The Royal Bank of Scotland Group

THE ROYAL BANK OF SCOTLAND GROUP'S

RESPONSE TO

THE PROPOSAL FOR THE NEW BASEL CAPITAL ACCORD

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INTRODUCTION

The Basel Committee's proposal for a New Capital Accord represents a significant shift in the principles upon which Regulatory Capital will be computed and held. At the centre of the proposal is the objective to align regulatory capital to the risks undertaken by banks so as to eliminate the distortions caused by the existing capital framework and thereby reinforce systemic stability.

The Royal Bank of Scotland Group (RBSG) supports the Committee's efforts to construct a Capital Adequacy Framework that is sensitive to the degree of risk within a bank's portfolios and the risk management and control practices that apply to these. We welcome the inclusion of a menu of approaches that seeks to accommodate banks of varying size and sophistication and which promotes the use of a bank's own internal risk methodologies. In principle, we are also supportive of the Basel Committee's effort to promote safety and soundness via the construction of a Capital Adequacy Framework that combines rules for minimum capital with regulatory supervision and market discipline.

This document sets out our formal response to the Basel Committee's proposal. We welcome the opportunity to contribute to this significant initiative and look forward to future involvement.

EXECUTIVE SUMMARY

The Royal Bank of Scotland Group (RBSG) has closely examined the Committee's proposal for a new Accord as a package. We broadly welcome the proposals but conclude that further consideration and enhancement is required for the Basel Committee's strategic objectives to be achieved. Our examination leads us to conclude that the proposals will result in a series of "unintended consequences" if elements of the proposal are implemented in their current form. In particular, we conclude that the Committee needs to consider the potential impact of the proposals in terms of:

- Asset Financing, which has not been accommodated under the proposed Accord and as such may not only be unattractive to banks but also encourage this activity to be conducted by non-bank unregulated financial institutions;
- Small- and Medium- sized Enterprise (SME) sector given the lack of recognition provided for physical collateral in the Foundation Approach and the approximate doubling in the capital requirements implied by the corporate risk weights relative to the retail risk weights;
- the competitive position of banks assigned to Foundation given the current calibration;
- the potential destabilising effects of the disclosure requirements; and
- the motivation banks might have to outsource other activities, possibly to unregulated entities, if the charge for Operational Risk is considered not to be reflective of a bank's actual experience of operational risk losses.

We conclude that attention needs to be paid to the balance and interplay of Pillars 1, 2 and 3. Our concerns are underlined by the FSA's view that the Committee's stated objective that the new Accord "should continue to enhance competitive equality[1]" is to be understood not as "equality of outcome" but as "equality of opportunity"[2]. Whilst some commentators are of the view that unlevel playing field concerns can be remedied via a reliance on prescriptive rules provided under Pillar 1, we believe that an over-reliance on Pillar 1 is both inappropriate and unrealistic. Instead the Accord should include provisions for regulatory consistency and transparency.

To meet these concerns we suggest below a number of measures which could be taken to ease implementation of the proposals within the broad mechanisms proposed under the New Accord.

1. Promote the "I" in the Internal Ratings Based (IRB) approach. That is allow all non-Standard banks to be assessed as Advanced by removing the unnecessary hurdles to Advanced status; in return, those banks would accept a series of capital floors computed relative to Foundation to restrict the degree of capital improvement. This would address our concerns regarding implementation, but support the incentive structure implied by the proposals and address the lack of consideration given to physical collateral in Foundation IRB. Of course, this still demands that Foundation (as a computational device) needs to be appropriately calibrated.

[1] Overview of the New Basel Accord, paragraph 29
[2] FSA presentation – "The New Basel Capital Accord", 23rd January 2001

2. Rely on a Pillar 2 approach to operational risk based upon a scorecard approach that would target best practice control mechanisms to ensure operational risk is demonstrably managed. We outline such a proposal later in this reply. In any event we believe that for the part of income derived from credit and market risk the operational risk charge should be no more than 5% of the capital allocated to such activities while a different consideration might apply to that part of income generated from other activities. We also point out that the 20% charge is inappropriate because: (i) it is based on a survey of a limited number of banks and all the attendant problems that such a small sample presents; (ii) it includes risks already addressed by banks that apply a "holistic" approach to risk assessment and therefore account for these losses in their credit and market risk processes; and (iii) it fails to adequately acknowledge the risk reducing effects of a comprehensive risk management functions in concert with good controls.

3. Clarify the meaning of "w" in its use to address "residual risks" that contain Operational Risk elements[3]. Allow banks that apply a holistic approach to risk assessment (as described in number 2 above) to determine their own weight for "w" in a manner consistent with that proposed for haircuts for financial collateral in paragraphs 92 and 203 of *The New Basel Capital Accord*.

4. Introduce reciprocal disclosure by Regulators under Pillar 3. This will help to address level playing field concerns without sacrificing the flexibility offered under Pillar 2 by resorting to prescription under Pillar 1. Such regulatory disclosure would provide the markets with a clear signal as to how various national supervisors have implemented the Accord and reduce each bank's own disclosure burden.

5. Re-focus the bank disclosure proposals in Pillar 3 on analysis directed at credit portfolio performance measures/stress tests (e.g. a "notch" downgrade across the credit portfolio) and summary data on the credit quality of the portfolio under discussion. This will ensure that meaningful information rather than "raw" data is provided to market participants.

If the Committee is of the view that this re-orientation of their proposals cannot be fully adopted, we strongly recommend that the Committee consider a "dual-speed" approach whereby businesses within a bank with the necessary systems/data can move onto the Advanced approach ahead of less developed entities within a Group. We would also argue for a re-examination of Foundation IRB with respect to physical collateral, a distinct treatment for Asset Finance and a re-examination of the treatment of the loss given default (LGD) element across the Internal Ratings Based Approaches.

In addition to setting out overall conclusions and recommendations we offer the following observations on specific elements of the proposal for *The New Basel Capital Accord.*

Calibration, Incentives and Scope

The Benchmark Risk Weight Function

With regard to Benchmark Risk Weight (BRW) function we make six distinct observations.

1. The BRW has been calibrated to incorporate both expected losses (EL) and unexpected losses (UL). We believe that to the extent reserves are taken that are not included in the

[3] RBSG considers residual risks to also include risks arising from the uncertain realisation of "ex-ante" loss given default estimates or the unwillingness of a bank to pursue a guarantor.

definition of the capital base, allowance must be made for these reserves against regulatory capital requirements. We also request the Committee to recognise high margin products with comparatively high but stable expected losses. To do so otherwise would run the risk of exacerbating social exclusion or dislocation in the relevant retail and corporate banking markets.

2. We have identified the "point of invariance" which is the point on the BRW function whereby a corporate (with a specific set of risk characteristics) attracts the same capital for credit under the current Accord as under the proposed Standard and IRB approaches[4]. We are of the view that the proposed calibration does not make appropriate allowance for the currently proposed additional 20% operational risk charge.

3. With regard to the effective "hard-coding" of the 50% loss given default (LGD) rate within the BRW and Risk Weight (RW) functions we make two comments:

   - the 50% LGD rate creates a perverse incentive structure and represents a capital floor. We prefer transparency and suggest any and all capital floors be removed from inside the BRW and RW functions and be placed "externally" such that the functions are re-cast using an LGD of 100%; and
   - the final risk weights under the proposals are the result of the interplay of the non-linear BRW function and linear LGD component. Such a formulation implies that when the LGD is fixed a bank with an early PD assessment policy will unambiguously attract a higher capital weight than a bank with a late PD assessment policy.

4. The 50% calibration of the Retail BRW function is widely viewed as providing some capital relief under the proposals. We note, however, that currently within the UK residential mortgages (with an LTV of less than 100%) already attract a RW of 50% but otherwise all other retail exposures are risk weighted at 100%. Thus, any capital relief offered by the Retail BRW function would appear to depend upon the overall book quality and the mix of mortgage and non-mortgage assets in the portfolio.

5. We make two comments directed at the two "upward adjustments" to the components of the BRW function:

   - a 30% adjustment included because Tier 2 capital is not viewed by the Committee to be equally as loss absorbing as Tier 1 capital – a view we challenge; and
   - an additional 20% adjustment to compensate for those banks that are systematically lenient in their PD assignment.

   We argue against the inclusion of either of these adjustments. Both measures are crude and presume a "one-size-fits-all" approach to banking regulation that may potentially work against those banks that operate a strong risk management process.

6. The Committee must note that many G10 banks hold capital in excess of the minimum regulatory capital requirements and manage their businesses through the cycle. We would

[4] The BRW function has been constructed to produce a 100% risk weight for an obligor with a 0.70% probability of default (which is akin to a BB S&P grade). If the underlying transaction is 3 years and a 50% loss given default (LGD) is assumed the resulting risk weight is 100%.

also urge the Committee to consider the impact of its research upon retail risk management practices that rely on PD estimates that are more akin to "point-in-time" than "through-the-cycle" estimates.

Incentives Across the Spectrum
We consider that the structure of the IRB risk weights, especially as they apply to Foundation IRB, are punitive in comparison to those constructed for Standard for the segment of the market where obligors attract a PD rate greater than 0.70% (akin to an S&P grade of BB). Whilst we are aware that the Committee may be of the view that the retail risk weights and credit mitigation rules offer some capital relief, this outcome must be considered against the ability of large commercial banks (assigned to Foundation IRB) to service the SME sector.

Corporate vs. Retail
On a related note, a meaningful discussion as to the identification of the retail and corporate boundary would clarify how some SMEs might be treated under *The New Basel Capital Accord*. The boundary between these portfolios must be developed to ensure that all banks with significant corporate and retail activities are treated equally. In order to stimulate discussion, we propose that admissibility of exposures for a retail treatment be based on well established categorisations of customers using consistent, comparable risk management techniques and sufficient numbers of relatively low value positions associated with the low volatility in the loss distributions typical of a retail portfolio.

Operational Risk – Calibration & Data
We believe that the Operational Risk proposals seek to address risks that are already fully considered by banks with a holistic approach to risk and a strong credit culture. In this regard, we question the proposed infrastructure required to support the overall calibration and particularly the Internal Measurement Approach (IMA). We particularly challenge the requirement for "clean" operational risk data if the industry is forced to re-classify losses arising from such examples as the failure to perfect security in the case of a counterparty default. Drawing on our experience we believe that Operational Risks should be fully captured under Pillar 2. Under Section 9.5 we suggest a assessment process built around an auditable scorecard to allow the regulator to set an appropriate charge. If, however, a Pillar 1 charge is to be applied we strongly believe that the Operational Risk charge should be minimal (e.g. no greater than 5%) for a large diversified group, such as RBSG, which concentrates in credit related products.

Implementation Requirements
We recommend that the Committee reformulates the implementation requirements for a bank seeking to achieve Advanced IRB status. We are of the view that the current formulation of this rule implies an excessively high hurdle for a large banking group with a wide range of banking activities. We therefore propose that the Committee allow all non-Standard banks to be Advanced IRB in exchange for a series of graduated floors, or adopt a 'dual speed' approach (whereby a business within a bank with the necessary systems/data can move onto the 'Advanced' approach ahead of less developed entities areas within the group).

IRB – Determinants of the Charge
Our comments address the individual IRB elements that combine to determine a bank's final regulatory capital charge for credit.

PD and the Definition of Default

RBSG is concerned that the default events described by the Committee may work to force banks with "early problem management" policies to adopt an early definition of default. Given that the BRW and RW functions (Section 1.1.3) do not guarantee that capital charges are EL invariant, we would argue that the regulatory LGD rates being applied to Foundation IRB need to reflect the timing of the definition of default. With respect to Advanced IRB, we note also that, if internal definitions of default do not map directly to the reference definition of default, then historical LGD rates may also lose their meaning. We therefore recommend that the Committee adopt a flexible approach under which banks can employ their internal definitions of default.

LGD, Physical Collateral and Asset Financing
Insufficient attention appears to have been paid to the issue of physical collateral under the Foundation IRB and the implications that this will have on traditional sectors of banking, such as Asset Financing and the SME market. With respect to Asset Financing, we recommend that it could be treated as (i) a separate exposure type (as distinct from Corporate Exposures or Project Finance); or (ii) be accommodated by including a wider range of physical collateral types within Foundation IRB.

Credit Risk Mitigation – Limits on its recognition
This comment relates to the limits set on the recognition of credit risk mitigation via the deployment of "w" and haircuts on collateral. We urge the Committee to provide clarity as to the role of "w" in order to promote a meaningful discussion with this industry. We are currently of the view that the Committee is seeking to use "w" (and haircuts) to address distributional issues with respect to average LGD rates. We argue and emphasise that issues of document failure and residual risk are already captured in our historical LGD estimations and/or pre-emptive haircuts applied to collateral taken, credit derivatives and guarantees. Consequently, we would recommend strongly that the Committee, within Foundation IRB, accepts the use of internal estimates of "w" rather than adjusting LGD/PD rates with a "one-size-fits-all" factor.

EAD and contingent exposures
We welcome the Basel Committee's suggestion that it may be possible for banks to use internal models to estimate (EAD) for the purposes of computing the regulatory charge charged against the counterparty risk on OTC derivatives. We do, however, ask the Committee to review its rules for the credit conversion factor for undrawn facilities under Foundation IRB versus the Standard approach.

