. If the Committee proceeds on this basis, however, the following should apply:

1. The cap of 1.25% on general provisions as Tier 2 capital should be removed.

2. Expected margin income should be recognised in the calculation of EL (especially key in the retail portfolio).

3. In the IRB approach, the maturity adjustment and the granularity index should not be applied to the EL portion of the capital requirement.

4. Guidance should be given to supervisors to take margin income into account in their expectation of banks operating above the minimum capital ratio (Principle 3, Pillar 2).

"All or nothing" requirement in respect of the adoption of, and progression through the IRB approach (para 159 et seq.)

Lloyds TSB believes strongly that this area needs to be revised. Whilst we understand that the Committee would wish to prevent banks from gaming the system, this can be controlled via Pillar 2. In addition, we should not lose sight of the underlying objective of the proposals, which is to base regulatory capital on the risk profile of the bank and to reward improved risk management practices. There is a danger this rule may encourage perverse risk management and investment decisions.

Restrictive conditions could discourage banks from:

1. Pursuing sensible acquisitions.
2. Entering new markets.
3. Developing new products.

Banks may also seek to exit from areas in which the regulatory capital requirement is too onerous.

Internationally active banks should be able to articulate their plans to the regulator, who should agree a flexible plan to enhance risk management practices over a reasonable period.

Therefore, banks should be able to progress to and through the FIRBA to the AIRBA on a phased basis with the agreement of the regulator. Full account should however be taken of the size and materiality enabling some portfolios, which it is agreed are not material, to be excluded from the more advanced approaches. If, however, the regulator believes that a bank is not making adequate progress at any time, remedies are available under Pillar 2. Further clarification of what constitutes materiality is required rather than leaving this entirely to local regulators' interpretation.

Such an approach is considered reasonable and indeed is recognised by the Committee, in allowing a piecemeal move through the approaches included in the Operational Risk 'continuum' approach.

Credit Risk Mitigation

Collateral

Although the Committee has enlarged the range of eligible criteria, it is in our view still too restrictive. In particular the recognition of risk mitigation in the small and medium size corporate sector is inadequate. Much of the lending to this sector is secured by physical assets and a failure to reflect this in the Standardised Approach and FIRBA could remove incentives to use the FIRBA and might inappropriately influence the extent of (secured) lending to small and medium size businesses. The presence of collateral can also positively influence default probability, through the leverage provided against potential defaulters.

Lloyds TSB recognises that there are issues to address with regard to physical collateral, such as the requirement for near cash status, objective worth and reliable and stable markets over time, but the matter should be explored further, particularly in respect of asset and receivables finance. [See below - section 'Asset Finance']

This subject is explored in detail in the IIF response, but we wish to highlight it as a critical issue.

"W" Factor

This subject is well handled in the IIF and BBA submissions, and is a major issue. We recognise the rationale for this factor, but favour its elimination or modification. It seems harsh to apply another capital requirement for "residual risks" without defining them, particularly when there appears to be overlap with the separate operational risk capital requirement. Historically there will be a 'W' element in LGD data.

At the very minimum, the final Accord should clarify the issues, to explain the rationale for this factor in order to avoid any inconsistency and ensure that there is no 'double-counting.'

IRB Approach for Corporate, Bank and Sovereign Exposures

General remarks, for example covering the EL/UL issue and Granularity Index apply here in addition to specific points raised below.

The requirement for no more than 30% of gross exposures to fall in any one grade is unhelpful and may create a perverse incentive for banks to lend into sectors or segments not otherwise countenanced by risk management priorities. It should therefore be eliminated, or used as a guideline rather than a rule, triggering discussion with the regulator and therefore captured under Pillar 2.

In addition the Accord prescribes a rating system appropriate for an IRB approach as having two distinct dimensions, a borrower assessment and a second dimension that reflects transaction specific factors. The precise nature of the Committee's intentions is opaque as regards transaction specific factors and, since we assume it will be the first dimension borrower rating that will determine the risk weight, the relevance is unclear. The Committee's requirements with regard to the allocation of non-performing loans to a minimum of 2 grades, and the definition of 'non-performing' assets are similarly unclear and should be clarified.

