Basel Committee for Banking Supervision
Consultative Document 164: Strengthening the Resilience of the Banking Sector
Response by the Royal Bank of Scotland Group

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This Appendix is intended to be read in conjunction with the covering letter for our responses to the Basel Committee's December 2009 capital and liquidity consultation papers.

Proviso

At the date of submission of these comments to the Committee we have not yet completed the process of collating and analysing our QIS results. This analysis process will help us to review and update our view of the relative importance of the individual components of the proposals and their cumulative interaction. The following is therefore subject to later change.

Definition of capital - paragraphs 60-109

General comments

We have no material or strong concern with the elimination of the distinction between upper and lower Tier 2 and their combination is consistent with the generic view of gone concern capital. The characteristics of Tier 3 capital are generally awkward to align with the trend of looking to strengthen the overall quality of capital tiers and the elimination of this form of capital does not cause undue concern.

The proposed criteria for Core Tier 1 undoubtedly support the desire to strengthen the quality of the respective tiers of capital. The focus on permanence, loss absorbency and flexibility of payment are essential pillars for Core Tier 1. Proposals centre around the requirement for a "predominance" of Core Tier 1 within Tier 1 but the document defers proposing specific floors, pending review of the QIS data. The calibration of any ultimate limit for non-Core Tier 1 would be of critical concern to us.

The proposed approach to grandfathering in respect of non-Core Tier 1 capital instruments is a key consideration here as the presence of material amounts of legacy instruments may distort comparability of capital ratios for regulatory purposes and across peer groups. We think it is likely that many interested parties, including rating agencies, will continue to apply their own capital definitions and in doing so may discount the contribution of grandfathered instruments.

The proposed characteristics of Tier 2 capital, including common subordination and prior regulatory approval for early calls, reinforce the standing of this capital as gone concern capital. Given the requirements around amortisation and prior regulatory approval for calls we disagree with the requirement for a minimum five-year maturity. Tier 2 capital will remain fully available as gone concern capital until maturity and supervisors already have powers to restrict early redemptions. The qualification criteria for Tier 2 capital should not be over-engineered. That would hinder issuing Tier 2 instruments. This category of capital will continue to have a significant part to play as a source of funding.

Grandfathering provisions should be framed to be consistent wherever possible to avoid relative distortions and inequitable capital treatments. Clarification of the intended scope of availability of grandfathering should be provided as early as possible to remove existing uncertainty in capital markets. The scale of the significance of our concern about grandfathering is expected to become clearer on completion and analysis of the QIS exercise. Key analysis will include an assessment of the phasing implications of managing transition in regard to qualifying criteria of capital, the predominance issue and also the impact of capital deductions.

Aspects in respect of prudential filters and deductions, and specifically their application at the Core Tier 1 level, are covered below.

The recent financial crisis tested the effectiveness of loss absorbency in capital instruments, with particular relevance to non-Core Tier 1 items. Effective loss absorbency would be enhanced by characteristics that go beyond dividend and coupon discretion. Features such as write down of principal amounts or conversion to Core Tier 1 would underpin the strength of capital and offer secure mitigants in demonstrating the ability of an institution to satisfy regulatory stress tests. The application of grandfathering is again an important consideration here.

As a general principle, it is felt that triggers should be objectively set with an automatic, firm-specific character rather than driven by systemic criteria or regulator discretion. This will remove elements of market speculation over potential activation; further, triggers that hinge on regulatory decisions are considered problematic because they will remove transparency to investors. The general industry view is that triggers will need to be set low enough to appeal to debt market investors such that any breach is seen as remote enough so as to not skew market interest.

In respect of write-downs, we believe it is important to recognise that write-downs may be temporary in nature and that under certain conditions there will be the ability to write back up relevant instruments once all the underlying capital concerns that contributed to a trigger event have been remedied.

A number of proposed prudential adjustments prompt comment here.