Treatment of Maturity
We recommend that the maturity adjustment be extended to transactions that are less than 1 year in term. We make this argument with the knowledge that the abuse of the zero weight applied to commitments of less than 1 year must be avoided. We also ask the Committee to allow for maturity adjustment within Foundation IRB as a Foundation bank may be inadvertently disadvantaged in the market place if it is not allowed to take advantage of the capital relief offered on transactions with an 'economic maturity' of less than 3 years.

The Granularity Adjustment
We recommend that the granularity adjustment be dropped from the proposals. This recommendation has been taken with consideration as to the practicality of the granularity adjustment and its costly MIS implications against the information such a measure would provide, the current existence of large exposure reporting, as well as its untested properties.

Defaulted Loans
We seek confirmation that the term “charge-off” is similar to the UK accounting term “write-off(s)”. We also of the view that the Committee’s proposal creates the wrong incentives.

Retail
We welcome the recognition from the Committee that certain areas of the proposal e.g. Retail are underdeveloped. We also welcome the fact that the Committee is seeking input from the industry to these areas.

We note, however, that we are uncomfortable with the Committee’s approach to risk segmentation and perceived preference for “through-the-cycle” estimates of probability of default versus estimates that are akin to “point-in-time” (i.e. forward looking 12 month horizon) estimates typically used in Retail. Further, we provide feedback on the Committee’s request for information on this exposure type.

Project Finance
We provide the Committee with a definition used within RBSG. We also underline that a distinctive feature of this exposure class is that the value of any project is articulated clearly in the project’s documents (i.e. the operating, construction and debt service documentation) and the inter-linkage of the clauses.

Property
We believe that Property needs to be considered outside of Project Finance and the need for the Accord to accommodate jurisdictional idiosyncrasies particularly in support of the SME sector.

Equity Exposures
We are in general agreement with the Committee that equity is held for different reasons and the construction of any proposals for such a charge needs to take this into full consideration.

Securitisation
Our focus is on reducing the differential in: (i) the treatment of risk through securitisation and other financial transactions; and (ii) the capital treatment of participants according to the nature of their participation rather than the risk of their exposure. We also note that if (i) and (ii) are consistently applied a level playing field will be promoted globally.

Operational Risk
With regard to the Pillar 1 proposal, we draw attention to the lack of consideration given to a bank’s control environment. We further believe that a clear reduction in capital charges should be available to banks with a solid control environment. Again, we urge the Committee to re-consider both this calibration and its Pillar 1 emphasis.

Pillar 2
Interest Rate Risk in the Banking Book
We are in broad agreement with the Committee’s proposal but highlight two areas of concern:
- the disclosure requirements connected with this segment of the proposal are excessive; and,
- Annex 4 in *Principles for the Management and Supervision of Interest Rate* is prescriptive in nature.

Operational Requirements

We do not believe that the supervisory role is reduced with the prescriptive operational requirements and eligibility criteria under Pillar 1. The local regulator will still need to determine a bank's "sophistication". The extent to which a bank will be allowed to use its internal estimates and rating systems will be a direct function of this determination.

Our preference is to accept the role of Pillar 2 and look for avenues to promote consistent and transparent implementation. We urge the Committee to provide leadership in this matter through the provision of a statement of guiding principles that provide a benchmark for regulatory disclosure.

Disclosure

Bank Disclosure

We challenge the current form of the Pillar 3 proposals in terms of its volume, complexity and potentially destabilising effects. In response to these concerns we make two recommendations. First, the accounting information provided under Pillar 3 should be revised to be consistent with IAS30. Second, with respect to risk information, we recommend as an alternative a focus upon on performance measures/stress tests and summary data rather than the current proposal that focuses upon raw data.

Regulatory Disclosure

Finally, we consider that *The New Basel Capital Accord* should provide for reciprocal disclosure on the part of regulators. We argue that supervisory disclosure is required to promote the "even implementation" of the Accord across national jurisdictions. Such disclosure would provide the market with a clear signal and a comparison as to the various national regulatory standards to which banks are held. Such disclosure would have the added benefit of reducing the disclosure requirements of banks to the market.

THE RBSG'S RESPONSE TO THE BASEL COMMITTEE'S JANUARY 2001 PROPOSAL

1. CALIBRATION, INCENTIVES AND SCOPE

1.1 THE BENCHMARK RISK WEIGHT FUNCTION

1.1.1 CAPITAL: EXPECTED LOSS VERSUS UNEXPECTED LOSS

The Basel Committee has explicitly stated that under the Internal Rating Based (IRB) approaches the benchmark risk weight (BRW) function has been calibrated to cover both expected losses (EL) and unexpected losses (UL).

The Royal Bank of Scotland Group (RBSG) is of a view that, in principle, regulatory capital should cover UL only. We acknowledge however, that the Basel Committee is concerned that the current definition of capital includes general provisions in Tier 2 which may imply double counting if capital was defined to cover UL only and these same provisions were used to cover expected losses.

As a consequence of these concerns we accept that EL needs to be included in the Basel Committee's calibration of the New Accord. We do, however, ask that to the extent reserves are taken that are not included in the definition of the capital base, allowance is made for these reserves against regulatory capital requirements. Such an approach would imply the need to separately compute the capital requirements for expected and unexpected losses and would have the advantage of ensuring that some of the capital adjustments applied under the framework do not create unwarranted distortions. We are concerned that the proposals adversely prejudice high margin assets with comparatively high, but stable expected losses, even where the risk is adequately remunerated through pricing policy. In these instances, we would look for the Committee to recognise this margin income against regulatory capital required for retail portfolios.

1.1.2 POINT OF INVARIANCE

The benchmark risk weight function has been constructed to produce a 100% (credit) risk weight for a corporate with a 0.70% probability of default (akin to approximately BB S&P grade). We understand that this alignment is key to the Committee's calibration as such a corporate would attract the equivalent risk weight under both the Standard approach as well as under the current Accord.

Whilst we appreciate that the Committee wishes to ensure that the overall level of capital in the system remains the same, we do not believe that appropriate allowance (given that the benchmark risk weight has been calibrated to maintain an 8% capital ratio) has been made for the proposed 20% operational risk charge which is to be levied in addition to the credit charges.

We therefore suggest that the benchmark (credit) risk weight aligned to a PD of 0.70% be set at 80% given that the currently proposed 20% operational risk charge would then produce the same overall minimum capital charge as that under the 1988 Accord[5]. Any requirement for additional capital would then be determined under Pillar 2. We are hopeful the Basel Committee's second Quantitative Impact Study (QIS) exercise will address our concerns.

1.1.3 50% LOSS GIVEN DEFAULT (LGD) RATE

We have two related concerns as to the use of a 50% LGD.

The **first concern** relates to the benchmark risk weight (BRW) function (the cornerstone of the IRB framework) having been set with an embedded scalar of 976.5. One element included in this scalar is a 50% LGD rate. This same LGD rate reappears in the risk weight (RW) function. We seek clarity as to the Committee's motivation in the construction of these functions. We understand that the Committee sought to ensure that a corporate with a 0.70% probability of default attracts a 100% risk weight when the exposure to this corporate was given an LGD of 50%.

We recognise the use of an average 50% LGD from various LGD studies. An average speaks to a distribution and we also note that these same studies give broad ranges that generate this 50% average. The implication therefore is that for some cases the data may well generate an LGD greater than 50%. This outcome could be penal for some portfolios under Advanced IRB relative to Foundation IRB.

The adoption of a 50% LGD rate as a pivot point therefore implies that institutions will not always be rewarded for adopting risk management practices that promote the appropriate evaluation of collateral. Furthermore, as we are of the view that the BRW and RW functions could be re-calibrated to produce an appropriate set of risk weights calibrated at an LGD of 100%[6], we argue that the 50% LGD rate, represents a capital floor. This floor will work to limit the capital gains in Advanced given that a bank could have a range of LGD estimates (say 20% to 80%) that would result in an overall average of 50%.

If capital floors are to be included, these should be external to the BRW and RW functions. We therefore suggest that in the interests of transparency and the creation of the appropriate incentives, the Committee should consider the recalibration of both risk weights functions with an LGD of 100%. An expanded regulatory set of LGDs rates that would reflect a wider variety of collateral types could then be accommodated under Foundation IRB while still leaving Advanced IRB intact.

Our **second concern** relates to a timing issue outlined in Section 3.1.2 later in this document. We query which definition of default (in the timing sense) out of the suite of definitions proposed is related to the Foundation IRB 50% LGD. Timing mismatches in the assessment of PDs and corresponding LGDs (under Advanced) do not guarantee a neutral result:

[5] Such a change in the calibration would have a knock-on effect of reducing the capital weighting applied to PDs greater than 0.70% and thus help to mitigate our concerns regarding the punitive treatment SMEs will receive if they are classified as corporate exposures.
[6] For example, we believe that a similar pair of functions could be crafted to produce the same results as the current pair

> We note that proportional changes in the {PD, LGD} pair that leave the resulting EL rate unchanged, produce different RWs. For example, if your initial PD rate is 0.70% and your corresponding LGD rate is set at 50%, the resulting RW is 100%. If you adopt an "earlier" PD definition such that the PD rate is now 1.05% but the corresponding LGD is 33.33% (to produce the same EL rate), the resulting RW falls to 86%.
>
> This example, however, relies on the LGD rate changing in direct proportion to the revised PD assessment to guarantee the same EL. Actual data, however, is never as accommodating. Suppose the data only supported a change in LGD to 42%, the resulting RW is now about 108% to produce a net increase in capital. (To obtain a neutral result, that is a RW of 100%, the LGD would need to fall to approximately 39%).

We highlight the impact of timing mismatches and the choice of PD and LGD on the capital computation because this may inappropriately motivate some industry players to favour a "rigid" definition of default to mitigate against potential "gaming" opportunities between institutions. A rigid definition would require a "sufficient" adjustment in each bank's internal LGD data otherwise regulatory capital will unambiguously increase. RBSG does not support such an initiative given our view that: (i) "natural" definitions of default arise from the context of a bank's activities (as noted under Section 3.1); (ii) the underlying data tends to support a single LGD estimate for each business line as opposed to a multitude of LGD estimates referenced to multiple default timings; (iii) the MIS requirements of mapping internal definitions of PD and LGD to regulatory definitions could be significant; and (iv) the imposition of regulatory definitions is contrary to the spirit of an Accord which seeks to promote the use of a bank's own internal methodologies.

1.1.4 THE CALIBRATION FOR RETAIL

Under the proposals the Committee has calibrated the retail BRW function to produce benchmark risk weights that are approximately half the corporate BRW function. Any speculation that a bank's retail portfolio unambiguously benefits under the proposals depends critically on whether the internal LGD is sufficiently low and/or the asset quality is sufficiently good.

Under the current rules, non-mortgage retail gets a 100% risk weight but the asset quality would tend to be poorer on average than the large corporate portfolio. Thus high PD rates even under the retail BRW may generate large risk weights (e.g. a PD of 2% returns a BRW of 104%). Within in the UK, residential mortgages with an LTV of less than 100% currently attract a risk weight of 50%. These assets tend to be of higher quality than non-mortgage retail business and as such it is likely that the combination of PD and LGD for this segment will produce average risk weights of less than 50% under the proposals. Therefore, whether or not a bank benefits under the proposals would appear to depend upon overall book quality and the mix of mortgage and non-mortgage assets in its portfolio.

1.1.5 THE COMMITTEE'S CONSERVATIVE ADJUSTMENTS TO THE FUNCTION

Whilst the Basel Committee's technical document, *The Internal Ratings-Based Approach*, provides a brief overview as to the derivation of the benchmark risk weight function, the comments contained under this section reference a working paper produced by the Basel Committee Working Group on Overall Capital. This document, *Note on Issues Related to*

Overall Capital, was used as an annotated agenda for a discussion with bank representatives from G10 member countries on 26th February 2001 in Basel.

Our comments are specifically with reference to adjustments to the benchmark risk weight function to compensate for estimation error in PD estimates and the absorption capacity of Tier 2 capital.

While we appreciate that the Basel Committee may be concerned that the IRB approaches rely on internal ratings, we argue that compensating for dependency via the inclusion of a 20% upward adjustment in the benchmark risk weight function is inappropriate. Such an adjustment presumes that banks are systematically lenient in their assignment of PDs and do not review and correct mis-assignments. Moreover, the assumption of such an error would not promote "best practice" PD assignment within banks. In fact, we argue that the inclusion of such a buffer introduces a moral hazard whereby banks in knowledge of this buffer may be less conservative than would otherwise be the case. Finally, rather than relying on a penalty function that applies to all banks, the Committee should seek to rely on Pillars 2 and 3 to reveal and redress those banks' that are systematically generous in their PD assignment.

On the absorption capacity issue, we question the Committee's hypothesis that Tier 2 capital is less proficient at absorbing losses than Tier 1 capital. Further, we challenge whether a "one-size-fits-all" adjustment (30%) is appropriate when banks have different compositions of Tier 1 and Tier 2 capital. We suggest that this should be addressed under Pillar 2 rather than Pillar 1.