This and the other operational requirements are made in a fairly prescriptive manner (paras 189 -247) and would be better provided in the form of guidance. It would also be of use to understand how supervisors propose to deal with assessing compliance with such guidance.

Maturity Adjustment (para 225 et seq.)

Lloyds TSB questions the need for a maturity adjustment to be made to the regulatory capital calculation in the manner detailed in the Accord.

We consider that maturity should not have a negative impact on the risk weight, but there should be a beneficial impact for short term exposures (up to 365 day maturities.)

Beyond this horizon we see do not see a strong connection between term and EL/UL, and therefore believe that a standard maturity adjustment should not be applied. The following factors provide weight to our argument.

- The effect of maturity is not uniform, varying widely between different products/transactions. For example, we see a three year trade finance transaction as having a significantly lower maturity impact in risk terms, when compared to a general acquisition finance line over the same tenor.
- Maturity can be impacted by contractual terms such as covenants, which effectively bring forward maturity.
- Basel should not create dis-incentives for longer term credit. There is a danger of this within the current proposals given the harsher treatment of longer maturities,

and the risk that banks will structure agreements as a succession of shorter term transactions in order to game the system.

If the Committee does wish to pursue the proposal in its current form then the following issues should be addressed, where we have concerns;

- The Mark to Market Approach is relatively harsh on longer term exposures.
- The proposals concentrate on contractual as opposed to effective maturity. This would be misleading for example in sectors, where effective maturity is on average much less than contractual. We believe that there should be recognition of effective maturity on a behavioural/product basis, where statistical evidence is available.
- The focus should be explicitly upon residual, rather than original maturity, ie concentrating on the time remaining at any given point.
- As mentioned above, an amendment should be made to reflect the credit mitigation values of maturities less than one year. This topic is explored in the BBA response, and we endorse the position taken in that document.
- By way of implementation, the data requirements may prove demanding for some banks.

Currently neither Mark to Market nor Default Mode approach presents an ideal solution, and Lloyds TSB supports further work on developing a suitable treatment for maturity.

Granularity Adjustment (para 503 et seq.)

Lloyds TSB believes the approach to granularity to be flawed and it should be removed unless it is subject to significant amendment.

The basis of the model does not seem to recognise the fundamental determinants of granularity that are prevalent within banking portfolios, for example geographic or sectoral considerations. For example, 2 portfolios, 1 international and diversified by sector, and the other concentrated on a national and sectoral level would have the same granularity adjustment, if all other parameters were equal. This does not make sense and does not reflect the underlying risks. Similarly a bank with both corporate and retail portfolios receives no benefit in comparison to a bank with only the corporate portfolio element, which is also considered to be incorrect.

Further concerns exist from a calibration standpoint, with analysis suggesting the model to be volatile and inequitable in its treatment of varying degrees of granularity.

The approach is overly complex, will be costly to implement and lacks transparency; it is unclear what testing has taken place.

In summary, Lloyds TSB understands the underlying concept, but does not support the treatment as drafted, and believes that this aspect can be handled effectively under Pillar 2. This would also allow granularity considerations in retail portfolios, currently excluded, which may be a factor, for example, in smaller regional banks.

RETAIL

General

This is a particularly important area for Lloyds TSB and, although we consider the current proposals to represent considerable progress in comparison to the June 1999 paper, it is clear that much work still remains to be done. We fully support the concept of use tests but do not feel that many of the requirements in the current proposals would pass such a test when compared to industry best practice.

Definition of Retail Exposures (para 156.)

We support the general definitions given but do not agree that all four criteria need be met. It should not be individual exposures which are categorised as retail but rather the characteristics of a whole portfolio should be categorised. We would suggest that the criteria are used as guidance for supervisors in assessing the eligibility of portfolios as retail. The key point is that the exposures making up the portfolio should be many and homogeneous both in character and in the way they are managed. Such a definition would allow the inclusion of SME exposures within the retail portfolio, which we would strongly advocate and reiterate below in the SME section of this document.