Deferred tax assets (“DTA”)

The full deduction of DTAs associated with future profitability appears overly punitive and more in line with a gone concern approach rather than consistent with underlying going concern principles. In fact, DTAs will often have value even in a gone concern situation. Full disallowance will introduce procyclicality into the capital calculation and is inconsistent with IFRS accounting approaches which in turn apply prudent assessment of carrying values and scope for netting which are subject to independent audit. Possible alternative treatments for DTAs are to either (i) retain the alignment with the accounting evaluation or (ii) allow recognition of part of DTAs up to a prescribed cap as currently occurs in the US, either by reference to a quantum or the timeframe of realisation against expected future profits, or (iii)

deduction at an alternative level of capital to reflect the potential gone concern nature of the adjustment.

In our own case, with our recent history of large losses, DTAs at December 2009 stood at £6.5bn or 13.5% of current Core Tier 1 capital[1] and a phased transition to a new Core Tier 1 deduction approach or the grandfathering of current DTAs would be necessary to allow us to manage the capital position.

Minority interests (MI)

The proposed exclusion of all MI seems overly prudent and asymmetric in terms of still recognising 100% of related RWAs in MI subsidiaries. A number of international banks necessarily structure operations in certain emerging markets through local partners with associated MI and the proposed treatment would seem disproportionately punitive. An alternative treatment is to cap the level of MI that can be recognised by reference to the MI subsidiary RWAs or the impact on the capital ratio, so as to effectively disqualify any existing "surplus" MI in individual subsidiaries from cross subsidising exposures in other parts of a group.

Holdings of own shares and those of other financial institutions

We consider a limited market making exemption along the lines developed in the EU by CEBS will facilitate routine market making activity promoting liquidity in our own and other bank shares. The CEBS approach is to allow non deduction where less than 10% of an issue is held or where holdings are less than 3% of a bank's capital resources. Banks also hold shares to hedge the deferred compensation schemes which regulators are encouraging to a much greater extent than historically. We consider that long holdings of own shares acquired for this purpose should be netted off against the related long term liability.

Intangibles

We would seek clarification on a case by case basis as to whether it could be appropriate to allow recognition of certain specific intangibles such as mortgage servicing rights where a potential realisable value can be demonstrated rather than simply apply a blanket deduction.

The proposed requirements for hybrids specify prior supervisory approval needs to be secured for any exercise of call option. In addition, there is a prescribed requirement to either issue replacement capital or demonstrate to regulators a robust capital plan. These proposals appear robust.

Removing the existing regulatory filter could introduce potentially material procyclicality into Core Tier 1 capital figures by way of exposing the calculation to elements of short term volatility. We understand that the treatment of unrealised gains as set out under IFRS is subject to prospective review and revision. We would recommend that any regulatory proposal gives appropriate consideration to likely accounting developments.

If resolution remains to consider changes to existing prudential filters, it is recommended that an exemption/exclusion is considered for certain assets e.g. those held for liquidity purposes.

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[1] Source - Taxation note on page 91, capital resource table on page 114 of RBS Group 31 December 2009 financial statements. Core tier 1 on basis of current rules was £48.2bn.

Large exposures

The use of a going concern capital benchmark seems appropriate in gauging large exposure metrics. The transition to a new reference point, however, would introduce scaling issues given the lower base capital measure and we definitely agree the need to consider a review of the respective 10% and 25% thresholds. We would expect any new basis and thresholds to reflect the findings of the QIS and be calibrated so that large exposures constraints against existing credit appetite do not arise simply as a mechanical result of transitioning to the new capital base measure.

Contingent capital offers strong benefits in terms of providing buffer protection against the crystallisation of stress events, thereby contributing to the capacity of a regulated entity to satisfy regulator-set stress test scenarios. Consistent with the view set out above for triggers for conversion or write-downs on non-Core Tier 1 capital, we believe activation triggers for contingent capital should be objectively set and avoid regulator discretion except in the most unusual of circumstances. This will retain transparency for prospective investors and so facilitate the marketability of contingent capital instruments.

Counterparty credit risk - paragraphs 112- 177

Executive Summary

Given the complexity of the issues covered by this section of the proposals RBS would strongly recommend that the Basel Committee has bi-lateral discussions with industry participants.

RBS fully supports the need for a robust framework for ensuring the appropriate capitalisation and risk management standards for counterparty credit risk (CCR).