As a consequence of our concerns, we propose that these specific adjustments be dropped. If however, the Committee is of the view that they are required, such adjustments should be assessed under Pillar 2 and applied as a multiplier outside of the benchmark risk weight function (akin to what is done for market risk).

1.1.6 MINIMUM REGULATORY CAPITAL AND PRO-CYCLICALITY

We have been advised that the Committee is examining the potential pro-cyclicality of the IRB approaches. We would like to take the opportunity to remind the Committee that many banks across the G10 hold capital in excess of deemed minimum regulatory capital. Consideration should therefore be given to the manner in which the excess over the minimum could accommodate any pro-cyclicality. We would also argue that "best practice" banks are very likely to consider the implications of any pro-cyclicality via internal stress tests. We would also like to note that the pro-cyclicality argument neglects the fact that banks do manage their businesses through the cycle.

We would also urge the Committee to consider the impact of their conclusions and recommendations upon Retail risk management practices. Retail banks tend to use PD estimates that are more akin to "point-in-time" PD estimates that might arguably expose the retail banks to pro-cyclicality. This concern neglects the fact that within retail PD rates are revisited and revised frequently. This implies that changes in minimum regulatory capital would, in fact, occur incrementally and have the added advantage of providing the bank with a lead indicator as to changes in the economic environment.

1.2 INCENTIVES ACROSS THE SPECTRUM

We are of the view that the structure of the IRB risk weights, especially as they apply to Foundation IRB, are punitive in comparison to those constructed for Standard for the segment of the market below BB.

In view of the substantial differences in capital requirements, Foundation banks are likely to (i) substantially increase their pricing for higher risk counterparties, relative to Standard banks, and/or (ii) refuse to lend to such counterparties.

We are of the view that these concerns need to be specifically addressed in connection with the ability of large commercial banks to service the Small- and Medium- sized Enterprise (SME) sector. We remind the Committee that PD rates attached to satisfactory SMEs tend to be in the range of 1.0% to 3.0% per annum and thus banks assigned to Foundation IRB will be required to hold more capital than banks within the same jurisdiction but enjoying Standard treatment. We would argue that recognition of security, such as supported directors guarantees, invoice financing and an improved recognition of property, which are quite common for SME type entities, would help alleviate this differential.

We would also argue strongly that providing incentives to Standard institutions to service the lower end of the quality spectrum is not desirable from a prudential perspective given the adverse systemic effects that could ensue if they build large low quality portfolios.

Whilst we appreciate that the Committee is of the view that the Standard approach must be kept simple, we would argue that the IRB benchmark risk weights need to be more closely aligned to the Standard risk weights. Removal of the buffers discussed in Section 1.1.5 would substantially alleviate this competitive disparity.

We are also of the view that the Committee has set a high hurdle for banks seeking to utilise Advanced IRB and we ask the Committee to review this hurdle and the capital rewards for obtaining Advanced status against the MIS implications of both its operational and disclosure requirements. If the objective of the Committee is for Foundation to be a point of relatively quick transition, then the proposals need to be refocused to facilitate this transition. However, if this is not the case, and the Committee anticipates Foundation being a protracted or even a permanent assignment, then Foundation's competitive interaction with Standard and Advanced needs to be considered in more detail, in the context of the effect upon individual business segments. The RBSG's further thoughts on this issue and recommendations are provided in Section 2.2.

1.3 CORPORATE VS. RETAIL

Given the approximate doubling in regulatory capital requirements implied by the corporate risk weights relative to the retail risk weights (for the same PD), a meaningful boundary between these exposure types must be developed. A meaningful boundary will also clarify how some SMEs will be treated under the Accord and thus ensure that lending to SMEs is not driven into the non-regulated sector or have unintended market structural implications.

We propose that any distinction between corporate and retail exposure types be predicated on the appropriate risk management process rather than on size indicators such as asset size or turnover as these might create disincentives and distortions in the economy. As customers grow and move from retail to corporate status then it is inevitable that the pricing they are faced with will adjust to their new status. This could create a serious disincentive to grow, which would be at odds with the enterprise culture being promoted by the UK Government.

For the purposes of defining what is understood as "retail" we first need to examine the nature of losses in the consumer retail portfolio. This could be described, alluding to an empirical assessment, as follows: Part of losses in retail are due to laxity on the part of the borrower – human nature – and should happen at all times, good or bad. The presence of this human behavioural aspect should lower the overall sensitivity to the general macro-economy. In a sense this sentiment is the beginning of a structural model of retail behaviour. The explicit recognition of the behavioural aspect of the consumer retail portfolio is the biggest motivation for advancing the case that retail is not like corporate and therefore has certain identifiable characteristics.

With this concept in mind RBSG proposes that admissibility of exposures for a retail treatment be based on well established categorisations of customers using consistent, comparable risk management techniques and sufficient numbers of relatively low value positions associated with the low volatility in the loss distributions typical of a retail portfolio. Another contributor to this low volatility is the diversification associated with retail portfolios. This portfolio perspective would allow the inclusion of some SMEs for consideration to a retail treatment for the purposes of computing regulatory capital.

1.4 OPERATIONAL RISK – CALIBRATION & DATA

We believe that operational risks should be fully captured in Pillar 2. For a large diversified group such as RBSG concentrating in credit related products we are of the view that this regulatory charge should be minimal (e.g. no greater than 5%) to reflect that institutions like ourselves already capture these risks within their credit processes and data. Further, operational risks are already captured in the market risk multiplier and it should stay there. We do however recognise that there are particular concerns about the implementation of this charge in other jurisdictions. Additional comments on the general form of the Operational Risk proposals can be found in Section 9.

We are of the view that the Operational Risk charge, assessed at a rate of 20%, and based in part on findings contained in, *Operational Risk: The Next Frontier (1999),* has been set significantly too high. In this regard we make two sets of remarks.

First, in regard to the survey used to generate this charge we note that: (i) the sample used was very small and thus arguably not representative; (ii) the estimates supplied were in reference to economic rather than minimum regulatory capital; (iii) the methodologies employed were known to be crude with no reference to time horizons or confidence levels; and (iv) many of these banks may have included reputational and strategic risk in their definitions of operational risk which the Committee has explicitly excluded from its definition. RBSG is of the view that these four factors combine to refute the use of this survey to support a charge of 20%.

Furthermore, we are also of the view that because the Committee's consultation with the industry on operational risk has not been fully co-ordinated with that for credit risk, insufficient attention has been paid to the fact that banks with well established credit and market risk cultures take a holistic view to risk. Specifically, we are concerned that the Operational Risk proposals seek to address some risks where questions, such as the impact of the failure to perfect security, are actively considered and the effect of any failure is factored into LGD estimates. This will clearly result in the doubling-counting of risks that would otherwise be covered by "w" (as discussed in Section 3.3.1).

We would also argue that any notion of re-classifying model error as an operational risk does not promote good risk management or best practice. Risk managers are not made responsible for improving their models by removing this "error" factor from their responsibilities via this arbitrary classification. These models range from internal ratings used by credit managers to assign PDs to counterparties to market risk Var and specific risk models.

In regards to our opening comments regarding data, in paragraph 19 in the supporting *Operational Risk* document to *The New Basel Capital Accord*, the Basel Committee notes that:

> "…the supervisory and banking community would be well served by industry supported databases for pooling certain industry internal loss data. This is important not only for operational risk management purposes, but also for the development of the Internal Measurement Approach…. A further related data issue is ensuring that "clean" operational risk data is collected and reported. In the absence of this, calibration will be difficult and capital will fail to be risk sensitive."

This specific requirement for the development and support of the Internal Measurement Approach is at odds with the RBSG call for flexibility of regulatory definitions for internal use to support the IRB approach (e.g. see Section 3.1 on the definition of default). Under the Advanced IRB approach, a bank must have 7 years of LGD data. This sets a high hurdle for banks to achieve Advanced IRB and it is within this very data set that many historical operational risk losses would have been captured and blended with credit risk loss data. We would argue that even if the entire industry immediately agreed to a set of definitions, the requirement that a bank must have 7 years of LGD data to be IRB Advanced would imply that the double counting problem would continue for 7 years.

To ensure that the integrity of our internal credit data is preserved and to promote the use of internal definitions we must mitigate against any external requirement to redefine the way we choose to attribute our losses. Consistent with our holistic view of credit and market risks we therefore believe that any loss deemed to be associated with a counterparty credit event should be classified as a credit loss. Regarding the model error issue any resulting losses would stay within the area that generated the loss. We must not overlook the fact that ensuring that credit risk is appropriately appraised and graded remains the top priority for the effective operation of banks and for the reliability and consistency of the model data. With this in mind RBSG has constructed an architecture to appraise its credit and market risks which relies on a variety of independent checks and balances to achieve consistency across its credit processes. We believe that it is essential that risk measurement systems should also reflect the way management runs the bank and the information it requires to do it successfully.

We accept that there is value in collecting data going forward that would aid in a more granular assessment of any losses. The credit and market risk losses with operational risk elements would be properly identified as such but remain within their respective areas for analysis at a future date for the purposes of an evolving regulatory capital framework beyond this current round of reforms.

2. IMPLEMENTATION REQUIREMENTS

2.1 STANDARD TO IRB

Under paragraph 159 of *The New Basel Capital Accord*, the implementation rules for the adoption of an IRB approach are provided as follows:

> A banking group that has met the requisite minimum requirements and is using the IRB approach for some of its exposures must adopt the IRB approach across (a) all exposure classes, as defined in paragraphs 153 to 158, and (b) across all significant business units (groups, subsidiaries, and branches) within a reasonably short period of time. Banks must agree to an aggressive, articulated plan to adopt the IRB approach across all exposure classes and business units with the home supervisor. Within this period, no capital relief would be granted for intra-group transactions between the IRB bank and a business unit on the standardised approach. This includes asset sales or cross guarantees.

While we accept that such a rule is necessary to avoid cherry picking, we would argue that if the capital charges implied under Foundation IRB were moved more into line with those implied by Standard, the Basel Committee's concerns regarding cherry picking could be addressed.

Moreover, we would like clarification on the implication of these rules for new acquisitions of new lines of business which may introduce exposures that will not be exempted due to the materiality of their size and perceived risk.

2.2 ADOPTION OF ADVANCED IRB ACROSS ALL EXPOSURES

Under paragraph 161 of *The New Basel Capital Accord*

> …. In the foundation approach to corporate, bank, and sovereign exposures, a bank must internally estimate the probability of default (PD) associated with a borrower grade, while relying on supervisory rules for the estimation of other risk components. The Committee has also developed an advanced approach in which banks may use internal estimates of three additional risk components: Loss given default (LGD), Exposure at default (EAD) and the treatment of guarantees/credit derivatives…When a bank has met the minimum requirements for any of these three elements, the advanced treatment of this element would apply. A bank would initially be allowed to move to the advanced approach for one element.

> However, once a bank moves to own estimates for one risk element, supervisors would expect the bank to move to the advanced approach for the other risk factors, within a reasonably short period of time, subject to the bank's ability to demonstrate that it meets the requisite minimum requirements. To support this, the bank would need to agree to an aggressive implementation plan with the supervisor.

We are of the view that the current formulation of this rule implies an excessively high hurdle for a bank seeking to achieve Advanced IRB if it is a large banking group with a diverse set of business activities. We are also of the understanding that whilst the Committee seeks to promote the use of a bank's internal measures, it has set a series of hurdles (of which the above is but one) to control not only cherry-picking but changes in global capital levels over the short term. We would urge the Committee to consider that one way to simultaneously address these objectives and constraints is to remove the hurdle for Advanced IRB in exchange for the industry accepting a series of capital floors computed relative to Foundation to restrict the degree of capital relief. Under such an arrangement Advanced IRB would then have several gradations aligned to a bank's sophistication and Foundation IRB would then be used only as a computational device to set the base level of regulatory capital. Of course, this still demands that Foundation (as a computational device) needs to be appropriately calibrated.

If such a proposal is not palatable to the Committee, we would then propose that banks be allowed to adopt a 'dual speed' approach under the IRB option, whereby businesses/portfolios which have the necessary data/systems can move onto Advanced ahead of other areas of a bank's group. Failure to allow this might hamper business units that have been spurred on by unregulated competitors to make the necessary investment in internal rating systems but are unable to proceed across the regulatory spectrum by other business entities not at the same stage of development.

To mitigate against cherry picking under the 'dual speed' approach, we propose an extension of the regulatory proposals devised to address this issue for banks moving from Standard to Foundation. Namely banks must agree in advance an articulated roll out plan for bringing all businesses (subject to a materiality standard) from Foundation onto Advanced. However, this timescale could be an extended one in business area where historic information is not available. Failure to allow 'dual speed' could result in banks divesting those parts of the portfolio which would prevent the remainder of the business achieving Advanced status, perhaps to entities which were less able to support such businesses and at the cost of reduced risk diversification.

Finally, we would argue that one of the above approaches is necessary if the new Accord is to accommodate jurisdictional idiosyncrasies associated with dealing with physical collateral and /or property.

2.3 Minimum Requirements

2.3.1 Rating Systems

Within *The New Basel Capital Accord* document, the Committee makes several comments regarding minimum requirements for rating systems. In this regard we would like to offer several comments.