Risk Weighted Assets for Retail Exposures

Formula for derivation of risk weights (para 424 et seq.)

We support a risk weighting discount for retail exposures over corporate, although we suggest that the figure could be adjusted for different product lines. In general, we consider a discount of 50% to be insufficient for retail portfolios. This is particularly true if no allowance is to be given for the margin income earned to compensate for relatively high EL (and priced for) on many retail lines. The Accord (para 476) does already require that loss estimates should be included in pricing and it would seem anomalous to then ignore this for capital. We will conduct further analysis to support the IIF work proposed with a view to proving a more realistic treatment.

Risk Inputs (para 431 et seq.)

We comment below on the definition of default for retail exposures. However, the concept of default does not exist for retail customers in the same way as for corporate. Retail credit scoring models are typically built to predict the probability of an account reaching a certain default definition within so many months of underwriting the advance. This is unlikely to correlate to the probability of portfolio 'default' within 12 months from today because of the vintage and risk mix of the portfolio. The scorecard default (sometimes called 'bad') definition is merely an analytical point and has no economic relevance to the customer who will almost certainly already be subject to debt recovery activity by the time that point is reached.

Minimum Requirements for Retail Exposures

Minimum requirements for segmentation (para 443 et seq.)

Good segmentation is the key to sound portfolio risk management. However, the primary segments used should ideally follow the business strategy and not drive the strategy themselves. Increasingly this means that segmentation is primarily based on customer rather than product segmentation and geared to the value (actual or

potential) which the customer gives to the bank. This should also ensure homogeneity of customer treatment within the segment. Second to customer segmentation is segmentation by borrower risk. We see no benefit in separate segmentation by delinquency status; in our experience this is likely to be a factor in a continuum of borrower risk rather than a separate segment per se. Vintage is also unlikely to be a key driver of risk, but rather it may be a characteristic of the overall borrower risk. Since these requirements are to satisfy an internal ratings based approach, we consider more flexibility is required to satisfy a use test, which can be validated by supervisors.

Number of exposures within a segment (para 450/1.)
We support the comments in the Accord. We are aware that some banks are making comments with regard to the use of samples. Although we are not opposed to this in principle, we do consider that at sub portfolio segment level it is unlikely that sufficiently robust sample sizes will be available to many banks. We would be concerned at the accuracy of models built on this basis.

Completeness and integrity of rating assignments (para 454/7.)
We are concerned that there may be a slight misunderstanding of the use of behavioural (or performance) scoring in risk segmentation. Customers will not remain in a segment for a twelve month period and then a review carried out. Rather it is the portfolio segment which is assessed for predictive strength. In larger and more sophisticated portfolios rescoring may well take place monthly and an individual account could move up or down one or more risk segments based on account performance. This does not imply that the scoring system itself is not working. The key to management of retail risk is that it is conducted at portfolio level and not at account level (albeit that individual account actions are effected).

Criteria on orientation of rating system (para 459/61.)
We support the spirit of the Accord in this area but are concerned that risk scoring systems should not be required to be put into the public arena. These models are commercially highly sensitive (and in some aspects open to fraudulent misuse). We are of course happy to share methodologies and results of analysis with supervisors but would strongly resist any wider publication.

<u>Requirements for estimation of EAD, and either a) PD/LGD or b) EL</u>
(para 462/72.)

Definition of Default (Retail)
The proposed reference definition of default should not apply to retail. It should be driven by internal risk management requirements and mapped flexibly for capital purposes. In retail, default represents more an analytical breakpoint than an economic event.

Scorecard methodology is the norm in this sector. Performance of a scorecard is closely monitored. A time series of data is held for this purpose, on which decisions to adjust the scorecard are made. Even if there were a correlation with the reference default definition, this definition would only be used for reasons of capital adequacy, and not good risk management. Moreover, lenders would probably have insufficient

performance history to be eligible for the IRB approach in 2004, given existing historic data may incorporate a different definition.

