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Secretariat of the Basel Committee on Banking Supervision,
Bank for International Settlements,
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Switzerland

15 March 2013

Dear Sirs,

Revisions to the Basel Securitisation Framework

I enclose The Royal Bank of Scotland Group's ('RBS') response to the above consultative document and welcome the opportunity to comment. We have set out below what we see as key themes arising from our analysis of the proposals. RBS has also been an active participant in the joint trade association response, of which we are supportive.

Introduction

RBS is broadly supportive of the Basel Committee on Banking Supervision's ('the Committee') objectives in revising regulatory capital requirements for securitisation positions.

Whilst we recognise the concerns the Committee has in relation to aspects of the current Basel securitisation framework, we would point out that considerable progress has been made by the banking industry in actively strengthening their risk modelling and risk management approaches and there have been significant positive changes to the securitisation market since the financial crisis. For example, retention, due diligence and disclosure requirements, combined with regulation of credit rating agencies and the changes they have made to their rating methodologies, have all strengthened the governance around the securitisation markets. We urge the Committee to take into account the progress made when calibrating the new framework.

The Committee acknowledges the importance of global consistency of outcomes when implementing their proposals and we wish to stress the importance of this to ensure a level playing field and to avoid regulatory arbitrage.

The Committee's proposals for revising the securitisation framework are part of a wider suite of prudential capital, liquidity and infrastructure changes affecting the banking industry and we hope that these current proposals are considered as part of a more holistic view of the cumulative effect of all of these changes and their impact on the real economy.

Securitisation is a key component of the real economy providing not only additional liquidity to banks but also providing the corporate sector with access to capital markets for secured financing. It is actively used by the car manufacturing industry, as well as providing other manufacturing and operating companies with working capital. This additional liquidity provides for cheaper and wider credit availability to the end consumer and is a healthy part of the modern economy. Studies have highlighted the positive relationship between the level of securitisation and the level of lending in the real economy.

Securitisations also provide a useful funding tool for banks to raise secured financing without reliance on central bank funding schemes and can also provide long term matched funding, reducing reliance on short term wholesale markets. The impact on providers of such funding should also be considered as part of these proposals.

We therefore urge the Committee to allow enough time to ensure robust analysis of quantitative studies and to avoid undue conservatism that may adversely impact the securitisation market and wider global economy.

Key observations

At the time of this response, we have yet to complete the quantitative impact study which is due by 29 March 2013 and hence our comments are provided without due regard to the potential financial impacts. The quality of our analysis and contribution to the consultation would have greatly benefited from having more time to study the technical papers accompanying the consultative document which were not published until the end January. We are also participating with an inter bank working group which is developing an alternative modelling solution. We would ask the Committee to provide industry with another opportunity to comment on the proposals once all of the relevant information has been properly collected, collated and analysed.

At this stage, our main points are:

- With regard to the two choices presented, we believe that Alternative A is preferable because it can be applied consistently across securitisation tranches and best meets the Committee’s aims. However, Alternative A still incorporates jurisdictional choice which may lead to inconsistencies, arbitrage opportunities and competitive distortions. We would therefore suggest that an approach that has a defined and fixed hierarchy be implemented whereby the modified supervisory formula approach (MSFA) sits at the top.

- We have concerns that there will be significant difficulties in firms being able to implement MSFA, especially those with investor only positions. This difficulty arises from the need to complete full advanced internal ratings based (IRB) credit reviews on the underlying assets to enable firms to use this approach. We therefore urge the Committee to consider a degree of flexibility in utilising MSFA in cases where there are minor data availability gaps and where the risks are still understood.

- We also ask that the Committee considers grandfathering provisions as part of the implementation of these rules. This will reduce uncertainty within the securitisation market and prevent potential cliff effects which would otherwise occur upon the introduction of these rules.

- We believe that there needs to be further clarity on how the proposals apply to trading book securitisation positions. We also note that the quantitative impact study (QIS) excludes trading book securitisation positions, which will not provide a comprehensive view of the impact of these proposals.

- We have some concerns with the modelling used in the MSFA and ask the Committee to consider incorporating credit cycle effects.