We note that the Committee outline criteria concerning management oversight of the rating system and process. We welcome the spirit of these criteria, but we not confident that the proposal gives enough emphasis to the basic systems and controls surrounding the credit process that ensures that the initial PD assignment reflects the credit quality of the obligor. We are of the view that this emphasis is required given that under the IRB approach PD assignment is a key driver to the regulatory capital computation (which under Foundation IRB is generally mechanistic).

With respect to the coverage of ratings we note that under paragraph 244 each borrower within a given portfolio must be rated. We support the sentiment of this requirement but believe that the practicalities of this requirement could be too onerous. For example, in the case of multinationals having many subsidiaries it would be impractical to provide a rating for all subsidiaries that have access to facilities. Thus we propose that so long as the principal borrower to whom we will ultimately look for repayment is rated, then this will be sufficient.

Further, we seek clarification on paragraph 259 where it is stated that the rating criteria should be specific enough to allow for "third party assessment". We are concerned that this may imply a rigid prescriptive model that would potentially limit the scope for our internal analysts to bring their experience to bear.

Finally, under paragraph 262 reference is made to the assessment of risk factors for an unspecified future horizon. We are sympathetic to this requirement as internally we assign PDs estimated on a 1-year horizon but our internal analysts do take into account factors beyond this period. Nevertheless, given the inclusion of the maturity adjustment consideration needs to be given to the potential for double counting future downward migrations through both the maturity adjustment and the conservative assignment of the rating.

2.3.2 Commercial Real Estate (CRE) and Residential Real Estate (RRE)

As stated under paragraphs 316 to 321 in *The New Basel Capital Accord*, CRE and RRE will only be eligible for recognition as collateral within Foundation IRB subject to various operational requirements some of which are a cause for concern.

The conditions laid down in paragraph 319 are acknowledged as contributing to sound banking practice. We would however challenge the practicality and the need to undertake 'across the board' professional valuations every three years or "when a maturity event (renewal, default or refinance of the underlying facility) occurs". Given that renewal of some facilities will be annual (e.g. overdrafts) then on a strict interpretation of this clause, revaluation would also be required at least annually rather than within three years as suggested. We would counter-propose that a materiality threshold linked to the loan to value

ratio and/or asset quality be introduced. For example, where the LTV is 90% or more periodic valuations would be undertaken.

Furthermore, there is no scope to recognise second legal charges when these have material value and we would ask for a reconsideration of this issue. This is particularly relevant for the SME market where director's guarantees will be supported by charges (often second charges) over their homes. Non-recognition of this would be wrong and would disadvantage this sector.

3. IRB – Determinants of the Charge

3.1 PD and The Definition of Default

3.1.1 General Comments

While we appreciate the reference definition of defaults provided by the Basel Committee

> "is not intended in any way to affect banks' legal rights and remedies should a borrower fail to meet its obligations under a credit agreement, nor is it intended to establish or alter accepted accounting standards [and]… is intended solely to address issues related to consistent estimation of IRB loss characteristics."

We question the direction being taken by the Committee and would urge the Committee to adopt a flexible approach under which banks can employ their natural internal definitions of default which arise from the context of their particular business activities[7]. We would suggest that if a bank is employing a definition of default that is measurable, definable and can be validated, then this definition should be approved for internal and regulatory purposes. Again, as default definitions will have an impact on how LGD rates are defined, we wonder whether our interpretation of the Committee's approach to default may move to increase the already high hurdle for IRB advanced. Specifically, if the existing internal definition of default does not map directly to the reference definition of default, then historical LGD data may lose its meaning.

We also query what is the particular definition of default that is consistent with the mandated 50% and 75% LGDs under Foundation IRB.

We would like the Committee to consider that definitions of default created for the large corporate book are not suitable for Asset Finance or Project Finance and should not be considered relevant to these exposures types. (Asset Finance is addressed under Section 3.2 while Project Finance is discussed in some detail in Section 5).

[7] For example, we would expect the definition used in a bond portfolio to be significantly different from that used for SMEs. In the former, a missed interest payment will trigger default but for the latter, banks will generally pursue every avenue available to keep such entities from failing.

Finally, we strongly urge the Committee against implementing definitions of default that would discourage banks from "early problem management" as this is a standard and successful part of our own loss mitigation processes.

3.1.2 THE DEFINITION FOR THE CORPORATE BOOK

For Corporate Exposures, under paragraph 272 of *The New Basel Capital Accord* "A default is considered to have occurred with regard to a particular obligor when **one or more** of the following events has taken place:

- it is determined that the obligor is unlikely to pay its debt obligations (principal, interest, or fees) in full;
- a credit loss event associated with any obligation of the obligor, such as a charge-off, specific provision, or distressed restructuring involving the forgiveness or postponement of principal, interest, or fees;
- the obligor is past due more than 90 days on any credit obligation; or
- the obligor has filed for bankruptcy or similar protection from creditors."

One way to view the events under this definition is to view the first credit event outlined as an "early" definition of default whilst the last is very late. If this is the case and the Committee is in fact requesting us to adopt the "earliest of" any of the events we question the appropriateness of the assumed LGD rate of 50% in the benchmark risk function. A very early regulatory definition of default should imply a high recovery rate (i.e. a low LGD).

Apart from the relationship between the timing of the definition of default and what that might imply for any LGD rate assumed under Foundation IRB, we have several concerns regarding the definitions provided. In regards to the first credit event identified in the definition we seek to query the meaning of "unlikely" as we are concerned that the concept is "woolly".

We see some merit in the second credit event outlined in the definition although we remain uncomfortable with the definition for several reasons, notably the, inclusion of distressed restructuring involving the postponement of principal, interest, or fees. RBSG views such activity as a common feature of active management of potential problem accounts to reduce the probability of actual business failure. Provided there is no economic loss or specific provision raised we are of the view that this should not be considered as default.

We would recommend that the third credit event suggested needs to be modified to reflect materiality of default and finally, with regard to the fourth credit event we are of the view that this definition is too late. In the UK insolvency proceedings tend to be the last resort.

Given the above set of concerns we would favour a modification of the second credit event identified in the definition as follows:

- a credit loss event associated with any obligation of the obligor, such as a charge-off, specific provision, or forgiveness of principal, interest, or fees;

Moreover, in our view the three remaining definitions originally proposed can be accommodated by this single flexible definition.

3.1.3 THE DEFINITION FOR THE RETAIL BOOK

Under paragraph 466 of *The New Basel Capital Accord* "A default is considered to have occurred with regard to a particular obligor when **one or more** of the following events has taken place:

- it is determined that the obligor is unlikely to pay its debt obligations (principal, interest, or fees) in full;
- a credit loss event associated with any obligation of the obligor, such as a charge-off, specific provision, or distressed restructuring involving the forgiveness or postponement of principal, interest, or fees; any reaging of a facility (e.g. extending the life of a mortgage to reduce monthly payments) is regarded as a default event, so long as such reaging is undertaken in distressed circumstances to mitigate a default event;
- the obligor is past due more than 90 days on any credit obligation; or
- the obligor has filed for bankruptcy or similar protection from creditors."

We are concerned that the default events described by the Committee have an implied chronological/risk order. Similar to our response to the corporate definitions of default we are concerned that the first retail definition includes "unlikely to pay" and could be too early. The current form of the second definition of default is also troubling. We are concerned that both customers and banks will be penalised if active risk management results in an imposed default definition that is too early.

In general, within the RBSG's Retail Bank default is deemed to occur when there is anticipation of potential loss, at which point corresponding action is taken, including raising a provision (based on EAD and expected LGD). In the case of Personal Mortgages and Personal loans such a loss is generally anticipated when the mortgage or loan is 3 payments in arrears. In the case of Personal Current Accounts "early problem management" (EPM) is triggered if maximum acceptable exposure, as measured by a combination of behavioural score and other factors such as turnover, is exceeded. If the problem is not resolved within 90 days it moves to default. As in the case of Personal Current Accounts, with Business Customers an EPM process is initiated if a customer exceeds a maximum acceptable exposure in terms of risk as measured by a combination of behavioural score and credit assessment. If the problem is not resolved it moves to default. Individual cases are assessed by a combination of business viability and customer willingness to comply. Cases can move quickly to default if a clear risk of failure is identified. Where an agreed solution is in place, a typical case will spend 9-12 months at the EPM stage, to ensure compliance with the strategies set; failure to comply will result in default.

The above represent typical default profiles. However, default can occur at any time if a risk of loss is identified, e.g. loss of contact with a customer in arrears. For Credit Cards, a reported default is defined as an account three cycles in arrears of making payment of an agreed minimum amount. However, a notice of default might be issued to a customer prior to or later than this reported time of default.

In summary, the Committee's definitions conform to the RBSG's Retail Bank provided refinancing initiated as part of the RBSG's EPM is not regarded as triggering a default event. We would consider it unreasonable to view rescheduling at EPM as a default event because

the relationship with the customer has not broken down and across the industry there is less consistency /objectivity in initiating EPM than default.

Given the above set of concerns we would favour a modification of the current form of the second credit event identified in the definition as follows:

- a credit loss event associated with any obligation of the obligor, such as a charge-off, specific provision, or forgiveness of principal, interest, or fees;

This single flexible definition has the advantage of being the same as that proposed under the corporate banner.

3.2 LGD, PHYSICAL COLLATERAL AND ASSET FINANCING

Apart from the proposal for residential and commercial (which is considered under Section 6 of this document), we are concerned with the lack of consideration provided for physical collateral as a risk mitigant within Foundation IRB. The effect of this will be to increase the relative amount of regulatory capital that a Foundation Bank would need to hold (as compared to an Advanced IRB bank), and hence the relative cost to the customer. This will potentially place Banks at a serious competitive disadvantage to other non-regulated finance providers, which would be able to take physical collateral into account to a greater extent in their risk assessment and pricing.

In particular, the whole area of Asset Financing is not addressed. This activity is entirely asset-led and the nature and quality of the asset being financed has historically been more important in assessing the risk of a transaction than the credit quality of the counterparty. As they stand, we believe that the Committee's proposals could effectively preclude participation in this market for banks within Foundation IRB. We would argue, therefore, that Asset Financing is a distinct activity worthy of special treatment. We would further note that Asset Financing in itself is not a homogeneous activity. Some transactions involve the financing of large internationally traded assets such as planes and ships while others tend to be strongly identified with the mid-market. All mid-market, and a significant proportion of big ticket counterparties are graded below investment grade, thus the treatment of the collateral supporting these transactions is key to the development of a robust and risk sensitive framework.

We would assert that Asset Financing is distinct from the typical form of corporate lending on which the IRB corporate exposure framework has been developed. In particular we would like to underline that under Asset Finance agreements the Bank has a set of risk mitigants that derive from the ownership of the asset. These include repossession, inspection rights, loan to value ratio assessment, return conditions and the ability to re-market the asset for sale or rehire.

The Committee’s proposals for Project Finance indicate that it is prepared to recognise discrete areas of activity and we would strongly urge the Committee to give further consideration to the case for separate recognition of Asset Finance over the coming months. We would like to offer our help in developing any initiatives being considered to address this issue.

In support of such dialogue we would like the Committee to consider the merits of identifying Asset Finance as an exposure type distinct from both Project Finance and Corporate Exposures. To this end we would like to suggest the Committee considers the following definition:

> Asset Finance is the provision of funding through either a hire, rental or lease arrangement characterised by the funder's ownership of the asset which is hired to the user. The funder does not rely solely on the performance or utilisation of the asset nor the income generated by the asset for repayment. The primary repayment obligation is therefore a credit risk on the user underpinned by the security provided by the ownership of the asset.

If the Committee takes the view that it has no appetite to consider Asset Financing as a distinct exposure type, we recommend that standardised haircuts be applied to the LGD factor applied to collateral assets. This could easily be applied to internationally traded assets such as planes and ships where historical price and recovery information is available. For instance, work currently being finalised in respect of narrow and wide-bodied aircraft indicates that, for a normal operating lessor and given a well managed book, LGD's are in the region of 15%-20%. This recommendation, of course, should be viewed in the context of our earlier remarks (under Section 1.1.3) regarding the calibration of the BRW function and our questions regarding the use of a 50% LGD rate as a pivot point.

Additionally, as an example of the point noted at the end of Section 2.2 regarding the need to accommodate jurisdictional idiosyncrasies, we are of the view that assets traded within national borders, such as cars and vehicles need to be subject to similar treatment under the Accord.

In closing, consideration of jurisdictional idiosyncrasies also applies to the treatment of receivables in support of invoice financing which is a common financing option for SMEs in the UK.

3.3 CREDIT RISK MITIGATION – LIMITS ON ITS RECOGNITION

3.3.1 "w"

Under paragraphs 86 and 90 of the *Overview of the New Basel Capital Accord*, the Basel Committee outlines that the purpose of "w" is to (i) maintain the banks' focus on the credit quality of the underlying borrower and (ii) "reflect the extent to which the enforceability of the documentation used has been upheld in practice" (i.e. credit mitigation does not mitigate against all risks).