Lloyds TSB would advocate further consideration of a “no reference definition solution” applied within a retail approach based solely on EL.

Data collection and documentation (para 473/4.)
The requirement for a complete history of borrower characteristics is potentially expensive and is in our view unnecessary. A customer’s historic risk position is not of any particular value except to the extent that data is required to develop future models. In our view what is needed for the purpose of assessing capital requirements is the current risk profile, much of what has happened historically is to various degrees immaterial. That said, some data is of value from a historical perspective, for example account performance trends, but other types, such as of holding credit bureau data going back many years, would appear to offer negligible value.

Use of internal ratings (para 475/6.)
As mentioned above, we fully support the concept of use tests but suggest that in the dynamic environment of retail credit risk management that a more flexible approach is needed to ensure that the regulatory environment does not hold back the development of good risk management practice.

Internal validation (para 477.)
Given the proliferation of scorecards and the frequent adjustment to these, validation procedures must be amended. LTSB supports the proposals detailed in the BBA response.

Disclosure requirements (para 478.)
Across the Lloyds TSB group we would anticipate having in excess of 200 retail segments. As mentioned above we would not be prepared to put commercially sensitive models into the public arena which we do not consider is necessary in order to assess the capital adequacy of the group. We consider that a more acceptable method needs to be found to balance the justifiable needs of investors with those of the business to compete in a difficult business environment. Good and innovative credit risk management can give a bank a powerful competitive advantage that we would be reluctant to have to share too widely.

SMEs

This sector is of vital importance to the general economy and must be carefully considered. The proposals as they stand will have an adverse effect on SMEs.

Since most SMEs are unrated, the Standardised Approach would assign a 100% risk weight. The lack of recognition of physical collateral is critical for this sector, since businesses are more likely to be required to provide collateral to support borrowing, and such collateral is more likely to be physical.

If banks were obliged to apply the Corporate IRB approach to all SMEs the increase in the capital requirement would be significant. In addition, both the initial and ongoing operational cost of having to change processes and systems to match the requirements of the Corporate IRB model will be significant. These both in turn might be reflected in higher pricing for SME finance. We would not welcome such an outcome.

Lloyds TSB strongly believes that where small businesses are managed using a behavioural scoring system on a portfolio basis, these should be eligible for the retail approach under the framework. We explicitly do not advocate a definition of 'small' business in this context, since size of turnover, borrowing and employee headcount are not comparable across countries, neither do they provide a robust approach in the same territory (eg wholesale and retail businesses). However, banks using behavioural scoring systems do have parameters in terms of size of business for which such tools are considered to provide effective risk management support.

This would still remain the question of medium sized businesses, where the FIRBA is particularly harsh in its treatment. We believe that the required level of capital is excessive because of:

1. the 1.5 multiplier within the IRB risk weighting function
2. the model used to calculate the risk weighting function which specifies an asset correlation assumption of 20%, that many banks consider to be too high.
3. the inadequate recognition of property and other physical collateral
4. no recognition of credit risk mitigation value of less than 1 year maturity.

The proposals must take account of the potential adverse impact on the SME sector, otherwise the ability of small and medium sized business to raise finance could be significantly curtailed.

SECURITISATION

The proposals do not seem to offer adequate beneficial treatment for the use of synthetic or asset backed securities in the management of credit risk, and initial observations suggest capital requirements will increase. This will discourage the use of tools, which validly mitigate credit risk in the banking book, and we support the further work that the Committee intends to undertake with the Industry. We endorse the comments in the BBA response on this subject.

PROJECT FINANCE

We have some difficulty with the proposed definition of Project Finance exposures, which we consider to be too broad. As drafted it would cover a wide range of transactions, ranging from SMEs to large corporate propositions with significantly different risk drivers, borrower characteristics and risk management approaches across the spectrum. As currently defined many of our portfolios would contain Project Finance transactions within them and separate identification of such transactions would be burdensome. We therefore consider that the definition of Project Finance exposures for regulatory purposes should be based upon the characteristics of the underlying transactions, which are structured upon cash flow

deriving from underlying commercial contracts and subject to frequent review, being monitored against forecasts, performance targets and other covenants.