We set out further details of our observations and our response to the consultative document questions in the annexes to this letter. We would be happy to elaborate further on any of the points made and look forward to engaging with, and supporting, the Committee in progressing these proposals

Yours faithfully

Rajan Kapoor
Group Chief Accountant

Enc:
Annex 1 – detailed comments
Annex 2 – response to consultative document questions

There are a number of points that we believe warrant further discussion as part of a considered view to establishing a new securitisation framework. We very much support the Committee in developing a proportionate framework that avoids jurisdictional inconsistency, is more risk sensitive and avoids cliff effects. Given the complexity of the proposed framework and the material impact it could have on the securitisation market and wider economy, we are concerned that there is insufficient time for robust review, due diligence and impact analysis to allow for the development of the most appropriate framework.

We set out below our observations covering:

- Ensuring that the calibration of the framework is proportionate
- Consideration of the impact to trading book securitisations
- The need for grandfathering provisions
- Our thoughts on an appropriate hierarchy
- Allowing greater flexibility in utilising MSFA where some advanced IRB data is not available

Calibration

Given the potential impact on the securitisation market and wider economy, we urge the Committee to allow sufficient time to conduct robust due diligence on the impact of these proposals.

Securitisation is an effective way for both banks and corporates to access the capital markets for secured financing and is an important component of a healthy economy. We are concerned that an unduly conservative securitisation framework could have an adverse impact to the functioning of this market. In particular, the additional costs resulting from an inappropriate calibration are likely to manifest as higher borrowing costs for end consumers.

In order for these costs to be commensurate with the associated risks, we believe that the overall securitisation framework and associated calibration should be relevant to the current securitisation market, taking into consideration the material improvements which have occurred post crisis.

At the time of this response, our work continues to analyse and quantify the impact of the proposed models. We are therefore unable to provide an informed view of the model calibration and of the parameters used. We are also participating with an inter bank working group which is developing an alternative modelling solution. We will be happy to engage further once this work is completed.

Modelling of MSFA

We have an initial concern with the nature of the modelling approach used in the MSFA. We believe that the approach may not model the credit cycle appropriately, as it does not capture mean reversion in economic conditions.

We believe that it is possible to incorporate the credit cycle effect into the MSFA approach by enhancing the model in a manner analogous to the BCBS working paper and are working through this. We would be happy to engage with the Committee on alternate approaches to formulating the MSFA.

Scope

We note that neither this consultative document nor the fundamental review of the trading book explicitly address trading book securitisation positions. We ask the Committee to provide some clarity in this area.

We are concerned that the QIS does not include the impact of the proposals to trading book securitisation positions. The secondary market is crucial in providing liquidity to enable the functioning of the primary markets and hence we believe it is vital that this impact is fully understood. We also consider the impact on trading book securitisation positions is necessary to properly calibrate the framework.

If this framework is to be extended to trading book securitisation positions, we request a further opportunity to review and provide comments.

Grandfathering

We believe that grandfathering provisions are necessary to prevent the risk of damage to banks' balance sheets which could impact global recovery. We would therefore encourage the Committee to consider grandfathering provisions as part of the implementation of these rules.

We are of the view that the increase in capital requirements resulting from these provisions on existing securitisation positions could result in wide-scale disposal of these positions by banks to protect their capital ratios. The resulting fall in securitisation asset valuations would lead to losses being incurred by banks, which could have a negative impact on global recovery.

We are also concerned that there is currently insufficient data on existing securitisation investor positions to be able to utilise certain methodologies in the proposed framework. This challenge has been recognised in previous legislation, for example Article 122a of the Capital Requirements Directive, where grandfathering provisions have been used to address this.

Grandfathering provisions will reduce uncertainty within the securitisation market and prevent potential cliff effects which would otherwise occur upon the introduction of these rules.

Hierarchy preference
With reference to the hierarchy options set out in the Committee's proposals, our preference would be for a hierarchy based on Alternative A but modified to remove jurisdictional choice.

As the Committee recognises, it is important to create a globally consistent approach to create a level playing field and prevent arbitrage across jurisdictions. As such we do not support any jurisdictional choice within the securitisation framework. Moreover we believe that the Committee's objectives could be better achieved through a single fixed hierarchy which uses all of the methodology options set out in Alternative A.