Our understanding of the above is that the Committee wishes to address both documentation failure (which could occur for a variety of reasons) and residual risks (e.g. the decision not to pursue an "unwilling" guarantor notwithstanding the fact the guarantor may have the resources to pay. This may arise for a variety of reasons including the value the bank puts on the relationship with the guarantor).

Whilst we recognise the Committee's viewpoint, we are troubled that a bank's credit control procedures are not being fully recognised by the Committee and institutions with strong credit

cultures are being penalised. Within the RBSG's corporate bank we take an "holistic" approach to credit. There are processes in place for the on-going monitoring of all aspects of credit risk.

We would like to emphasise to the Committee that issues of documentation failure and residual risk are already captured in our historical LGD estimations and/or pre-emptive haircuts applied to collateral taken. Consequently, we would strongly recommend that the Committee, within Foundation IRB, accepts usage of these estimates rather than adjusting LGD/PD rates with a "one-size-fits-all" w. We appreciate that the Committee may be of the view that such estimates only come once a bank is granted Advanced status, but we would argue that acceptance of this should be allowed within an expanded Foundation IRB approach. This would have the added benefit of aligning Foundation IRB more closely to Advanced IRB and is consistent with the proposal for haircuts for financial collateral in paragraphs 92 and 203 of *The New Basel Capital Accord*.

In regards to guarantees firstly we argue that the Basel Committee needs to take note of a common industry practice of agreeing facilities with one company in a Group subject to guarantees being provided by the parent/principal entity or cross guarantee structures. This occurs when a subsidiary is, for whatever reason, not an attractive credit on a stand-alone basis and provides a pragmatic means to support corporate structures. The inclusion of a "w" factor under such circumstances is unnecessary as this practice and the associated documentation/cross default clauses are well established (FSA Banking Supervisory Policy Section NE 7.4 which recognises such structures create "mutuality of debts".) We further argue that the proposed "w" will create considerable pressure on Foundation banks to lend only to the strongest parts of Corporate Groups.

Secondly, we ask the Committee to reconsider the proposed floor for guarantees especially with respect to how such a floor may impact that segment of the SME sector classified as a corporate exposure.

3.3.2 On-Balance Sheet Netting

Under the current proposals the Committee recognises on-balance sheet netting to a single counterparty by setting "w" to zero. As already noted in Section 3.3, within the UK cross guarantee structures in support of group (inter-company) netting arrangements have long been a feature of the mid/large corporate market. These are permitted under the current regulations (FSA Banking Supervisory Policy Section NE 7.4) which recognise that such structures create " mutuality of debts". Thus we think "w" should be set to zero for such balance sheet netting arrangements. The implications on payment systems of not allowing on-balance sheet netting by corporate groups need to be borne in mind.

3.3.3 Haircuts

Under paragraphs 92 and 203 of *The New Basel Capital Accord*, we note that the Basel Committee may permit a bank to use its internal estimates of haircuts (H_E, H_C and H_{FX}) if the bank has obtained supervisory recognition for an internal risk model under the 1996 Market Risk Amendment.

For the purposes of financial collateral we strongly support this approach. Whilst we understand that "this is not to be confused with own estimates of LGD under the advanced approach" (paragraph 203, *The New Basel Capital Accord*), we note that this exception

indicates some support for partial use of own estimates within Foundation IRB, such as RBSG's own stance on "w".

We note that the Basel Committee has sought to address the volatility of the underlying exposure via an adjustment to the collateral held against that exposure, in addition to any FX risk arising from currency mismatch. We agree that these risks exist although it is unclear how to apply the suggested rules to a collateralised counterparty on the trading book. We make these comments with reference to Section 3.4.2 under this response document.

In regards to the implied haircuts levied on commercial real estate (CRE) and residential real estate (RRE) and summarised in paragraph 212 in *The New Basel Capital Accord*, we argue that the proposals are penal and substantially undervalue this form of collateral. The proposal requires collateralisation of 140% or more before an LGD of 40% can be applied. This is very conservative in comparison to 50% levied where no collateral is held. Historically property has materially contributed to recoveries from defaulted debts. This type of collateral should result in a lower LGD than proposed and indeed evidence from our SME portfolio for direct property lending indicates a level significantly lower than 40%. We would urge the Committee to revisit the calibration of this haircut.

3.3.4 Treatment of Repos

We are concerned that the application of the Committee's rules to the repos and reverse repos market (where the underlying security is a non-government bond) will be a significant departure from the current EU treatment. The overall effect of this treatment is that capital is charged on the net MTM in favour of the credit institution. In addition, the important role played by the repo market in terms of collateral for payment systems needs to be borne in mind.

We are concerned that under the proposals banks could see a significant increase in regulatory capital held against these transactions as the application of "w" and haircuts are applied equally to repo-style transactions as for any other type of collateralised transaction. We are of the view that such an approach does not sufficiently take into account the safety, liquidity, and sound risk management practices that are representative of these markets. The effect of the proposal would be to implement a regulatory scheme that would apply too high a cost relative to the risks, and ultimately adversely affect the repo market.

We remind the Committee that various industry practices mitigate the risks in this market. These practices include:

- daily marking-to-market (MTM) of the collateral to ensure that the exposure is positively collateralised;
- the provision of variation margin where the exposure is under-collateralised; and
- documentation that standardises many sound risk management practices, such as, providing for right of set-off so that a single amount is established, as well as allowing the party not in default the ability to close out all transaction in the event of default or bankruptcy under a legally enforceable contract under the applicable law in effect.

It is our belief that in order to continue to qualify for the current net MTM treatment that is enjoyed by broker-dealers and banks internationally, there should be continued emphasis on the above practices.

3.4 EAD and Contingent Exposures

3.4.1 Standard versus Foundation

Under paragraphs 42 and 43 of *The New Basel Capital Accord*, the credit conversion factor (CCF) for undrawn committed facilities in the standard approach is to be set at 50% for commitments with an original maturity over 1 year and 20% for commitments for facilities with a maturity less than 1 year. In this particular case, we question the Committee's treatment of EAD vis-à-vis the 75% CCF being proposed under Foundation IRB in (paragraph 232, *The New Basel Capital Accord*) regardless of maturity.

Such a proposal will disadvantage Foundation banks that provide back-up facilities to major corporates and in this regard we seek clarification from the Committee as to their intent. On the issue of intent clearly this provides no incentive to gravitate from Standard to Foundation.

3.4.2 Counterparty Risk on the Trading Book

Under the current Accord, exposure at default on a derivative is calculated as the positive mark to market of the trade plus specified add-ons (which vary by transaction type and residual maturity) to reflect potential future exposure. These add-ons are expressed as a percentage (ranging from 0% to 15%) of the notional amount.

The netting and aggregation rules further determine how a trading business estimates its exposure at default to all its counterparties for regulatory capital purposes. Whilst we appreciate that some netting benefit is offered under these current rules we would like to underline that these rules fall short of capturing the actual risk.

It is for this reason that we welcome the Basel Committee's suggestion (paragraph 117, *Internal Ratings Based Approach*) that it may be possible for banks to use internal models to estimate exposure at default for derivatives. Given that we still have questions regarding the implementation of this new Accord (as outlined in Section 2.2), we are concerned that this consideration may only apply at the "Advanced level".

3.5 Treatment of Maturity

3.5.1 Maturity and the Treatment of Transactions of Less than 1 Year

The "fulcrum" of the current proposals IRB is a 3 year transaction with an PD of 0.70% and a LGD of 50%. The proposed maturity adjustment (whether it be based on the Committee's Mark-to-Market (MTM) or Default Mode (DM) research) is therefore neutral for transactions with a term of 3 years, provides some relief to transactions between 1 and 3 years in length and ensures that transactions with terms greater than three years attract a higher capital charge.

We would like to indicate it is appropriate that further capital relief is offered to transactions with a maturity of less than 1 year and thus argue that the maturity adjustment should be extended to transactions below the 1 year point.

We make this recommendation recognising that the abuse of the zero weight applied to commitments of less than 1 year under the current Accord must be avoided. In the manner suggested in footnote 6 of *The Standardised Approach to Credit Risk*, the bank must prove to its local regulator under Pillar 2 that it is monitoring its transactions (via its credit review/approval and documentation procedures) on the basis of the "economic maturity"[8] and that it must be ensured that a roll-over is not treated like a "fresh loan" unless new approvals have been given.

The concept of maturity needs to be developed to reflect the behavioural aspects of the transaction rather than contractual maturity as emphasised by the Committee's proposed definition of effective maturity under paragraph 226 of *The New Basel Capital Accord.*

3.5.2 Foundation IRB

Under paragraph 126 of *The Internal Ratings Based Approach* the Committee notes that it is considering whether the maturity adjustment "should be an option that some supervisors could implement for banks on the Foundation approach". Currently the adjustment has only been developed for inclusion in the Advanced approach.

We would urge the Committee to allow the maturity adjustment within Foundation IRB given the high hurdle being set for Advanced IRB. We are concerned that a Foundation bank may be inadvertently disadvantaged in the marketplace if it is not allowed to take advantage of the capital relief offered on transactions (across both their traditional banking and trading operations) with a maturity of less than 3 years. We would also note that if the maturity adjustment is not applied to Foundation IRB the Committee may be encouraging some banks with long-dated books to remain Foundation banks. We do not believe that this is the incentive structure the Committee wishes to incorporate within the Accord.

3.5.3 The Calibration of the Maturity Charge

RBSG has considered the two maturity grids proposed by the Committee. Given that the purpose of this reform is not to address credit modelling or valuation issues we have chosen not to provide further comment on the MTM grid and express our current preference for the set of adjustments provided under Table 5. We must emphasise that Table 5 has been chosen for reasons of simplicity and transparency (which we consider appropriate for the current capital reform) and does not signal our internal modelling preferences.

3.6 The Granularity Adjustment

As outlined by the Committee, the granularity adjustment describes the extent to which there remains significant single borrower concentrations (for non-retail exposures).

We would like the Committee to review the practicality of the objectives of the granularity adjustment with reference to the complexity of these proposals (and the costly MIS implications) against the information such a measure provides. The adjustment only offers information on size and neglects to reflect the diversification benefits arising from the maturity structure of the bank's portfolios, its geographic structure or composition of business

[8] We take issue with aspects of the Committee's definition of "effective maturity" as provided in paragraphs 129-137, in *The Internal Ratings-Based Approach.*

activities. Further, if we interpret "baseline" RWAs in paragraph 515 of *The New Basel Capital Accord* to include retail, the granularity adjustment then represents a tax on a bank's retail business given that this exposure type itself is not included in the granularity adjustment.

Finally, we would also remind the Committee that across the G10, banks are already required to undertake some form of large exposure reporting. Thus we strongly argue that some variant or extension of this already existing regulatory tool be seriously considered by the Committee in place of the proposed granularity adjustment.

Thus, while we appreciate that the Committee is employing a measure that seeks to address some of the issues normally captured by credit models, we are of the view that the proposal for a granularity adjustment should be reconsidered and removed from the New Accord.

3.7 Defaulted Loans

In paragraph 188 of *The Internal Ratings Based Approach*, the Committee seeks feedback on the issue of the assessment of capital against defaulted loans. First and foremost, RBSG seeks clarification. Paragraph 188 makes frequent reference to the term "charge-off(s)". This is not a term we are familiar with, as it is not used in UK accounting. We assume it is similar to the UK accounting term "write-off(s)". If this is the case then we see no issue in respect of write-offs. The act of a write-off, in UK accounting terms, is the application of a specific provision to a debt. This act has no separate impact upon the level of exposures if exposures are already recorded as net of specific provisions (as also proposed in paragraph 188, and set out in paragraph 108, of *The Internal Ratings Based Approach*).

Furthermore, we have concerns that the proposals, particularly as they apply to IRB banks, will generate excessive capital requirements for defaulted exposures against which specific provisions have been raised as illustrated below.

> Once default occurs the eligible forms of collateral (e.g. financial collateral) are likely to be realised within a very short time frame. Accordingly, remaining exposures will be considered as unsecured under the proposals.
>
> Assuming that the debt is not subordinated, the relevant risk weights under the Standardised and IRB approaches will apply. Once a bank raises specific provisions, to cover the specific estimate of the loss that is anticipated it is still required to hold capital at the relevant rate of the residual exposure.

It is reasonable to expect banks to hold significantly more capital to cover defaulted exposures where no specific provision has been made. However, the difference in the capital requirements under the Standardised and IRB approaches is notable and does not create the appropriate incentives.

Where specific provision has been raised against defaulted exposures it is still appropriate for banks to hold some capital to cover the difference between the estimated loss in cash flows and the realised economic loss to compensate for any mis-estimation in the provision requirement.

4. RETAIL

4.1 OPENING REMARKS

We appreciate the Basel Committee's efforts to consider retail exposures as distinct from corporate exposures.

We appreciate that the proposal for retail exposure represents the Committee's initial thoughts and are pleased that the Committee has undertaken to share their preliminary views on the treatment of retail exposures for the purposes of stimulating a response from the industry.

To further the development of the Committee's Retail proposals, we have responded to the Committee's request for comments on segmentation, PD assignment and behavioural scoring, and LGD and EAD estimation. We have also provided comments on our treatment of expected losses and provisioning and write-off practices.