Default, in terms of covenant breach, has rather different implications in Project Finance transactions than under standard corporate facilities, often triggering discussion of refinancing opportunities on open market commercial terms, rather than work-out or recovery of asset security.

We accept that Project Finance transactions demand a different approach in the assessment of credit risk and the determination of a credit rating. However, given the nature of larger Project Finance transactions whereby defaults (in terms of the reference definition) are rare, we do not consider that a separate rating scale calibrated to probability of default will prove feasible for many banks. The assessment of the rating may be by statistical or manual means, or, more likely, with the application of judgement by experienced and diligent lenders. However, in our view Project Finance credits should still be rated according to the normal corporate rating scale.

The regulatory capital requirement for Project Finance exposures should in our opinion be based upon an Expected Loss approach, rather than a de-composed PD/LGD basis.

ASSET FINANCE

We consider that Asset Finance portfolios will be placed at a significant competitive disadvantage by the proposed FIRBA, as a result of relatively higher PDs and the lack of recognition of physical collateral. This will disadvantage individual banks in terms of increased capital requirements and also create competitive issues, given the number of non-bank institutions in this sector which will not covered by the Accord. We would be in favour of recognising a greater range of collateral, particularly in the field of asset finance, where our loss experience suggests more favourable treatment, especially in the case of receivables finance.

We do not consider the argument against the recognition of physical collateral on the basis of the difficulty in valuing assets to be strong. Many asset types, including motor vehicles and aircraft, are subject to independent valuations and robust value over time. In the case of receivables finance the underlying assets are often subject to third party approval by ECAI-type body and have uniquely self-liquidating characteristics.

Operational requirements for adopting an advanced approach will need to be carefully crafted. The proposal (IRB Para 420) discusses basing these on those applied in corporate portfolios. Some requirements would clearly be inappropriate for Asset Finance portfolios, for example the need to re-rate borrowers annually, where rating often takes place at the outset and is not refreshed during the life of the transaction, in the absence of material adverse developments, particularly in respect of account performance.

OPERATIONAL RISK ISSUES

We strongly believe that the conceptual and methodological difficulties of measuring operational risk create a considerable danger that much resource will be directed towards the production of data and calculation of risk, where a robust and rigorous outcome is unlikely. This will increase costs, and distort the calculation of capital. It may have unintended consequences, such as attributing excessive capital to businesses with a high operational content, but little risk of unexpected loss.

General comment:

Lloyds TSB is concerned that, notwithstanding the work that has been done to date and any further studies, neither the IMA nor recently proposed 'Scorecard Approach' will accurately reflect the risk profile of any bank and will therefore result in an incorrect or inappropriate regulatory capital requirement.

Both methods will be costly to develop and implement, and are likely to result in unduly burdensome regulatory intervention/supervision/scrutiny.

Lloyds TSB accepts the principle of a regulatory capital requirement to cover operational risk and believes the proposals justify further industry-wide research and development, in which we are committed to participate. However, given the relative infancy of the various methodologies, it is essential that the final Accord provides sufficient flexibility and time to test in a 'live' environment - until proven sufficiently robust - to satisfy the Committee, regulators, industry and the wider range of key stakeholders - before being implemented.

There will clearly be no benefit in pushing forward and implementing an IMA approach, which later proves to be unworkable and/or the results of which calls into question the credibility of the Basel Committee, country regulators or indeed the banks themselves.

Specific comment:

Lloyds TSB broadly supports the industry responses submitted by BBA and IIF but wish to make the following specific comments, either to endorse specific elements of the industry responses or where the Lloyds TSB perspective may differ from the industry response(s).

