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Dr. Nout Wellink
Chairman
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

15 April 2010

Dear Dr. Wellink

Strengthening the Resilience of the Banking Sector

I enclose The Royal Bank of Scotland Group's ('RBS') response to the above consultation. We have set out below what we see as key themes arising from our analysis of the proposals. The attached appendices comment in more detail on specific aspects of the proposals.

Overall objectives

We fully agree with the overall G20 objective of strengthening capital and liquidity levels in the banking system, and in improving the quality, consistency and transparency of banks' regulatory capital base. Banks have already made significant progress in this respect, and we will continue to engage in this process as well as support regulators constructively in developing appropriate regulation that delivers these objectives.

We would also stress the importance of a balanced approach to strengthening the regulatory framework, one that places equal emphasis on preventative measures such as strengthened governance and risk management standards, and effective supervision, alongside necessary improvements in capital and liquidity buffers.

More broadly, we would urge a holistic approach to identifying and addressing the root causes of the crisis. Besides banks' own shortcomings, and certain regulatory and supervisory weaknesses, wider macro-economic factors were also a significant consideration. Whilst failures in the financial sector clearly need to be addressed, regulation cannot on its own deliver financial stability. We would therefore urge the wider policy making community to address the monetary, fiscal and other economic policy issues raised by the crisis.

Aggregate impact and timing

Whilst fully supporting the direction of travel with respect to capital and liquidity, we would urge a note of caution as to how far and how fast policy makers move in that direction. The cumulative and wider economic impacts of these proposals are not yet known. The scale and pace of the reforms present supervisors and banks with major challenges in assessing which specific measures will deliver the desired protection for tax-payers and what the trade offs will be for the wider economy.

Although banks are working hard to respond to the Quantitative Impact Study (QIS) by 30 April, we are concerned this exercise will not provide all the information required for a definitive considered assessment and transparent discussion on how to calibrate the framework. The Committee's as yet unpublished proposals for specific measures for systemic institutions and for provisioning practices cannot be factored in, nor are various other regulatory changes included in the QIS. The cumulative interaction of the multitude of individual proposals may include unintended consequences which are difficult to identify at this consultation stage and in the current timescales, given the many other changes and pressures we are all facing.

Noting the G20's clear desire for the development of new capital and liquidity rules to be substantially complete by the end of 2010, we would urge the Committee to consider how best to phase in the new requirements on an incremental basis which permits a steady gradual progression to the end goal whilst providing mechanisms to quickly amend specific measures which do not operate as intended. In considering the transition path, care needs to be taken to ensure that this is framed in such a way that markets do not simply anticipate all the changes up-front, in a way which negates the benefits of a transition, and that carefully considers the market's capacity and willingness to absorb the capital raising required and to build up liquidity levels, at a time when the attractiveness of banks to the investor community may be re-rated.

The QIS focus on the impact on banks' capital and liquidity should be married with a wider assessment of the anticipated benefits and opportunity costs of greater financial stability. We understand that the Committee is undertaking a wider 'top-down' analysis, and would welcome a sharing of that analysis with industry and the public. Some trade associations and their members, including ourselves, are already working on similar analyses and will share these results with policy makers. This work makes clear that significantly increasing prudential requirements will reduce banks' return on equity to unattractive levels for investors. Potential responses by the banks to restore returns will involve business model changes which will have real economy impacts, thereby hindering economic growth. Responses are likely to fall into three main categories: reduction in the supply of credit (deleveraging), increases in the price of credit or reductions in costs and services.

Key comments on specific proposals

Our detailed comments on the specific proposals are discussed in the attached appendices. We highlight here our key comments where specific proposals may have disproportionate or perverse capital and business impacts.