As we have mentioned previously, we believe that the Committee needs to allow sufficient time for a robust analysis of the impact of the proposed framework in order to ensure that the both the hierarchy and methodologies are appropriate and proportionate.

We do not support Alternative B due to the subjectivity surrounding the classification of tranches as senior high quality and the potential cliff effects where the categorisation of securitisations positions changes.

Ability to fully utilise proposed methodologies
We ask that the Committee consider flexibility in allowing firms to use MSFA in circumstances where some advanced IRB data is unable to be sourced and where the risks are well understood.

We are concerned that the ability to obtain all of the advanced IRB data needed to apply the MSFA will be challenging for many securitisation positions, especially for existing securitisations and where the bank is an investor. It may be that in time all of the necessary data to use MSFA becomes available, but we do not think that this will happen very quickly or consistently across all jurisdictions.

We would be happy to discuss options with the Committee. Two possibilities which could be considered are as follows:

- In cases where the majority of advanced IRB data can be sourced, it might be possible to allow the utilisation of a small number of foundation IRB risk weights within the MSFA calculation. The threshold for determining the boundary as to when using foundation IRB is acceptable would need to be considered, but this approach could reduce unduly conservative capital requirements where the risks of the securitisation position are well understood.

- For securitisations with homogenous asset pools and where a small portion of advanced IRB data is unavailable, it might be possible to calculate weighted average PDs & LGDs for that part of the portfolio, based on available data for the majority of the pool.

We also note that the concentration ratio K_{IRB} approach will be similarly affected by advanced IRB data sourcing challenges and we suggest consideration of the options described above.

The cap is a crucial component of the proposed securitisation framework as it is designed to prevent excessive capital requirements being taken due to conservatism embedded within the framework. We are very concerned that the ability to use the cap is compromised even in cases where advanced IRB data is unavailable for a small portion of underlying assets. We again suggest that the use of foundation IRB risk weights or a pool wide approach can be utilised to ensure proportionate levels of capital requirements.

Question 1: *What additional costs and benefits of the two hierarchies should the Committee consider? Which hierarchy presents the greater benefits relative to its drawbacks? Which hierarchy would best address the shortcomings identified with the current framework, whilst meeting the Committee's objectives?*

Both approaches will result in increased costs within the securitisation market and may lead to higher borrowing costs to end user customers. Fuller analysis and more time is required to properly understand the impact of the proposals on the securitisation market and wider economy.

With reference to the more appropriate hierarchy, our preference would be for a hierarchy based on Alternative A, but modified to remove the potential for jurisdictional choice.

Alternative B contains subjectivity surrounding the classification of tranches as senior high quality and the potential cliff effects where the categorisation of securitisations positions changes.

Question 2: *As regards Alternative A, could both the revised RBA and the SSFA be accommodated without raising concerns about regulatory arbitrage or level playing field?*

As the Committee recognises, it is important to create a globally consistent approach to create a level playing field and prevent arbitrage across jurisdictions. As such we do not support any jurisdictional choice within the securitisation framework. Moreover we believe that the Committee's objectives could be better achieved through a single fixed hierarchy which uses all of the methodology options set out in Alternative A.

We re-iterate the need to allow sufficient time for a robust analysis of the impact of the proposed framework in order to ensure that both the hierarchy and methodologies are appropriate and proportionate.

Question 3: *As regards Alternative B, which methods could a bank use to conclude that a securitisation exposure is of high-quality? Would the use of these methods likely result in a capital charge consistently related to credit risk across banks and countries? Would Alternative B produce material cliff effects as exposures deteriorate below high-quality?*

Alternative B contains subjectivity surrounding the classification of tranches as senior high quality and the potential cliff effects where the categorisation of securitisations positions changes.

Some possible alternative methods which could be utilised to determine whether a tranche is senior high quality are factors such as:

- Implied leverage of the tranche (defined as L=(1-A)/(D-A) where D and A are detachment and attachment levels),
- Leverage in the underlying assets
- Performance of the underlying assets

High quality should not rule out tranches that are not most senior, providing there is sufficient subordination in the structure.