Calibration

A stated objective of the Accord is that there will be no increase or decrease in the overall level of regulatory capital across the industry. This suggests that any capital requirement for operational risk would be compensated by a commensurate reduction in the credit and/or market risk requirements. However, initial impact analysis suggests that such savings will be only marginal - certainly much less than the figure of 20% of current minimum regulatory capital suggested.

We would therefore strongly recommend that the question of overall calibration be reviewed in the light of the results of the Quantitative Impact Study 'QIS 2' and subsequently during the implementation period. Whilst historical records in respect of

operational losses are incomplete, the profit and loss experience of the bank suggests that regulatory capital to cover Unexpected losses need be no more than 5-10% of total regulatory capital.

Definition and Scope (para 6 et seq.)
Lloyds TSB supports the BBA response and accepts the definition as written but also supports both the BBA and IIF response regarding scope. Whilst a broad definition is considered appropriate for risk management purposes, the scope of any regulatory requirements will need to be clearly defined if it is to be applied consistently across firms and jurisdictions.

Therefore, scope should be limited to *debits to the profit and loss account* and should therefore exclude latent, contingent and indirect losses, as well as 'near misses.' This will ensure that the capital requirement is consistent, transparent and readily captured and auditable. Clearly those excluded items should continue to be monitored and should be taken into account when considering the effectiveness of management controls.

Expected vs. Unexpected Losses (EL / UL) (para 9 et seq.)
A certain level of loss will be 'expected' in any business activity and as such is simply another cost of doing business. It will therefore be built into pricing and expensed to the profit and loss account as incurred. To impose a regulatory capital requirement would require an allocation of capital – in addition to income – and as such would represent a significant element of 'double-counting.'.

Interaction with Pillars 2 and 3 (para 15.)
Mention is made of the 'qualitative' (as well as quantitative) requirements under Pillar 1, both as a means of assessing eligibility for a particular capital assessment technique and to assess a bank's control environment and prudent management of operational risk. However, whilst the value of prudent management and strong controls is clearly stated, only upward adjustment of the capital requirement is envisaged, thereby providing only limited incentive to improve above the 'standard' criteria set for any particular approach. In this regard, we would welcome early release of the paper covering 'guidance and criteria' for Pillar 2.

In addition, it is understood that Pillar 2 may be applied differently across jurisdictions, which may limit even further the extent to which any element of qualitative assessment/adjustment may be applied, if at all.

It is therefore essential that some form of qualitative adjustment (up or down) is allowed under Pillar 1.

The continuum concept (para 17.)
Whilst broadly supported as conceptually in the right direction, there are significant issues to resolve if a truly 'risk sensitive' approach is to be achieved – and be seen to work. In order to recognise the 'innovation' required and 'evolutionary nature of the new framework' more time will be required to develop, test, modify and validate the various approaches.

Ongoing industry liaison (para 18.)
Lloyds TSB has been active in the industry work undertaken to date. However, whilst banks may strive to - '…develop systems to support an internal measurement approach…' - success, at this stage, cannot be taken for granted and the magnitude of issues that need to be resolved should not be under-estimated. Banks will need some comfort that the final Accord will provide sufficient flexibility to carry out the work outlined above, over the next one, two, or three years, if they are to commit to the additional resource and cost that will be required.

Approaches

Basic Indicator Approach (para 22.)
Lloyds TSB supports the IIF recommendations:
- Use of national accepted (GAAP) accounting definition of gross income
- Three year average of annual gross income figure(s).
- Introduction of 'qualitative' and 'linearity' adjustments - across all approaches

Standardised Approach (para 24.)
Lloyds TSB supports the BBA and IIF recommendation for:
- Exclusion of 'insurance' – subject to a separate regulatory regime and any equity is deducted from the calculation of regulatory capital.
- Increased granularity – using the 'level 2' business lines in 'Annex 2'as a way of improving risk sensitivity.
- Using just one 'indicator' – as a way of simplifying the approach (all suggested indicators are simply a function of size and not in themselves 'risk sensitive.'
- Use of national accepted (GAAP) accounting definition of gross income
- Three year average of annual gross income figure.
- Introduction of 'qualitative' and 'linearity' adjustments
- Flexibility in the final Accord to allow testing, review and change if appropriate, of business lines, indicators, etc.,

In addition, Lloyds TSB questions the 'relative weightings of business lines' (Table 1, Annex 3, page 21), in particular the inference that 'Retail Banking' carries a higher risk than any other activity. We strongly recommend that these weightings be closely reviewed following the QIS2 survey.