4.2 SEGMENTATION

We welcome the Committee's recognition that borrower and facility characteristics are typically used in the assessment of risk. We are concerned, however, that some of the statements made regarding segmentation may not accommodate the RBSG's approach to credit scoring and PD assignment.

The initial determination of a credit score is achieved using customer application data and credit bureau information. A PD can be assigned from the application score. This assignment is then monitored on a monthly basis, using a combination of delinquency, application and behavioural scoring.

The scorecards used in customer applications are developed specifically for each product type.

Within retail, the portfolio is naturally segmented by product (i.e. mortgages, other personal loans, personal current accounts and business current accounts/loans and credit cards).

Outside of the RBSG cards business, vintage is not explicitly considered as we are of the view that delinquency and behavioural scoring provide an up-to-date risk measure, removing the need for vintage to be considered. Where an account is not delinquent and behavioural scoring is not available, application score is used; in such cases vintage is implicitly accounted for, as scorecards are regularly validated to determine deterioration and are regularly replaced so as to remain current.

Our "segmentation", as such, is in order to facilitate PD calculation; product, delinquency and scoring are used in this context to calculate account-level PDs. These predictive factors are

not used to segment the book for account management purposes. We would welcome some clarification on the issue of segmentation.

For credit cards, further segmentation is made to product and vintage levels. Although account level PD is possible through application and behavioural scoring models, PD for credit cards is predicted by product and vintage and determined by respective delinquency levels.

4.3 PD Estimation

Within the Retail Bank, the initial PD assigned is based on application credit scoring. On an ongoing basis and where applicable, the PD is revised each month using a hierarchy of delinquency, behavioural scoring and application scoring. A "catch-all" bucket is used where none of the above are available. These PDs are then aggregated by product type. For all products the PD is assessed on a one-year time horizon. Our PD rates are both forward looking but based on past performance.

For example, let default be defined as 3 payments in arrears and consider that 12 months ago we had a cohort of 100 loans that were 1 payment in arrears. If we then found that over the year 10 of the 100 reach the position that they were 3 payments in arrears the one-year PD rate assigned to the current cohort of 1-payment down loans would be 10%.

The above is a simplistic example illustrating the discrete case; for continuous behavioural and application scoring, statistical regression models are built to estimate the PDs, using observed data from the previous year.

We are concerned that there may be a requirement to estimate PDs used in retail on the basis of a long run average. This approach is blunt and unresponsive to changing market conditions. We thus advocate the use of a dynamic methodology for establishing PD estimates, akin to that used within the Retail Bank at RBSG. These PDs are based on 12 month forward projections of likely default rates. They are refreshed on a monthly basis and are therefore both current and responsive to changing credit conditions.

4.4 Behavioural Scoring

We ask the Basel Committee to clarify their statements regarding behavioural scoring and risk segmentation.

Within the Retail Bank at RSBG behavioural scoring is used as a key predictor of PD and we are concerned with some of the Committee's statements with regard to the role of behavioural scoring and its relationship to segmentation.

We view product segmentation as the most "natural" and primary form of segmentation. We are concerned that this approach, which may imply an observable change in loss profile for a product segment over time, can not be accommodated by the Committee's proposal that meaningful segmentation implies a homogenous grouping of a pool of loans with risk characteristics that are stable over time.

4.5 LGD AND EAD ESTIMATION

As indicated earlier, within the RBSG's Retail Bank, PD rates are estimated at account level while LGD rates are supplied for each product segment as a percentage of EAD. Two aspects of the Basel Committee's proposals as they relate to LGD and EAD have given us cause for concern.

First, we are concerned that the criteria implied by the proposal may invalidate a view of LGD that is not driven by credit score or delinquency. We would like clarification of this point.

Finally, we would appreciate if the Basel Committee could clarify its discussion of EAD in the context of the retail exposures. We would like to verify that EAD as discussed in paragraphs 462 and 464 of *The New Basel Capital Accord* is defined in terms of future exposure in the event of default rather than current exposure.

4.6 TREATMENT OF EXPECTED LOSS WITHIN THE RBSG'S RETAIL BANK

Provisioning forecasts are calculated monthly and fed into the annual budgeting process that is reviewed quarterly.

Actual provisions are raised only at default and on the basis of historical LGD experience for that product (e.g. if actual loss experience is that 20% of the balance at default is ultimately written off, then a provision equal to 20% of this balance is raised on all new default cases).

Under RBSG retail pricing models, pricing at product level focuses upon the lifetime value of an account to the bank and is determined by ensuring that the NPV (or Return on Equity) of all expected future cashflows exceeds agreed hurdle rates. Under such a pricing model, products are typically segmented by the amount borrowed and term. PDs are applied to each segment incrementally over the life of the product (eg, PD in year 1, PD in year 2 etc…). The implied "credit reserve" factored into the pricing decision is the projected exposure in each interval multiplied by the appropriate incremental PD rate, adjusted for an average recovery rate.

We are concerned that the proposals penalise short term high risk business even where risk is adequately remunerated through pricing policy. This may act as a disincentive to lend and further exacerbate problems of social exclusion.

For Credit Cards, actual provisions are raised by product and vintage. Historical delinquency data is used to calculate a 12-month average roll rate for each delinquent bucket. This 12-month average, refreshed each month, is applied to current month delinquent bucket balances to determine the provision. The aggregate calculated provision movement for all products combined with the monthly write-offs equals the monthly bad debt charge to the P & L.

5. PROJECT FINANCE

5.1 INTRODUCTORY REMARKS

We welcome both the Committee's efforts to identify Project Finance as a separate exposure type within the IRB framework and its recognition that the elements of the framework for corporate exposures are inappropriate. We also recognise the Committee's concern that the unique characteristics of this exposure category can make it difficult to define the scope of Project Finance. Further, the Committee is concerned about data availability and the problem of calibrating risk weights given the specific characteristics of this exposure type. RBSG is of the view that property should be considered separately from Project Finance and remarks in this regard can be found under Section 6.

We hope that as a consequence of the consultation process that the Committee will be convinced that Project Finance should continue to be viewed as a separate exposure type, and will work to construct a set of rules which recognise the special nature Project Finance. To this end we have sought to respond to several of the issues raised by the Committee in the January 2001 proposal for *The New Basel Capital Accord*. We hope the Committee will welcome our comments on this aspect of the accord especially given our long history in this sector. The origins of the RBSG involvement date back to 1972 with the (NatWest Bank) financing of British Petroleum's Forties oil-field. Since that time, the RBSG has remained one of the major Project Finance banks in the world. Project Finance is currently managed within our structured finance units.

Issues on which we have specific feedback are definition, the nature of Project Finance, RBSG's approach to rating assignment, assessment of loss and EAD, and to risk assessment of Project Finance.

5.2 DEFINITION

We appreciate that the Committee is concerned that the working definition of Project Finance supplied under the January 2001 proposal is too broad. Thus, we would like to offer for consideration the definition used within the RBSG. While the RBSG's definition of Project Finance is similar to the Committee's our definition is narrower as we reference performance and completion as the primary risk drivers and underline the importance the project sponsor.

Within RBSG we typically define Project Finance as:

> lending in partnership with sponsor(s) to finance a typically immobile, unique, asset where the primary risk drivers are completion and performance of the asset being built. The debt service and principal repayment are primarily sourced from the cashflows generated by the project itself and risk is mitigated by not only charges over fixed assets (i.e. the project) but also by the robustness and commerciality of the set of contracts that detail the project.

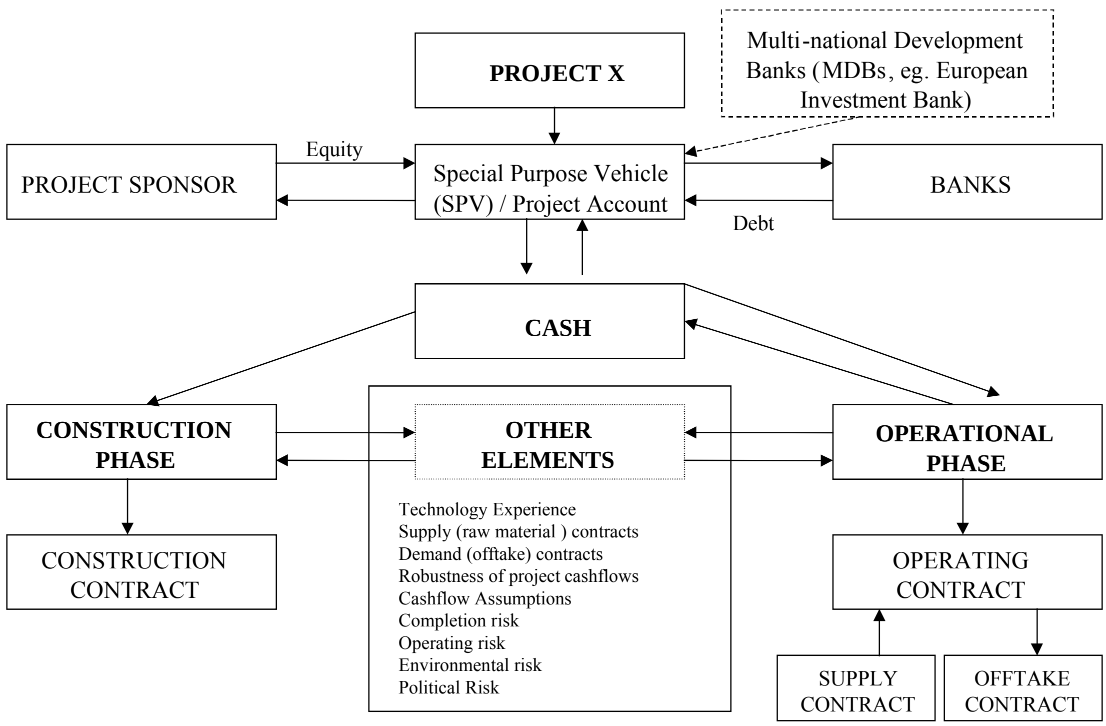
5.3 FURTHER COMMENTS ON THE NATURE OF PROJECT FINANCE

As outlined by the Basel Committee and provided under Figure 1, Project Finance operations are typically structured such that the borrowing entity is a SPV. This structure is generally adopted by project sponsors to limit their own exposure and identify the operation as a unique group of documents that articulate the robustness of the project to service the debt and provide a return to the sponsors. The value of the project's documents (i.e. the operating, construction and debt service documentation) is in the inter-linkage of the clauses. The clauses should be open enough to all to allow the project to be undertaken but also tight enough to give banks close control over the risks.

The projects can be sizeable and the financing is rarely bi-lateral and more normally involves a syndicate of internationally active banks. The sponsor injects equity into the SPV and seeks financing from the banks as well as multinational development banks. The resulting debt to equity ratio is typically 85:15. The RBSG's comfort with any given Project is derived from the robustness of the project – the structure of its documents and its cash flow - both of these can be independently audited. The risk mitigants under the documentation typically take the form of cross default or draw stop clauses which serve to halt the project if there is any variation in the performance of any of the contracts under the project.

Given this characterisation, Project Finance is more than just asset backed lending and should be considered as distinct both from Asset Financing and corporate exposures.

Figure 1: Generic Elements of a Project Finance Project



5.4 RBSG'S APPROACH TO RISK ASSESSMENT

At the outset of a project we carefully examine our relationship with the project sponsors. The sponsors are typically target clients with whom we either wish to start or develop our banking relationship. Their success in completing similar projects is a key determinant in our risk assessment. At a minimum we require the sponsors to provide minimum financing such that the minimum debt:equity of say 85:15 ratio is obtained. We also examine our experience with the contractor/operator, the robustness of our cashflow assumptions and analysis and the strength of our supply/offtake contracts against competition in the market place

Over the duration of a project we examine whether each phase of the project has met its timetable and whether the assumptions in the cashflow analysis continue to hold, whether all parties are performing in accordance with their specific contract and if the project represents the "state of the art technology" for the local economy. In this manner the credit assessment is forward looking. Projects operating "with some problems" are reviewed monthly. Management of the portfolio is pro-active and focussed - projects, sponsors and contractors are called on regularly, particularly during developmental phase

5.4.1 RISK MANAGEMENT - PD

While we lend and assign a PD to the special purpose vehicle, the credit quality and past experience of all the parties (from the project sponsor to all signatories of the documentation provided under the project) are key factors in the determination of the PD rate assigned to the SPV.

The risk grade for a project financing is arrived at after consideration of a wide range of the risk factors which typically include RBSG experience of sponsors and other parties to the project, technology, supply, demand, the robustness of project cashflows, the assumptions used in arriving at cashflows, the construction contract, the completion risk, the operating risk and the environmental risk.

The post merger bank is looking at combining the best features of the credit assessment practice of the two constituent banks. The evaluation process relies on the experience of the credit assessment team and on their knowledge of comparable projects already on the portfolio. The risk management of each project is conducted by an experienced, specialist team separate from the deal originator.

The initial risk grade assigned to a project finance structure are typically reviewed in full on an annual basis, with a short form review and prognosis conducted every six months. The assigned risk grade typically improves as the project progresses towards completion.

Each project is unique and therefore historic default data on the sector is unlikely to be relevant to a new project which will have its own idiosyncratic characteristics, however there could be trends that may be seen in some groups e.g. Italian or UK domiciled power projects if the data was collated.