There is one area set out in the consultation document for which RBS would like to provide some further thoughts: the proposals on the treatment of mark-to-market of counterparty losses.

RBS supports the need to ensure that the risk attributable to the market value of counterparty risk losses is adequately capitalised. Moreover, RBS supports the basic framework set out by Basel and, in particular, is in favour of the intention to look through the accountancy regime and directly at the economic risk. However, RBS finds that the current implementation would result in an amount of capital that is hugely disproportionate compared to the economic risk. This would result in a material divergence between capital and risk. In order to address the weaknesses in the proposed framework, RBS suggests the adoption of a methodology for capitalisation of CVA risks that:

- aligns the capitalisation of CVA risks to the market risk of counterparty credit risk through the use of risk-sensitive inputs consistent with those used to measure and risk manage CVA;
- uses an approach to capitalising the market risk attributable to counterparty credit risk that is consistent with the existing approach to capitalising market risk; and
- recognises in a conservative manner all effective hedges that are used to risk manage CVA risks.

Treatment of Mark-to-Market of Counterparty Losses

RBS strongly believes that the framework for the capitalisation of CVA risk should follow a number of key principles:

1. Capital should be aligned to the economic risk; less capital should apply to a hedged exposure compared to the same exposure that is unhedged and has higher economic risk.
2. The reduction in capital through hedging should be commensurate with the reduction in economic risk.
3. The magnitude of reduction in capital through hedging should be scaled in line with the effectiveness of the hedge and should not be binary in nature (i.e., hedges are either recognised as perfect or ineffective).
4. The degree of offset of economic risk should be recognised in capital in a conservative and prudent manner.
5. The framework for capitalising CVA risks should be formulated to avoid capital disincentives to reduce economic risk.

In line with these principles, RBS would contend that certain aspects of the proposed methodology to capitalise CVA risks result in an inappropriate divergence in risk and capital. This would lead to levels of capital that would be not only far in excess of magnitude of the risk that the proposals are seeking to capture, but that would not respond to changes in the underlying risk in an economically sensible manner.

Proposed Approach	**Comment**
Capital based on a stand alone VaR-based approach	The BCBS proposal requires a capital calculation for the market risk attributable to counterparty risk in isolation from the firm's market risk exposures. The market risk of CVA is measured and risk managed as part of the overall portfolio subject to market risk and the requirement to perform a stand alone calculation results in a material overstatement in the measurement of the CVA risk for capital purposes. This is exacerbated by the lack of recognition of hedges (see the point below). The proposal leads to a divergence between the CVA risk as determined for risk purposes and the level of risk assumed for capital purposes and is not in line with Principles 1, 2, 3 and 5 set out above. Whilst strongly believing that full modelling of CVA is by far the most satisfactory approach, RBS acknowledges that the market risk representation of counterparty credit risk could plausibly be achieved via the construction of hypothetical equivalent bonds, but stresses that it is critical that the features of these equivalent bonds (e.g., their notional) are so modified as to make them more consistent with the economic exposures as captured by an institution's sensitivities.

Proposed Approach	**Comment**
Restriction of eligible hedges to name specific instruments	The BCBS proposal restricts the eligible hedges to those instruments that directly reference the counterparty such as single name credit default swaps. In reality it is very difficult to hedge many names through name specific instruments and it is common practice for firms to use liquid, cost effective and transparent index credit derivatives to risk manage portfolios of exposures including exposures arising from counterparty credit risk. Although index credit derivatives may not reference individual names of a portfolio, they provide for effective hedges to portfolios. The current approach results in higher capital requirements for CVA risks that have been hedged by index credit derivative hedges compared to the same CVA risks that have not been hedged. This would contravene Principles 2, 3 and 5 and has two undesirable consequences: (1) it results in an inappropriate and unnecessary tension between risk management and capital optimisation and (2) materially misstates the level of CVA risk that is capitalised through ignoring the reduction in effective hedges. RBS strongly believes that it is of paramount importance that the framework for capitalising CVA risks incorporate the ability to recognise all effective hedges. We recognise that this will need to be done in a prudent manner so that relevant basis risks are considered (Principle 4).
The use of a 1-year time horizon in calculating VaR and stressed VaR	The existing market risk capital adequacy framework captures both expected and unexpected loss through the use of a 10-day time horizon and 99% confidence level. The minimum multiplication factor serves to appropriately scale the VaR to a prudent level for capital requirement purposes. Moreover, the introduction of a stressed-VaR-based capital requirement further enhances the capture of expected and unexpected losses attributable to market risk. The objective of the new framework is to capture the market risk of counterparty credit risk and the use of a one-year time horizon in place of a 10-day time horizon is inconsistent with the market risk capital adequacy framework and is inappropriately punitive, particularly as both the minimum multiplication factor and stressed VaR are both incorporated into the calculation of capital. RBS contends that the framework for capturing the market risk of CVA should be consistent with the basis of the existing market risk framework.