Question 4: *Are there alternative hierarchies or revisions to the two proposed (or a combination of both) that the Committee should consider?*

We believe that Alternative A should be modified, in line with the answer to Question 2, to accommodate the use of both the RRBA and SSFA, to avoid potential global inconsistencies.

Question 5*: The Committee recognises that in some instances and in some jurisdictions, the requirement for two external ratings could be difficult to implement or could impose additional costs on banks. The Committee requests feedback on the relative merits of reducing idiosyncratic, rating agencies' modelling risk with the costs of using two ratings and/or whether exceptions to this treatment should be permitted.*

We recognise that multiple ratings can help to mitigate mis-rating risk. However, given the banking regulatory direction is to reduce and in some cases eliminate the use of external credit ratings, reasonable alternatives should be available to firms, including the utilisation of internal assessments of credit ratings through supervisory approved models.

Question 6: *Is the RBA appropriately calibrated and formulated? Should other risk drivers be incorporated?*

At this time we are still analysing this and we will be happy to provide comments to the Committee when complete.

Question 7: *Is it appropriate to require that in order for the MSFA to be used the IRB approach should be applied for all underlying assets?*

We believe that there should be flexibility in allowing firms to use MSFA in circumstances where some advanced IRB data is unable to be sourced and where risks are well understood.

We are concerned that the ability to obtain all of the advanced IRB data needed to apply the MSFA will be challenging for many securitisation positions, especially for existing securitisations and where the bank is an investor. It may be that in time all of the necessary data to use MSFA becomes available, but we do not think that this will happen very quickly or consistently across all jurisdictions.

We would be happy to discuss options with the Committee. Two possibilities which could be considered are as follows:

- In cases where the majority of advanced IRB data can be sourced, it might be possible to allow the utilisation of a small number of foundation IRB risk weights within the MSFA calculation. The threshold for determining the boundary as to when using foundation IRB is acceptable would need to be considered, but this approach could reduce unduly conservative capital requirements where the risks of the securitisation position are well understood.
- For securitisations with homogenous asset pools where a small portion of advanced IRB data is unavailable, it might be possible to calculate weighted average PDs & LGDs for that part of the portfolio, based on available data for the majority of the pool.

We also think it may be worth exploring a separate foundation IRB based MSFA as a lower tier methodology within the securitisation framework hierarchy that would allow for a more risk sensitive approach using appropriately prudent foundation IRB risk weight inputs. The placing of such an approach within the hierarchy would need to be considered in reference to appropriate data and we would be happy to assist the Committee in this.

Question 8: *Is the MSFA appropriately calibrated and formulated? Does it incorporate the appropriate risk drivers? Is the calibration of tau and omega appropriate? If not, what evidence can respondents provide to support an alternative calibration?*

At this time we are still analysing this and we will be happy to provide comments to the Committee when complete. However we have identified one initial concern so far.

We believe that the approach may not model the credit cycle appropriately, as it does not capture mean reversion in economic conditions.

We believe that it is possible to incorporate the credit cycle effect into the MSFA approach by enhancing the model in a manner analogous to the BCBS working paper and are working through this. We would be happy to engage with the Committee on alternate approaches to formulating the MSFA.

Question 9: *Is it prudent to allow the use of the MSFA by banks making use of the foundation IRB approach (i.e. not calculating internal estimates of the underlying loans' LGD)?*

If foundation IRB approaches are permitted, these should also be permitted to be used by advanced IRB firms to overcome the data issues highlighted in Question 7. This would have the additional benefit of harmonising approaches among advanced and non-advanced firms.

Question 10: *Is the SSFA (particularly the constant term p) appropriately calibrated? Please provide justification and evidence, to the extent possible, for alternative appropriate levels of calibration?*

At this time we are still analysing this and we will be happy to provide comments to the Committee when complete.

Question 11: *Is the SSFA properly formulated or should other risk drivers, such as maturity, be incorporated?*

At this time we are still analysing this and we will be happy to provide comments to the Committee when complete

Question 12: *Has the BCRA been appropriately calibrated and formulated?*

We support the introduction of the BCRA as an option that can be used before having to use an automatic 1250% risk weighting and recognise it is a conservative measure. Due to its inherent conservatism it is important that it should be used solely as a backstop as intended, which is not the case for non-senior tranches in Alternative B, where it is the only available option.