5.4.2 RISK MANAGEMENT - EAD

EAD is limited to the current utilisation at the time of default. In Project Finance draw down is controlled by the documentation whereby non-performance under one contract brings

performance under the remaining contracts to a halt until a remedy that is acceptable to all parties is agreed upon.

5.4.3 Loss Mitigation - PD and LGD

A number of factors work to minimise the losses on a project and to return it to good health if an action occurs which is at variance with the schedules, activities and/or processes outlined in any of the legal documentation. Examples of such factors are the common incentives for all parties to achieve a successful outcome for the project, the damage to international reputations if a solution is not found, and the remedies available within the documentation.

Bank syndicates invariably structure re-financings if cash flow gets out of line with original projections. In an extreme case, the syndicate will apply pressure on the sponsor and advise the sponsor to provide additional cash or delay a dividend payment to support the project's cashflow. While a project may default the remedies are wide (e.g. postponement of dividend to project sponsors, acceleration of equity injections, postponement of principal repayments) and rarely results in loss rather an agreed redefinition of what is expected and timing of the cash flows.

Finally, the project is usually important to the local economy (in terms of employment and/or infrastructure) such that the local authorities usually have a vested interest in ensuring the success of the project.

5.5 Closing Remarks

Traditional Project Finance is a unique exposure type. The projects are complex and involve many parties and no two are the same. The idiosyncratic nature of this lending is emphasised by many banks' approach to restructuring and refinancing that can often occur post construction. Unlike standard corporate credit, restructuring of the debt profile can be seen as a positive recognition of the progress that the project has made rather than an indication of default leading to potential loss.

Traditional Project Finance deserves separate identification under new Accord but it does not lend itself to a prescriptive formula of "one size fits all". Additional work needs to be undertaken across the industry to present an appropriate response on this subject.

6. Property

The proposals indicate that property lending, (land, construction and renting) where the repayment of the facility is reliant on the income stream generated by the asset then the facility should be viewed as Project Financing. We consider this to be inappropriate. Project Finance needs to be more narrowly defined to focus on the specialised business of funding large projects, generally through the international banking markets, supported by detailed and complex documentation that mitigates the risks. Whereas Property Finance has some superficial similarities with the above, in that it can have a build phase followed by a period where it generates the income to repay the debt, it is typically based in the domestic market and is a much less complex type of transaction. Furthermore, unlike Project Finance there is

typically a wide range of potential users of the asset, either as new tenants or through redevelopment, and its marketability is therefore greater.

The proposals also introduce the ability to use the value of property held as collateral to reduce LGD and thereby reduce the capital weighting of the underlying facility. We welcome this initiative as a sensible step forward. However as proposed the effect is to materially undervalue this factor under Foundation and this may be especially punitive to SME financing. Thus we are of the view (as noted under Section 2.2) that there must be some scope for jurisdictional idiosyncrasies. For instance, in the UK the security cover underpinning SME financing is often represented as a debenture and floating charge that is backed by a number of assets but most notably commercial property. The UK market suggests that an LGD rate for commercial property over-collateralised by 140% or more is significantly below the proposed 40%. In closing, we remark the capital requirements should reflect the changing LTV profile due to paydown when computed on the basis of the lower of the original cost or market value. That is a lower LGD than 40% should be permitted in these cases.

7. EQUITY EXPOSURES

We appreciate that the Committee is of the view that it must "reinforce the resilience of the internal ratings approach for corporate debt exposures by removing the possibility that banks could incur a lower capital charge as a consequence of holding equity rather than debt of high PD obligors" (paragraph 381, *The Internal Ratings Based Approach*). We are also of the understanding that the Committee may have been motivated to consider this problem due to the decline in banks venture capital investments in "new economy" stocks over the last year[9].

We welcome the Committee's recognition that banks have held equity for a variety of reasons (e.g. as strategic holdings, trading for capital gain, or venture capital), which may necessitate the development of more than one approach. We are concerned, however, that the industry has not had sufficient time to fully consider the impact of these nascent proposals especially in terms of the significant holdings banks have developed over time.

Of the approaches outlined by the Committee, we believe that the PD/LGD approach is to be preferred over the market stress approach for venture capital equity investments purchased for venture capital. To this end we welcome the Committee's proposed consideration of unrealised gains[10]. We would like to take this opportunity to emphasise that these are a valuable mitigant against equity write-downs and must be included as part of any capital framework for this exposure class.

In an effort to assist the Committee in the development of this framework we would like to offer our ideas on the definition of default (as it pertains to this exposure type), PD, LGD and EAD. First, we recommend that given the nature of the exposure, a late definition is appropriate and should relate to the company becoming insolvent or going into receivership. We are also of the view that the current corporate rating can be applied to rate obligors as we do on occasion provide debt finance in addition to equity.

[9] The IIF's May 2001 *Report of the Working Group on Capital Adequacy*
[10] Paragraph 387, *The Internal Ratings-Based Approach*

8. SECURITISATION

We appreciate that the Committee is of the view that some securitisation activities are driven by regulatory arbitrage and as such may create systemic risk. Our comments are focused upon reducing the differential in: (i) the treatment of risk through securitisation and other financial transactions; and (ii) the capital treatment of participants according to the nature of their participation rather than the risk of their exposure. We also note that if (i) and (ii) are consistently applied a level playing field will be promoted globally.

8.1 1ST LOSS RISK POSITIONS

We agree that Originators and Sponsors should deduct from capital the amount of their 1st loss positions as these investments reflect their 'equity' interest in these transactions. However Investors should be required to risk weight their exposure according to the risk of the investment (see Risk Assessment below).

8.2 2ND LOSS POSITIONS

Originators, Sponsors and Investors should be required to risk weight their exposure according to their investment (see Risk Assessment below). Note that programme wide enhancement generally would fall into this category due to the subordinate nature of pool specific enhancement.

8.3 LIQUIDITY

We agree that consistent criteria should be applied to liquidity facilities to ensure that they are not providing credit support (i.e. increasing the credit quality of the asset pool and related credit enhancements).

However, provided this is the case, the quality of the asset pool and related credit enhancements should be reflected in the regulatory capital calculation. We would recommend that the risk weight of the asset pool and related credit enhancement be applied to the conversion factor in calculating the regulatory capital requirement.

The conversion factor should reflect the likelihood of being drawn. As this has been very low in the case of conduit liquidity, a conversion factor of 5% would be more appropriate than the 20% proposed.

8.4 EARLY AMORTISATION

In the case of securitising revolving credits we feel that a capital charge on the investor interest for aggregated structures incorporating a rapid amortisation feature is unwarranted

provided that the local regulator prohibits rapid amortisation in the case of an economic trigger being hit, but requires the securitisation to amortise more slowly (the amortisation 'tail') to ensure that there is a sharing of risk between seller and investor. The amortisation tail provides a cushion to the originating bank allowing the assets to return to the banks balance sheet relatively slowly and also easing the liquidity strain;

It should be noted that the seller to a large extent retains control over the writing of new business by the setting of the credit card limits and interest rates and so is able to a large extent control the size and yield on the credit card portfolio, and should be able to manage the portfolio to avoid an economic trigger event being hit.

It should also be noted that the seller is a regulated entity and should therefore be expected to have adequate capital and liquidity reserves to support its 'non-securitised' business.

8.5 Clean Break

It should be necessary for transferors to evidence legal transfer (i.e. supported by legal opinion) rather than 'true sale' which is open to different interpretations in different jurisdictions.

Provided the conditions for a legal transfer are met, transferees should not be restricted: (i) to 'qualifying' special purpose entities; or (ii) in retaining or transferring their assets.

8.6 Risk Assessment

Originators and Sponsors should not require greater regulatory capital for the retained risk position than the regulatory capital required to support those assets on balance sheet.

Originators, Sponsors and Investors should not have to apply greater regulatory capital to securitisation assets than for corporate assets with the same rating (unless 1st loss credit support provided by Originators and Sponsors). Moreover we take issue with the 100% LGD requirement (paragraph 61 of *Asset Securitisation*) for securitised assets when the LGD figure should be computed as per corporate investments.

Implicit[11] as well as explicit external ratings should be allowed to calculate the risk weight of an asset under the Standard Approach, for example, to enable the appropriate risk weight to be calculated on a pool for which only a short term rating had been sought.

The Standard Approach should also allow investors to look through a securitisation structure to the collateral assets and related credit enhancement to derive the appropriate external rating.

[11] For example, a senior tranche of a securitisation structure in which the mezzanine tranche has a short-term external rating could be derive its risk weight from the medium term equivalent of the short term rating

9. Operational Risk

9.1 RBSG's Reaction to the January Proposals

We acknowledge the Committee's requirement to explicitly address risks other than credit and market risks in *The New Basel Capital Accord* given the Committee's objective to create a risk sensitive Accord. Nevertheless we note that this field of risk management is in its infancy and has yet to go through the necessary evolution of isolating all possible paths of investigation let alone determine a risk framework based on a set of measurement standards which are broadly acceptable to the industry. Philosophically we believe that operational risk is a reflection of the way a business is managed and of the control structures put in place to operate its day to day processes. Given this perspective, we argue that it is inappropriate to create a Pillar 1 charge that adopts any particular quantitative. Our strong preference is a Pillar 2 approach which recognises the qualitative but measurable aspects of operational risk. Under Section 9.5 we outline a framework as to how it might be treated.

Thus whilst we welcome a number of features in the proposals, especially the exclusion of strategic and reputational risk from the scope of the charge and also the principle of recognising insurance as a form of risk mitigation, we are concerned with several aspects of the proposals. We are of the view that if these aspects remain unchanged, the proposed framework will only partially achieve its objectives of being more risk sensitive and encouraging better risk management. Moreover, we are also concerned that the proposals, as drafted, will not produce the intended outcome of neither raising nor lowering regulatory capital on average and could instead lead to an unwarranted increase.

In the more detailed comments below, we do not attempt to cover all the issues, but focus instead on three main areas of concern where we wish to put forward some recommendations for the Committee's consideration.

9.2 Absence of the Internal Control Environment

We note that each of the three options available within Pillar 1, the capital charge is calculated exclusively by reference to quantitative factors. Accepting that some qualitative hurdles have to be overcome before use of the more sophisticated approaches is allowed, nevertheless the calculation of the charge takes no account of investment in the control environment designed to reduce the risk profile of the business. In other words, too much emphasis is placed on backward looking quantitative elements with the result that the proposals, as currently drafted, only partially achieve the objective of a more risk sensitive capital charge.

Additionally, the absence of any qualitative adjustment under Pillar 1, which recognises the quality of controls, substantially reduces the incentive towards better management of risks within a particular approach. Of all the risk-types with which the proposal for a new Accord is concerned, operational risk is the least affected by external macro-economic factors, thus a good operational risk management function and good internal controls can have a significant impact on reducing levels of operational risk within a bank. This emphasises our view that this area is more appropriately considered under Pillar 2.

9.3 Calibration Revisited

We are of the view that the Operational Risk charge is too high. We revisit these concerns and expand on them below.

9.3.1 Calibration at 20% of Minimum Regulatory Capital

As discussed under Section 1.4 and outlined under paragraph 21 of *Operational Risk*, the 20% initial calibration of this charge is based on a survey of a small sample of banks. We also understand that it was based in part on findings contained in the BBA/IDSA/RMA survey, *Operational Risk: The Next Frontier (1999)*. We refute the use of this survey to justify a 20% calibration. First, the figures supplied under the survey were not only referenced to economic capital allocations which is conceptually not comparable to a minimum regulatory capital requirement. Furthermore, the methodologies employed were known to be crude with no reference to time horizons or confidence intervals and many of these banks many have included reputational and strategic risk in their definitions of operational risk which the Committee has excluded from the definition of operational risk in these proposals. Aside from the validity of the survey and the calibration it implies we are concerned at the use of business line weightings, derived in part from data provided by the same small sample of banks, to calculate beta values under the Standardised Approach. In particular we believe a weighting of 17% - 25% for Retail Banking to be excessive.

Finally, given that the RBSG is of the view that a number of losses which contain elements of both credit and operational risk should remain categorised as credit losses as they arise as a result of the credit process (Section 1.4), we would argue, that this holistic approach should reduce the level of calibration of the operational risk charge. Under Section 1.4 we also reference the complex infrastructure implied by the proposals to generate the data to support the overall calibration and in particular the Internal Measurement Approach (IMA).

9.3.2 Calibration at 30% of Gross Income under the Basic Indicator Approach

Industry research indicates that this particular calibration produces an even higher operational risk charge for the industry as a whole than the suggested benchmark calibration at 20% of minimum regulatory capital**.** We are concerned at the effect of the 30% gross income charge upon the other approaches, which will in turn be calibrated against this Approach. We therefore believe that further work needs to be undertaken to look at the mechanism for producing the calibration to ensure it does not result in over-capitalisation. We do not believe that such a calibration passes the basic sense check of being recognisable to management as posing risks at the levels suggested. Once again this suggests a Pillar 2 approach to this area.