It is noted in paragraph 124 that the use of a fixed notional in deriving the hypothetical bonds used to capitalise the CVA risk may result in a misstatement of the extent of potential CVA losses, but this approach has been selected for the ease

of implementation. It is further noted that the Committee will review other internal approaches that more accurately reflect the risk from a change in exposure.

RBS finds that, although conceptually flawed, the broad idea of an equivalent bond is a simple and working starting point towards the far more satisfactory, model-based treatment of CVA. However, in its current formulation, there are major shortcomings: the sensitivity to market risk factors is not captured (this would run against Principles 1, 2, 3 and 5) and the maturity of the bond is not linked to the economic risk. RBS therefore proposes that the notional and maturity of each hypothetical bond should be made a function of the sensitivity of the CVA to default and market-risk factors. This would allow a much better representation of the true market risk of counterparty credit risk and alignment of capital to economic risk.

The main advantages of the proposed approach would be:

- it retains the simple conceptual framework of the equivalent bond;
- it is transparent and risk sensitive;
- it naturally lends itself to further extensions towards full modelling, once enough confidence will have been gathered on the various components of the methodology; and
- it allows a prudent capitalisation by a careful choice of multiplier and of the extent of correlation allowed.

External ratings and cliff effects - paragraphs 178 – 201

No comment

Leverage ratio – paragraphs 202 - 38

Key Concerns

1. We understand regulators desire for a simple fallback measure. Our comments are aimed at ensuring such a measure does not create unintended consequences and achieves the objectives regulators have set themselves. We understand those objectives to be:

    - ability to monitor (and where appropriate control) overall leverage in the system.
    - a measure to supplement risk sensitive capital requirements.
    - ensure sufficient funding liquidity is present.

    Our key message is that only a leverage ratio that is institution specific would achieve these objectives. This does not undermine the requirement for simplicity and comparability that are a hallmark of the proposals, which should be maintained for calculation purposes. But we do see it as essential that any leverage ratio that is actually set as a binding requirement for a specific institution takes account of its specific business mix. This will not make it a risk sensitive requirement but it does mean that regulators and firms could have a sensible debate as part of their Pillar 2 discussions about what ratio is appropriate for a firm, focussing on variability of trends and recent changes rather than ratio levels which may not be transparently comparable across firms.

    Such an approach is particularly important given the calibration debate. An inappropriately calibrated leverage ratio is likely to lead to additional risk taking by some institutions, while hurting those that run low risk operations.

There is in our view no single calibration that could avoid such consequences. We would therefore argue strongly for institution specific leverage ratios, combined with a “comply or explain” Pillar 2 approach.

This approach, which we commend to regulators, will still allow the regulatory community to monitor overall leverage in the system, given that it maintains a uniform calculation which ensures comparability and the possibility of aggregation. Aggregation in turn will allow monitoring of the leverage in the system. However, the firm specific discussions will enable the monitoring to be much more effective, as the underlying drivers can be understood much more easily. Indeed, we would suggest that even for individual firms the process of monitoring, analysing and discussing trends in their leverage is what would provide the main benefit of a leverage ratio.