1. Leverage ratio

   We are very concerned that this "simple, non-risk based backstop measure" will become a binding constraint on credit risk, market risk and balance sheet appetite, especially if incorporated into Pillar 1 with exposures measured on a gross basis. In our view there is no single calibration that achieves regulatory objectives. However we think there would be value in using institution specific leverage ratios which incorporate regulatory netting as an input into the Pillar 2 discussion with supervisors. Specific concerns on the detail of the measurement approaches are discussed in the appendix. If implemented as currently proposed, the leverage ratio will significantly impact and complicate bank's activities without being a practical and useful measure.

2. Definition of capital - including minority interests and deductions

   Grandfathering and other transitional provisions are important in the current environment where the regulatory objective is to transition to stronger capital levels in the medium term without holding back economic recovery.

   We consider there may be realisable value in deferred tax assets (DTAs), recognised with the agreement of our auditors as assets under IFRS. If the Committee's concern is to avoid undue reliance on DTAs then other approaches, such as caps on DTAs as a percentage of regulatory capital, would address this. The proposal to fully disallow DTAs would have a pro-cyclical effect. In our own case recent losses mean that DTAs stand at 13.5% of end-December 2009 Core Tier 1 capital and a phased transition or grandfathering of current DTAs would be desirable.

   We disagree that the proposed exclusion of minority interests from the common equity element is appropriate. Minority interests provide protection against exposures in subsidiaries. Concerns about inappropriate cross subsidy can be addressed by adjusting for subsidiary RWA or capital ratio impacts.

   As regards holdings in own shares, 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 bank shares.

3. Counterparty risk requirement - lack of proportionality of CVA charge

   We recommend that the Committee engages in bilateral discussions with industry participants to explore the complexities of this area. In common with many other banks we consider that the preliminary proposal in the consultation paper to capture future volatility of the Counterparty Valuation Adjustment (CVA) will generate a highly disproportionate capital requirement that is not aligned with our risk management approach.

   In our attached comments we have set out in some detail suggested principles for how CVA can be capitalised which we would be very happy to discuss this further with you.

4. Liquidity

Liquidity Coverage Ratio: Whilst we agree that a ratio of this type would be useful, we are concerned at the unintended consequences arising from the narrow definition of the ring-fenced liquidity buffer. We believe this will have a serious impact on the bond markets and the mortgage market in particular. The need to publish the ratios, particularly the LCR, will be self-defeating as the assets in the liquidity buffer will no longer be usable in a crisis without the firm falling below the minimum and thereby announcing to the market that the firm has a liquidity problem. We recommend that the ratios be shared only with the regulators. We are also concerned at the level of the factors, in particular, for undrawn commitments to corporate clients, both financial and non-financial which will impact banks' lending capabilities.

Net Stable Funding Ratio: We believe this ratio requires a rethink as the factors used appear to reflect both idiosyncratic and market stress events rather than just the former. Additionally, the scenario appears to ignore management action that would take place over the 12 month horizon of the scenario. As currently framed, the proposal would require industry to raise very large amounts of term funding. This is at a time when several classes of investors, such as money market funds, are being asked to reduce the term of their investments, raising questions as to feasibility and cost. We agree that some banks did become overly reliant on short-term funding, particularly from the wholesale money markets. However, we caution against going too far given that a principal role for banks in society is to engage in maturity transformation. Again, second order consequences from curtailing that role need to be carefully assessed and ascertained.

In our view the LCR broad approach to the liquidity value of under 1 month corporate and financial institutions deposits, taken together with the NSFR requirement to increase bank term funding beyond what may be currently available may well result in banks having only one alternative to meet the ratios proposed, namely to reduce lending. This in turn will result in a reduction in the amount of credit available in the economy.

In making these comments it is not our intention to be unduly negative or obstructive but rather to draw attention to problematic parts of a complex and ambitious reform package. We look forward to working with supervisors in developing an understanding of the full implications of the current reform proposals, both from a prudential and wider macro-economic perspective, and to assist them in arriving at a balanced, risk-responsive framework that delivers on the overall objective of a stronger prudential framework.

Yours sincerely

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