Question 13: *What factors should the Committee consider in weighing whether the F parameter should be set at 2 for senior as well as non-senior tranches to avoid arbitrage opportunities?*

Given that the BCRA does not take into any consideration any subordination, we would not support setting the F parameter to 2 for senior exposures as the method is already conservative.

Question 14: *How prevalent and material are securitisation exposures backed by mixed pools?*

There are some examples where mixed pool asset securitisations do exist and the framework needs to accommodate these.

Question 15: *Is the proposed treatment for mixed pools appropriate, or should another approach be employed?*

In line with previous comments we have made in questions 7 & 9, we would like to be able to use a foundation IRB approach or pool wide approach where advanced IRB data is unavailable. This option should be utilised for mixed pools.

Question 16: *Is the definition of maturity appropriate, in light of the Committee's objectives?*

We request clarity from the Committee with regards to the definition as we are not sure what is meant by the statement that 'contractual payments must be unconditional and *must not be dependent from the actual performance* of the securitised assets'.

We request that the Committee gives further consideration to an expected maturity approach that accounts for prepayments and other expected redemptions, as this better aligns capital requirements to economic risk. We recognise that there is modelling risk associated with this and would be happy to discuss how this could be addressed appropriately.

Question 17: *Is the proposed 20% risk-weight floor set at an appropriate level? Please provide justification and evidence, to the extent possible, for alternative levels for the risk weight floor.*

The 20% floor for standardised approaches is internally consistent with current standard regulatory capital treatments excluding sovereigns. However, the modelling of MSFA is more analogous to the advanced IRB approach than the standardised rules and this should be considered in the calibration of the model to ensure an appropriate level for the floor.

Question 18: *Should the risk-weight floor for short-term exposures be the same as for long term exposures?*

Short term exposures are subject to lower credit risk than longer-term exposures and therefore it would be expected that risk weights should be lower. Therefore we do believe that the floor should differentiate between maturities. We think that more analysis is required to determine appropriate floors and would be happy to assist in this case.

Question 19: *Are the proposed caps and their interactions with the proposed floor risk weight appropriate?*

The cap is a crucial component of the proposed securitisation framework as it is designed to prevent excessive capital requirements being taken due to conservatism embedded within the framework. It is important that the cap can be explicitly utilised by investors as well as originators.

We are very concerned that the ability to use the cap is compromised even in cases where advanced IRB data is unavailable for a small portion of underlying assets. We therefore suggest that the use of foundation IRB risk weights or a pool wide approach, as described in the response to question 7, can be utilised to ensure proportionate levels of capital requirements.

We support that the cap should apply in instances where the cap is lower than the floor.

Question 20*: Are there other approaches that could provide a more risk-sensitive treatment while still being prudent and operationally straight-forward to implement?*

We agree with the Committee's proposal on the treatment of write-downs and purchase discounts.

Question 21*: Are the assumptions used in developing and calibrating the approaches discussed above appropriate in view of the Committee's stated objectives? Please provide empirical justification for alternative assumptions to those noted above.*

At this time we are still analysing this and we will be happy to provide comments to the Committee when complete.

Question 22*: Is the proposed treatment of retail securitisations using the same approaches as for corporate securitisations appropriate? Would additional complexity (in the form of an additional formula to adjust the AVCs of retail underlying exposures) be justified to remove the double-counting effect of maturity effects?*

We believe that this needs to be addressed as part of calibrating the securitisation framework.

Question 23*: How could concerns that securitised retail exposures have high default risk or high correlation be managed?*
Please provide data supporting any modifications to the proposed approaches, particularly the MSFA and revised RBA, to account for differences in risk based on underlying exposure types.

We believe that this needs to be addressed as part of calibrating the securitisation framework.

Question 24: *Is the relative calibration of the approaches appropriate? Please provide empirical data to support any conclusions.*

At this time we are still analysing this and we will be happy to provide comments to the Committee when complete. We are also participating with an inter bank working group which is developing an alternative modelling solution.

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