A particular concern is that trading activities are hit particularly hard if no netting is allowed. If that result is intentional we consider that the regulatory concern should be addressed as part of the supervisory review of trading activities rather than indirectly via a crude leverage ratio. We note that current proposals, which are already at the implementation stage, have already hit trading activities significantly. An additional concern is that under the proposed calculation methodology trading book impacts could add significant volatility to the leverage ratio. An implication from this is that firms involved in these activities would need a higher leverage ratio buffer, which would make a leverage ratio binding much earlier than a simple ratio would suggest.

Finally we would like to add that it is inappropriate to generalise from the few and restricted leverage ratios that operated in certain jurisdictions during the recent crisis and assume that the new proposals would have the same benefits. On the contrary we would be concerned that the significantly wider current proposals would be ineffective in comparison to existing schemes. We say this because existing leverage ratios were targeted to certain types of banking structures appropriate for their respective jurisdictions and did not have the broad scope that the new proposals have.

Detailed Issues

2. We read the Committee’s proposals as suggesting that a leverage ratio applies on a consolidated basis. Certainly for monitoring the overall leverage in the system a group leverage ratio ought to be sufficient. If the leverage ratio is also applied to individual subsidiaries, as currently proposed in the EU CRD4 working paper, we feel that this would cause additional complexity around the treatment of intra-group transactions and will complicate balance sheet and treasury management across the Group. This reinforces the importance of the Committee implementing a useful and practical leverage ratio measure that can be meaningfully used in supervisory reviews.

3. To us the proposals represent an extreme scenario, well in excess of the plausible requirements that are generally required for stress tests. This reduces the usability of such a ratio for management purposes. We nevertheless recognise regulators’ desire to introduce a simple measure. This reinforces the need to have the proposals implemented on an institution specific basis, otherwise business models relying heavily on risk mitigation, with appropriate netting and holding security will be negatively impacted.

4. Netting – We would favour a consistent approach to netting, as opposed to no netting. This is because we feel that legally enforceable netting, particularly if

recognised for accounting purposes, is an important risk mitigant that should be recognised by regulators. While we accept that there are differences between jurisdictions, we are not convinced that these are material enough to justify a position of no netting.

5. Repurchase transactions and securities lending transactions – We feel that the risk of such activities is incorporated in liquidity requirements and it would not be appropriate to also manage this on a gross basis for the leverage ratio. We assume that the netting proposals in this instance refer to netting against the same counterparty, in which case we are of the view that netting should be allowed.

6. Securitisations – We would prefer alignment to regulatory de-recognition rules as these are more representative of the real risks. Regulators have significantly tightened up the significant risk transfer requirement and therefore we do not see the benefit of using the accounting treatment. Finally the alternative proposed of no de-recognition will simply make the leverage ratio less relevant to the real need of both regulators and firms.

7. Derivatives – We would support an accounting approach with netting and appropriate off-sets. While we accept that this would not take into account future potential exposure, we are not clear about the rationale for incorporating future potential exposure. It is our understanding that the leverage ratio does not have a one year horizon, or a similar concept. As a result we feel that the accounting approach is appropriate. We have already explained why netting should be allowed.

8. Credit derivatives – As already indicated we feel that netting and where appropriate off-setting should be recognised, at least to the extent allowed in the market risk framework. Without such recognition we feel that trading activities are treated more harshly than other banking activities. This is because trading activities, unlike most banking book activities, are undertaken on the basis that risks can be hedged away. As a result the non-recognition of netting and off-setting has a more punitive effect on these activities. This is one of the reasons why we say that a single leverage ratio across all institutions is not workable. The appropriate place to address concerns with credit derivatives is the capital requirement calculation, not the crude methodology of the leverage ratio. A further difficulty we have with the current proposals is that they suggest a punitive approach to credit derivatives by overstating the maximum possible loss. We suggest some reference along the lines used in the comprehensive QIS: "For a short position this limit could be calculated as a change in value due to the underlying names immediately becoming default risk-free. For a long risk position, the maximum possible loss could be calculated as the change in value in the event that all the underlying names were to default with zero recoveries".