9.3.3 Scope of Charge

We are concerned that the proposals require that regulatory capital should be held against operational events where no loss has been incurred (e.g. near misses) as there is no corresponding effect in the Profit and Loss account against which to measure the risk. We believe it would further overstate the minimum capital requirement to ignore recoveries (e.g. from insurance) and to include costs other than external payments directly linked to the event.

9.3.4 ABSENCE OF DIVERSIFICATION BENEFIT

Under the Standardised and Internal Measurement approaches a bank must map its activities to a line of business as defined under Annex 2 of the January 2001 *Operational Risk* document. The capital computation under these approaches is devoid of any benefit for diversification - capital charges calculated for each business line and loss type are added together to produce the overall charge for the firm. Since risks across different business lines are not correlated in this way, the result is an overstatement of the minimum capital requirement that may particularly impact larger, more diversified banks.

9.3.5 LINEARITY ISSUE

The capital charges being proposed under the Basic Indicator, Standardised and Internal Measurement approaches all presume a linear relationship between size and risk. The problem of "linearity" is introduced by the use of size based exposure indicators as a proxy for the amount of operational risk inherent in a business line. This will result in bigger banks having to hold disproportionately high levels of regulatory capital although they are arguably more sophisticated in identifying risks and are able to spend more on mitigating risks.

9.4 TIMETABLE

As stated above, the methodology for measuring operational risk is still at an early stage of development and at present no industry standard has emerged. A great deal of effort is currently being invested by the industry to develop working versions of the different approaches under Pillar 1. These approaches will need to be tested using data being collected under the Quantitative Impact Study and on an ongoing basis over the coming years. It is probable that changes to the existing proposals will be appropriate in the light of such testing and it may prove necessary to consider alternative, qualitative approaches (e.g. under Pillar 2). We are therefore concerned with the timetable set for implementation, which, due to the lengthy EU legislative process, means the period for constructive consultation and dialogue on the proposals is restricted to the first nine months of this year.

9.5 RECOMMENDATIONS

As outlined above, we have a number of specific concerns in regard to the Operational Risk proposals and a general concern that debate on this topic is at a very early stage. Furthermore we emphasise that our preference is for Operational Risk to be addressed under Pillar 2 and would welcome further dialogue on how this would be constructed. To stimulate the debate we attach Appendix I, a summarised template for a scorecard that targets some of the more common essential controls. This template illustrates how the overall internal control structure could be assessed and classified into 'bands' to formulate an operational risk capital charge under Pillar 2.

Nevertheless, in the spirit of co-operation we submit that the following recommendations would help to address the concern in Sections 9.2 and 9.3:

1. Reconsider the current proposed calibration in the light of data being collected under the Quantitative Impact Study and on an ongoing basis.

2. Include in the Standardised and Internal Measurement approaches a factor, developed by reference to the same data as above, to adjust the capital charge for diversification of the operational risk profile.

3. Retain in the final version of the proposals sufficient flexibility to allow for changes of detail needed in the light of testing (based on data collected after the consultation period) and to reflect subsequent developments in methodology. This is particularly important in view of the need to avoid premature "hard coding" of such detail in the related EU Directive.

4. Include qualitative adjustments to the calculation of the Pillar 1 charge based on objective and verifiable assessments of the quality of a bank's internal control structure. A number of industry initiatives are currently underway to develop a methodology based on a scorecard approach, which has yet to be fully fleshed out, but which may prove fit for this purpose. Such adjustments, whilst not directly resolving the linearity problem, would in some measure compensate for it and are therefore all the more necessary. They would also create a more risk sensitive, forward-looking framework and would encourage appropriate behaviour.

10. PILLAR 2

10.1 INTEREST RATE RISK IN THE BANKING BOOK

We believe that the Committee is correct in placing "interest rate risk in the banking book" in Pillar 2 of the framework and that the fifteen principles proposed therein are effectively a distillation of existing good practice.

There are, however, two points of detail within the consultative document which cause RBSG some concern.

Under Principle 13, in *Principles for the Management and Supervision of Interest Rate Risk*, banks are directed to "release to the public information on the level of interest rate risk and their policies for its management". Whilst we agree with this principle, we are concerned that the core and supplemental disclosures specified in Appendix 6 of Pillar 3 are somewhat excessive. This is particularly so given the need to produce this analysis to auditable standards for such a widely diversified Group.

We suggest two modifications that might make the disclosure requirements more acceptable, namely:

(a) bolstering the concept of materiality (i.e. large banking groups would be able to exclude small businesses or books with negligible interest rate risk and thus concentrate modelling resources on the larger businesses and portfolios with greater potential for interest rate risk); and

(b) the full level of disclosures need only be shared with the banks' regulator and auditor and that only a standard summary is put into the public domain.

Our second issue of detail regards the prescriptive nature of Annex 4 in *Principles for the Management and Supervision of Interest Rate Risk.* Whilst the Annex is only an example of a standardised framework to be used for supervisory reporting purposes only, we are concerned at some of the directive language contained in it such as “core deposits are to be slotted assuming a maximum duration of 2.5 years”. We would have expected the relationship, under Pillar 2, to be more one in which banks were expected to justify to their regulator their existing methodologies and assumptions. Thus we would simply recommend that Annex 4 be dropped.

10.2 OPERATIONAL REQUIREMENTS

The Pillar 1 minimum requirements set by Committee are both quantitative and qualitative and work to determine where and when a bank can use its internal measures. We are concerned that the Committee has taken an overly prescriptive approach to address “level playing field concerns” and not fully recognised that prescriptive approach does not necessarily imply that the supervisory role is reduced. Under the Accord, a bank’s “sophistication” and the extent to which it is allowed to use its internal estimates and rating systems will be a direct function of the local regulator’s assessment of whether criteria and operational requirements prescribed under Pillar 1 are met.

An example of such a requirement is the need for 7 years of LGD data before a bank will be given consideration in using its own estimates under IRB Advanced. Final determination of whether the data set is valid, however, will be determined by a plethora of criteria concerning the quality of the data. For instance, each estimate of LGD must be grounded in historical experience and empirical evidence and, at the same time, be forward looking. Moreover, banks must have at least several distinct LGD grades which provide a “meaningful differentiation of loss rates, yet, taken together reflect the full range of the bank’s credit extending activities.”

We argue that such prescription may introduce significant inflexibility (especially for EU countries where this language may become codified) and does not reduce the scope for uneven implementation of the Accord as each supervisor will have undoubtedly interpreted these requirements against a different test or suite of test standards. The Committee needs to take a leadership role to promote the consistent implementation of some of the operationally complex aspects of the Accord and articulate a set of guiding principles that address questions such as data pooling. A statement of standards would also provide a set of benchmarks for regulatory disclosure and in this regard we urge the Committee to consider our remarks on regulatory disclosure (Section 11.2) as a means of ensuring a consistent and transparent application of the Accord.

11. DISCLOSURE (PILLAR 3)

In principle, the RBSG accepts the important role that additional or enhanced disclosure play in new Accord. However, we are concerned by the volume and complexity of the proposals and remain to be convinced that they would achieve the objective of improving market discipline. We believe that, to promote a uniform approach to the new Accord amongst national regulators, they should be required to publish summary information about its implementation in their jurisdiction.

11.1 BANK DISCLOSURE

Whilst we recognise the role Pillar 3 provides in its support of Pillars 1 and 2, we are unconvinced about the need for the volume and complexity of the information required under the current Basel 2 proposals and note that the requested data may include proprietary information. We are also of the view that the disclosure proposals could be potentially destabilising. Moreover, we are the view that the information being requested does not fulfil the Committee's objective as articulated in paragraph 3 of the *Pillar 3 (Market Disclosure)* document. That is, the use of market disciple to reinforce minimum rules and supervisory review. The Committee's aim has been to develop a set of proposals that will allow market participants to "…assess key pieces of information on scope of application, capital, risk exposures, risk assessment and management processes, and hence the capital adequacy of the institution". We therefore would like to make two recommendations in this regard.

The first is in regard to the types of accounting information that Pillar 3 requires. The volume and complexity of the proposals are such that they are not suitable for inclusion in general purpose financial statements. We support efforts by the International Accounting Standards Board (IASB), through its review of IAS 30 'Disclosures in the Financial Statements of Banks and Similar Financial Institutions', to improve disclosure by banks globally. Although the objective of disclosures in financial statements is not that contemplated by the Accord, we urge the Committee to work with the IASB to ensure that data that would help market participants and are consistent with the aims banks' financial statements are mandated in the revised IAS 30. However, we have concerns that, given typical timetables for the publication of annual financial statements, the information in them is unlikely to be sufficiently current to influence market behaviour. If Pillar 3 is to operate effectively some other means of disseminating the data on a more timely and frequent basis than financial statements should be considered. The disclosures may well be price sensitive and some mechanism for meeting Stock Exchange requirements on the communication of such information would have to be met.

The second recommendation is in regard to the types of risk information that Pillar 3 requires. We are of the view that market participants would, in fact, be better served by a focus on the performance of an institution's credit portfolios under a variety of scenarios supplemented with relevant summary data about the portfolio(s) under investigation. These scenarios should be related to management's understanding of the macro economy and any forecast of such. A bank could for example, publish its forecast of the macro-economy or ranges of the important macro-variables that the bank thinks matters (stock market levels, interest rates, oil prices etc). Alternatively, it could publish a benign, a most likely and an adverse change in the current macro-economy. In either case, the bank could disclose how the portfolio(s)

under investigation responds. Scenarios reflecting adverse economic conditions may help address pro-cyclicality concerns.

An example of relevant summary data could be the publication of asset quality distribution say using the 3 broad bands as contained in the Committee's Quantitative Impact Study (QIS). That is, bands from 0 to 0.20% (which is investment grade), 0.20% to 0.8% (which is at or near investment grade around BBB), and greater than 0.80% which is sub-investment grade.

In addition to these macro-economic scenarios, in the credit context a bank could publish how its current credit portfolio would respond to the following two tests:

(i) a notch (internally determined) down grade everywhere;
(ii) a down change in PD of say 10% (a PD of 1.00% becomes 1.10%)

In all cases, to prevent the disclosure of proprietary information, disclosure of quantitative results could be restricted to percentage changes only. These tests together generate information about the rating system in use - the granularity of the grading system and the quality distribution of the exposures across the range of grades/PDs in use.

We would welcome further dialogue with the Committee on how this approach may be applied to specific exposure types and/or the trading book.

11.2 REGULATORY DISCLOSURE

It is vital that *The New Basel Capital Accord* is implemented in a consistent and transparent manner. To this end we see significant merit in each national regulator publishing summary information that allows objective comparison of how national regulators have implemented the Accord. Such disclosure would have the additional advantage of providing market participants with useful aggregate information that might allow the Committee to reduce the disclosure burden for individual banks.

For purposes of this discussion we suggest that such a disclosure requirement needs to include the following:

- statements that require national regulators to indicate how they choose to test the various Pillar 1 criteria. One such criterion is whether a data series for LGD assessment qualifies for Advanced IRB treatment;
- statements regarding each regulators interpretation of what constitutes an aggressive timetable when a bank is rolling out IRB;
- the distribution of banks applying for and achieving the Standard approach, and Foundation and Advanced IRB status;
- the distribution of exposures across the various exposure classes;
- disclosure as to the criteria used to determine "retail" or "corporate" boundary within a jurisdiction;
- the distribution of banks applying for and achieving the various operational risk approaches; and
- a summary list of areas of the Accord where national supervisors have applied discretion to accommodate jurisdictional idiosyncrasies.

APPENDIX 1

- As stated under Section 9.5, we would like the Committee to reconsider the Operational risk proposals published in January 2001 and adopt a Pillar 2 treatment of this risk with a charge referenced to an objective assessment of a bank's control environment.

- The assessment could be based upon a scorecard that would target best practice control mechanisms within an organisation (examples of which are shown below) to ensure that operational risk is demonstrably managed.

- While we appreciate that the contents of such a scorecard would need to be carefully considered by the Committee, we have included a set of qualitative criteria that outline our early thoughts on this matter.

- Under the provided template 'A' is the most punitive band with the full % charge being levied, whilst (moving through 'B' to 'D') 'E' is the least punitive having been arrived at via an assessment of the internal control infrastructure of an organisation.

Band	STARTING Operational Risk Capital Charge %	Factor % (See scorecard)	FINAL Operational Risk Capital Charge %
A	X	0	X
B	X	(I)%	X less Factor (I)%
C	X	(II)%	X less Factor (II)%
D	X	(III)%	X less Factor (III)%
E	X	(IV)%	X less Factor (IV)%

		Scores						
No.	Qualitative Control Measure	0	2	4	6	8	10	Total
1	Business Continuity Planning and Tests							∑
2	New Product Approval Process							∑
3	Key Performance/Risk Indicators							∑
4	Turnbull Reporting (Risk Identification)							∑
5	Insurances							∑
6	Operational Risk Reviews							∑
7	High Level Controls Manual and Procedure							∑
8	Supervisory Manual and Senior Manager Responsibilities							∑
9	Compliance Reviews and Training							∑
10	Internal Audit							∑
								∑

	Band A 0 – 20	Band B 21 - 40	Band C 41 - 60	Band D 61 - 80	Band E 81 - 100
Factor	0	(I)%	(II)%	(III)%	(IV)%