Insurance (note 6, second sentence, page 7 refers.)
Lloyds TSB strongly support the BBA and IIF recommendations to exclude insurance from the scope of any regulatory capital requirement for operational risk, for the reasons stated. Firstly, Insurance activities are subject to their own regulatory regime(s) and inclusion would create an uneven playing field with insurance businesses operating under differing regulatory regimes. Secondly, as equity in any consolidated insurance business is deducted for regulatory capital purposes, inclusion would result in banks being required to raise additional capital.

Internal Measurement Approach

Methodology (para 31.)
Lloyds TSB would welcome clarification on what would constitute '*a critical mass of institutions that have been able individually and at an industry level to assemble adequate data over a number of years to make the approach workable*.'

Such clarification is necessary for banks to assess the feasibility, or otherwise, to achieve such 'critical mass,' as well as undertake a meaningful cost/benefit analysis of being able to achieve qualification for the IMA approach - and determine what further work is required.

Structure of IMA (para 32.)
Lloyds TSB supports the issues raised and recommendations made in both BBA and IIF responses.

As already stated, for the implementation of a workable IMA approach, it is essential that the final Accord allows sufficient flexibility and time to fully test, modify and amend the methodology, functional form or individual components, using 'real data.' This work may take one, two, or even three years.

Business lines and loss types (para 33.)
Lloyds TSB support the IIF recommendations regarding categorisation of business lines and loss types, with data capture based on direct loss 'events,' with the 'trigger' being the 'effect' e.g. a debit to the profit and loss account.

Key issues (para 39.)
- Lloyds TSB support the loss categorisation definitions put forward under Appendix F and G of the IIF response.
- Lloyds TSB supports the further work proposed by the IIF on development of a 'Risk Profile Index.' – but share the concerns raised by the BBA.
- Lloyds TSB supports the need for more work to determine the relationship between Expected Losses (EL) and Unexpected Losses (UL) – to support restriction of capital requirements for UL only.
- This work should include a review of the accounting standards covering the ability to raise provision for 'expected' and 'unexpected' losses.

Loss Distribution Approach (para 40.)
Lloyds TSB support the IIF response for further work to be undertaken – but also shares the reservations expressed by the BBA.

Qualifying criteria (para 41.)
Lloyds TSB support the IIF and BBA responses; essentially we look forward to release of the consultative 'Operational Risk Sound Practices' paper before responding in more detail.

Review of Other Issues

The 'floor' concept (para 45.)
Lloyds TSB is concerned that any 'floor' will prove to be a dis-incentive to advancing through the continuum approach. Of particular concern is the absence of any indicated level at which this floor may be set. The commitment to 'review the need… two years after implementation…' provides little comfort that any floor will be reduced/eliminated.

Furthermore, there is concern that the floor may be used as a crude tool to maintain the overall level of capital across the industry, given the likely reductions in capital requirements to cover credit risk and the need to keep levels of capital around current levels.

One way to make the concept of a floor more acceptable would be to introduce a 'cap' which would serve to 'smooth out' any volatility in the calculation of the operational risk capital requirements. This could fall within requirement under 'Measurement and validation' (para 44, bullet point 9, page 10, of the Operational Risk consultative document) which states that "bank management should incorporate experience and judgement into an analysis of the loss data and resulting PEs and LGEs. Banks have to clearly identify the exceptional circumstances under which over-rides may be used, to what extent they are to be used and who is authorised to make such decisions."

