The Royal Bank of Scotland Group

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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

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Dear Sirs,

Recognising the cost of credit protection purchased

I enclose The Royal Bank of Scotland Group's ('RBS') response to the above consultative document and welcome the opportunity to comment. The key issues arising from our analysis of the proposals are set out below. RBS has also been an active participant in and has contributed to responses from trade associations.

We support the Basel Committee on Banking Supervision's ('the Committee') objectives in preventing capital arbitrage within the credit risk mitigation framework and the disallowing of protection when there is no meaningful transfer of risk; however we do not consider that the proposals, as drafted, are the most suitable way of achieving those objectives.

Effective credit risk mitigation by buying credit protection is an integral part of a firms' risk management, complimenting other methods such as receiving collateral; regulators should not discourage prudent risk management, particularly of higher risk exposures.

By taking a capital charge against premiums paid for credit protection, the proposals diverge from the principle that the regulatory treatment should follow the accounting rules for measurement. We would urge the Committee not to diverge from the accounting rules in this way. However if the Committee continues with the proposals, then spread income must also be considered as part of the capital adjustment..

Furthermore, these proposals could have a detrimental impact on a firm's lending capacity with a knock on impact to the real economy. The capital benefit of credit protection allows us to meet the requirements of our diverse customer base in a more cost-effective manner. Without credit protection, the availability of financing to the real economy will be reduced and the costs of borrowing higher.

RBS does not believe that the cost of protection, or the risk weighting of the underlying exposure, should be the key consideration in determining whether the credit risk mitigation is for capital arbitrage purposes. RBS would support an alternative method of identification of capital arbitrage transactions, one which is principles based and focuses upon effective risk transfer. RBS would urge the Committee to develop a set of objective, comprehensive and flexible criteria that may be used to demonstrate such a transfer.

As drafted, the proposals could result in significant global inconsistency due to the number of options which permit national regulator discretion. We consider it essential that the proposals are implemented in a globally consistent manner to ensure a level playing field and to avoid regulatory arbitrage.

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Detailed Comments

Government Guarantees and Trade Finance Transactions

The Committee has specifically asked for feedback on whether the proposals should be applied to trade finance and transactions supported by government guarantees. We strongly urge the Committee to ensure that such transactions are outside the scope of these proposals. Trade finance transactions are structured in many different ways, but often credit protection is an integral part of the lending which would not occur without such protection, generally supplied by specialist trade finance guarantors, either government backed or commercial schemes. These schemes facilitate international trade and support economies through the provision of finance. Whilst the facilities on their own may have a risk weight of 150% (or higher under an IRB approach), the underlying exposure cannot be looked at in isolation. The spread on the facility takes into consideration the premium that will need to be paid on the guarantee, and this forms part of the overall lending decision.

Accounting Considerations

RBS believes that these rules should not apply where both the underlying exposure and the protection are held at fair value through profit or loss under IFRS, as any changes in valuation are immediately recognised through earnings and future premium obligations are already taken into account in valuation of the hedge. Given that there is no option to delay the recognition of gains or losses on assets that are fair valued, there is no opportunity for capital arbitrage which the Committee is attempting to prevent under these proposals.

Further, the proposed changes to the impairment methodology under IFRS should be considered by the Committee. These changes to the accounting framework would lead to earlier recognition of impairments using an expected loss methodology, rather than the current incurred loss methodology. This would obviate the need for implementing the Committee's proposed changes to the regulatory capital framework.

150% Risk Weight Threshold

Given that the purpose of the rule is to prevent capital arbitrage transaction, it is inappropriate to use a threshold based on risk weight of the underlying asset to determine whether a charge applies, since this cannot be an indicator of whether arbitrage is taking place. Instead, in order to achieve its objective, the Committee should devise a set of criteria for establishing whether arbitrage is being undertaken. The criteria contained within the newsletter published by the Committee in 2011 on "High Cost of Protection" should be used as the basis for this and expanded upon where required to consider additional items such as whether the firm is financing the protection provider in return for the protection or if there are any mechanisms for risk to be transferred back to the protection purchaser. If, however, the Committee is minded to set an arbitrary threshold, this should be merely a trigger for the need for further consideration of the intended aims of the credit risk mitigation.

Spread Income

The proposals introduce the option that the present value of spread income can be taken into consideration. It is acknowledged that taking the present value of the premiums into consideration without the corresponding spread of the asset would be one-sided. RBS believes that, if the Committee is minded to proceed with its approach, it is crucial that spread income is included in the final proposal, and not left to national discretion. Further, other income received in relation to the assets should also be taken into consideration, for example the unwind of a discount for assets recognised below par.

Synthetic Securitisations

RBS believes that the current significant risk transfer framework ('SRT') would identify any transactions which were structured for capital arbitrage purposes. Regulators can already take premiums payable into consideration when assessing transactions for SRT, and if they are not satisfied that this has been met, the protection will not be recognised. Therefore it is unclear what additional safeguards these proposals bring to synthetic securitisations.

Traditional Securitisation – proposed rule change

The proposed rule change states that, for traditional securitisation, the originator bank must incorporate the cost of protection purchased in the form of guarantee or credit derivative in significant risk transfer calculations. However traditional securitisations involve the sale of assets into a SPV, not the purchase of credit risk mitigation. Accordingly the Committee should either delete or clarify this proposed change.

In summary, RBS would support proposals which discourage arbitrage transactions, but believes that these proposals do not best fit that objective. RBS believes that they could have an adverse impact on lending and may cause a disconnection with firms' risk management.

We would be happy to elaborate further on any of the points we have made and look forward to engaging with the Committee in developing these proposals.

Yours faithfully

Rajan Kapoor
Group Chief Accountant