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The Royal Bank of Scotland Group

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Dear Sirs

Consultative Document – the Non-Internal Model Method (NIMM) for capitalising counterparty credit risk exposures, BCBS254

I enclose The Royal Bank of Scotland Group's ('RBS') response to the above consultation paper and welcome the opportunity to comment. The key issues arising from RBS's review of the consultation are set out below. RBS has been an active participant in the joint trade association response.

Key Issues

RBS welcomes the move towards a single approach to capitalising non-internally modelled counterparty credit risk that more appropriately balances risk sensitivity, simplicity and comparability. RBS notes, however, that while there are aspects of the framework which are more sensitive to the economic risks of certain transactions, there are also several aspects of the framework where undue conservatism is either hardcoded, through the use of floors and multipliers, or implicit, in the calibration of supervisory factors from periods of stress.

Replacement Cost

RBS firmly supports the move to more clearly differentiate margined and unmargined transactions in the regulatory capital framework and sees this as a key improvement for NIMM over the Current Exposure Method ('CEM'). However, RBS has observed margined trades where the driver for the Exposure at Default ('EAD') is the Threshold Amount detailed in the collateral agreement for the netting set; without any collateral agreement, i.e. if the same trade was unmargined instead, the EAD would fall dramatically (Question 4).

This outcome seems at odds with the principles of sound risk management since it may be entirely legitimate to have high thresholds, say, for mitigating tail risks. There will also be situations where, due to varying activity levels with a given counterparty, there may be a fall in the number of trades within the netting set such that the Threshold amount is high relative to the cumulative mark to market. Given these two examples, RBS believes that the replacement cost aspect of the EAD formula should be revisited to ensure there remain appropriate incentives to enter into margined transactions, and to manage tail risks in a prudent manner.

Potential Future Exposure ('PFE')

RBS would urge caution in the Committee seeking simplicity in areas where the risk factors are inherently complex. Not only can this lead to undue conservatism, but there is a risk of inconsistent application of the rules to such trades between market participants. RBS notes this in several aspects of the various PFE formulations (Questions 3 and 6), perhaps most acutely around the definition of notional amounts, where RBS would be willing to work with the Committee towards providing greater clarification for certain products.

A key example is the Committee's proposals on sold option positions. The consultation does not discuss the cost-benefit of changes to the current proposals such that counterparty credit risk capital requirements are charged against sold option positions. RBS notes the Committee's observation that sold options do not present counterparty risk on their own, and seeks confirmation that they should be excluded from the hedging set notional amounts. RBS considers the costs incurred in the current approach as disproportionate.

The delta adjustments in the PFE formulation require further thought when applied to certain more esoteric instruments, say, basis swaps or spread options, where the notion of being long or short may not be applicable. In these instances, the current framework is silent as to the approach a bank should take.

Further, RBS notes that for non-modelled market risk, banks are entrusted to calculate their own deltas, subject to local regulatory approval, to feed a supervisory formula. Banks are required to ensure their models meet certain minimum requirements, and subject to this constraint, RBS sees no reason why the same concession could not be made in the context of NIMM.

There are aspects of the FX PFE Add-on formulation which RBS sees as potentially inconsistent with other areas of the capital framework. The Committee notes a desire to avoid basis risk in only allowing the same currency pair within a hedging set; RBS would contest that any basis risk arising from this would be appropriately capitalised under the market risk framework and should not therefore feed into the EAD for counterparty credit risk. Furthermore, netting within hedging sets of currency pairs with significantly different maturities may understate exposure. One potential solution might be to introduce maturity categorisation into the FX hedging set framework. RBS sees considerable benefit in the Committee revisiting the FX proposals in particular.

Other uses for NIMM

RBS notes note the potential for the Committee to replace CEM with NIMM in other areas of the prudential framework (Question 1). While RBS considers NIMM to be a marked improvement in how non-modelled exposures are measured within the regulatory capital framework, it believes that to consider the use of NIMM for other purposes should require a further QIS exercise to encompass any such application.

To this end, RBS would support further elaboration on how the Committee arrived at key numerical factors within the NIMM formulation and how these might be applied for other applications. For example, RBS would question the use of the alpha scaling factor in the determination of hypothetical capital floors for Central Counterparties.

RBS would be happy to elaborate further on any of the points made and looks forward to engaging with the Committee where necessary. In the first instance, any questions should be referred to Ralph Mountford on +44 20 70859231.

Yours faithfully

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