9. Other off-balance sheet items – While we accept the need for simplicity in any leverage ratio calculation we would urge regulators to consider the effect this has on the wider economy. We would urge the Committee to take account of the secondary effects of depriving commercial companies of the benefits of undrawn credit facilities and letters of credits, which this proposal will lead to. This is particularly important in the current environment where firms more than at any other times need to be able to access liquidity at short notice. We are convinced therefore that behaviourally the inclusion of many such off-

balance sheet items will hit the vulnerable parts of the economy, such as SME's and firms relying on international trade.

10. Disclosure – While as a general statement we are in favour of Pillar 3 and the additional transparency it provides, we are doubtful that in the case of the leverage ratio disclosure would achieve regulatory objectives. This is because as a measure it does not actually contain any comparability between firms, given the different business models that are in place and the overly simplistic assumptions made in calculating it. We would therefore caution regulators against forcing firms to publish a ratio which can only be sensibly used in a firm specific context. We would have no objection to private disclosure of leverage ratios to our supervisor as part of a Pillar 2 dialogue.

Procylicality - paragraphs 239 - 262

We share the view that the procyclical interaction of the capital and accounting regimes needs attention. Any changes in the approach to the recognition and measurement of provisions for financial reporting purposes must be dealt with by the IASB and should not be confused with counter-cyclical buffers and other regulatory measures.

Cyclicality in the minimum requirement

We agree the Basel II framework has increased the risk sensitivity and coverage of the regulatory capital requirement and recognise that there is a trade off between increasing risk capture and sensitivity at a given point in time and the degree to which the minimum capital requirement is cyclical overtime. However we consider the extent of this effect is not yet clear. Once further evidence has been gathered, we agree the Committee should assess what additional measures to dampen cyclicality could be developed, over and above the flexibility already available to banks and their supervisors in the framework to dampen cyclicality via the application of downturn or through the cycle PDs. Care will be needed to ensure the use test principle is not undermined by the use of overly conservative regulatory PDs.

Forward looking provisioning

Earlier accounting recognition of expected losses would reduce procylicality and we support the proposal to move from an incurred to an expected loss approach. At this date the IASB proposals are still in consultation. We do not agree with the current IASB expected cash flow proposal based on an Effective Interest Rate methodology. We consider that it will prove to be procyclical and also complex and costly to implement. In our view IASB can meet the G20 objectives via adoption of a simpler model which makes greater use of the systems developed for Basel II purposes. We do agree with the Committee that the methodology eventually adopted should reflect expected credit losses in existing portfolios over the life of the portfolio.

We strongly oppose proposals for 'dynamic provisioning' which conflate the recognition of losses for accounting purposes with the need to provide a buffer against losses which may arise in future over the economic cycle from business which has yet to be written. We believe such measures reduce transparency and therefore have the potential to seriously damage market confidence in financial institutions.

We note that the Committee plans to publish specific proposals on provisioning later in the year and that the IASB consultation also only closes later this year. Further analysis and decisions on specific policy responses should be deferred until we have the fuller picture.

Building buffers through capital conservation

We agree that there may well be a case for counter-cyclical capital buffers to be built over and above the minimum capital requirement but, as already stated above, we oppose measures such as 'dynamic provisioning' which distort the financial reporting framework.

The conservation buffer is compatible with the FSA's current Pillar 2B add-on and such consistency is welcomed. The buffer must be capable of being drawn down at the relevant point in the economic cycle. We are concerned that if information on buffers is in the public domain market participants such as rating agencies will react adversely to drawing down on these buffers and they will quickly be viewed as fixed additional capital requirements. We note that we are already required to obtain supervisory approval of our ICAAP, which includes an assessment of the impact of proposed distributions and stress testing results, as part of the Pillar 2 process and so do not see the necessity of hard coding a formulaic approach into the requirement, although we accept the numeric example in the paper is illustrative only.

Excessive credit growth

We look forward to opportunity to review the Committee's proposals when published later this year. At this point we simply note that calibration factors, e.g. economic variables and trigger levels, should be tailored to individual banks and that while indicators such as credit supply / GDP can help to identify asset bubbles, drawing specific conclusions from one on the other requires context and interpretation.