Outsourcing (para 48.)
Lloyds TSB supports the BBA and IIF responses and, in particular, would welcome clarification on the proposed, definition of and criteria to determine the 'clean break' required.

Risk Transfer and Mitigation

Insurance (para 50.)
Lloyds TSB broadly supports the BBA and IIF responses. However, Lloyds TSB has increasingly 'self-insured', partly in response to the inadequacies of insurance cover, and the process for meeting claims. We would therefore need to be convinced of the value of policies purporting to cover operational risk, and concerned that we might be forced to exchange a relatively more certain management framework for a less certain one.

PILLAR 2 (para 586 et seq.)

We support the concept of Supervisory Review as an integral part of the Accord, but we do have some concern over the uniformity of approach of regulators around the world. We strongly believe, therefore that the Basel Committee should ensure that statistics are published on a regular basis, by national regulators, illustrating the application of the various elements of the Accord. Notably, this should show the level of progression within Pillar 1 options, and the extent to which Pillars 2 and 3 are being applied. This transparency would serve to facilitate consistent application of the Accord.

Whilst Lloyds TSB accepts in general that a level playing field approach to the supervision of banks is preferable, in practice we accept that this is not a likely result. We support the role of the supervisor and the four principles set out in the draft accord (para 592 et seq.). These principles however allow for a flexible interpretation of the level of capital required by a bank and are almost bound to cause differences between jurisdictions and potentially banks within jurisdictions.

Particularly in the case of retail (where international competition is relatively small) we consider that there is potential for greater involvement of the supervisor to resolve some of the uncertainty resulting from the relatively untested models.

PILLAR 3 (para 633 et seq.)

We do not believe that general purpose financial statements which are intended to report to shareholders on the performance of the business are an appropriate place for the very substantial regulatory disclosures that Basel are now proposing. We would accept that some additional disclosure may be helpful to the shareholder in providing insight into the risks being entered into by the business, particularly in the area of credit, although this would be substantially less than currently proposed.

The International Accounting Standards Board have a working group which is currently considering what disclosures banks should make. Rather than producing their own requirements in a void, the Basel Committee should work with the IASB to produce a set of recommendations which has the support of both the financial accounting and regulatory bodies. Only by going down this route would it seem likely that the disclosures will gain general acceptance.

Suggesting that the disclosures should appear in the financial statements raises other important issues. The requirement that some of the information should be published quarterly causes an immediate problem because none of the major UK banks are currently reporting that frequently. Changes to established financial reporting practices should not be driven by the regulators. Even if a different medium for reporting was to be found, some of the information required is price sensitive and would need to be made available more generally. In these circumstances it would need to be put into context.

Inclusion in the accounts would also appear inappropriate because by the time that the accounts are published it will already be out of date. It is difficult to see how market discipline will work effectively if the information is as much as three months old.

Turning to the requirements themselves:

1. They appear to be a "wish-list". In the case of a large bank, the resulting volume of disclosure will be enormous. Rather than creating transparency there is likely to be less transparency because of the sheer volume of information.

2. In a number of places the proposals overlook the fact that there are different consolidation bases for accounting and regulatory purposes. Mixing the two is likely to lead to considerable confusion amongst the readers of the accounts (Lloyds TSB has many small shareholders who may be confused by a wealth of data).

3. We would question whether the market will actually understand many of the disclosures and whether they will in fact foster market discipline.

4. There are a number of detailed disclosures that we believe are unnecessary, for example:
- fair values of embedded derivatives in hybrid capital instruments
- impact on the economic value of the Group given specified interest rate shocks
- details of 250 days back testing results

Whilst Lloyds TSB accepts there is value in disclosure to support the objectives of the supervisory / capital regime, the current proposal requires significant development to deliver that objective. In conclusion:

1. The scope and depth of data is too great.
2. It is difficult to see how the data proposed for disclosure supports the objectives of holding regulatory capital.
3. There seems to be little co-ordination with accounting practice/standards development.

There is a substantial risk that the added complexity of information disclosed may obscure the financial standing of a company.