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Dear Sirs

**ADVANCED NOTICE OF PRUDENTIAL RULE-MAKING**
**- NEW BASEL CAPITAL ACCORD**

Thank you for the opportunity to comment on your proposals for implementing the Basel Accord within the United States.

By way of background, the Royal Bank of Scotland (RBS) is the fifth largest bank in the world. We have significant exposure in North America, including Retail and Commercial Banking, Asset Finance and Capital Markets operations. The largest single business, measured by assets, is Citizens Financial Group, Inc., a Providence-based commercial bank holding company that operates more than 825 Citizens Bank branch offices in Connecticut, Massachusetts, New Hampshire, New Jersey, Rhode Island, Pennsylvania and Delaware.

Citizens Bank, with over $75 billion in assets, falls outside the "top 10" group of core banks mandated to operate the advanced approaches for credit and operational risk by end 2006. However, Citizens, ranked within the top twenty US Banks as measured by assets, does fall into the second tier of Banks that may opt into the advanced approaches. The majority of the Group's other exposures fall within the EU and will be covered by their third Capital Adequacy Directive (CAD3). Given our geographic spread, we are clearly interested in how the proposals will be implemented within the US and, importantly, identify where these proposals and implementation plans may differ from those emanating from the EU and the UK's FSA.

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Our response, is in two parts:

- Our key concerns with the Basel proposals and the ANPR implementation proposals are outlined in appendix 1. Underpinning these concerns is a belief that the Basel proposals are too complex and prescriptive and that the Basel Committee and/or National Regulators can go further in simplifying the Accord to ensure its effective implementation and understanding of it by banks, regulators and analysts alike.
- The second part includes answers to the specific questions included within the ANPR, these are set out in Appendix 2. Generally, we have not answered questions in those areas, such as Expected and Unexpected Losses, where the Basel Committee have requested further feedback by 31 December 2003.

We hope that these comments are useful to you in taking forward your implementation of the new Basel Accord and, as importantly, during your final deliberations at the Basel Committee through to the middle of 2004.

Please do not hesitate to contact me should you wish to discuss any of these points in more detail.

Yours faithfully

Richard Gossage
Director, Group Risk Management
Royal Bank of Scotland Group

## HIGH LEVEL CONCERNS

**APPENDIX 1**

Our key concerns with the framework/ANPR are as follows:

### 1) Home: Host Implementation and the Level Playing Field.

It is disappointing that the home: host issues have not been sufficiently addressed, especially as the target audience for the Basel Accord is internationally active banks. Unless greater progress is made in discussions between regulators, the current proposals will require banks to operate parallel systems in order to satisfy the needs of local and lead regulators. The lack of agreement on the standards for Pillar 1, allocation of capital under AMA or principles for Pillar 2 Supervision threatens to undermine the level-playing field. Clear principles for the resolution of home: host issues are required.

Consistency around approval and implementation approaches looks unlikely to be achieved for internationally active banks operating across multiple jurisdictions. Consistency can only be achieved through agreement on standards for Pillar 1 and principles for the scope and assessment of risk under Pillar 2. To date, there has been little comparison of approaches for Pillar 1 and little or no focus on Pillar 2.

### 2) Bifurcated Approach to Capital Adequacy within the USA.

As part of RBS's response to the Basel Committee's CP3 (dated 31st July 2003), we raised concerns about "regulatory stretch", specifically whether the regulators will be able to recruit the right number and quality of staff to regulate the new Capital framework. We believe, given the bifurcated approach being adopted, that this concern is less likely to apply within the American market.

Whilst this is a positive effect of the bifurcated approach, we remained concerned about the very high entry standards being proposed for operational risk. As it currently stands, banks that can achieve the ANPR standards for credit risk but feel less comfortable about adopting the advanced approach for operational risk at the initial implementation date will be forced to remain on Basel 1. We urge the US Regulators to discuss transition arrangements with other regulators so that a more flexible approach can be accommodated particularly if it is consistent with a bank's overall implementation plan approved by the home regulator.

For banks like RBSG with large US subsidiaries, such an approach also gives rise to a catch-22 situation. For example, if the current approach to operational risk remains unchanged, then it is possible that our US subsidiary would remain on Basel 1. However, there is no guarantee that the home regulator, the FSA, would allow such an approach. We are then faced with a potential scenario of having to run separate frameworks to satisfy the requirements of various regulators.

### 3) Complexity & Prescription.

The Pillar I rules of the new Accord are highly complex. We still believe, despite the Madrid announcement of the Basel Committee and the pragmatism incorporated within ANPR, that there

is a real risk that key stakeholders - bankers, regulators, investors and market commentators will not fully understand these proposals. The complexity and prescription has a knock-on impact on cost and benefits, approval and ongoing supervision.

We believe that the time has now come to adjust and simplify Basel 2 in order to preserve the significant amount of effort that has been invested to date. We believe that the Accord can be more closely aligned to banks current and evolving risk management practice. This could be more effectively achieved through a simpler Pillar 1 and Supervisory agreement on principles for the management of risk and capital under Pillar 2. Such a framework, based on a holistic view of risk management grounded in the Use Test, would minimise the risk to the financial system as a whole.

We are currently working with the Institute of International Finance (IIF) on proposals regarding possible simplifications to Basel 2, which will be shared with the US Regulators shortly.

**4) Stifling, rather than facilitating, innovations in Risk Management.**

RBS remains concerned that the Basel proposals, incorrectly implemented, could stifle innovation in risk management, especially as the most advanced banks already use approaches that surpass Basel 2 in sophistication. We have consistently advocated that without greater flexibility built into the Accord, sections of the new rules run the risk of being obsolete by 2007.

Despite these concerns, which are still valid, we were pleased by the ANPR commentary that the calculation methodologies set out in the Basel Committee's 3rd Consultative Paper represent only a sub-set of the possible calculation methodologies, and that banks are free to use any calculation and validation methodologies which meet the qualitative and quantitative standards required. We believe this is a practical and appropriate position and that such flexibility should be reflected within the main Basel Accord.

In addition, we would welcome further clarification from the Agencies around how the application and assessment process will operate in practice for those banks which opt in to the Basel 2 approaches, and in particular, the way in which issues regarding differences in approaches from parent to subsidiary will be treated.

**5) Arbitrage.**

The current Accord is simple, arbitrage opportunities are few in number but large in effect. Banks and regulators know such arbitrage opportunities. We fear that the complexity and scope of current proposals will create more opportunities for arbitrage than they eliminate.

**6) Theoretical Underpinnings (Data and data availability).**

History, on which Basel 2 estimates are based, is not always a good predictor of future performance. Banks do not have the same quantity or sufficiency of data for all portfolios. Portfolios do not behave in the same way and cannot, realistically, be assessed on the same basis. It is unlikely that institutions will be able to estimate the probability of default for all their borrowers on a consistent basis as this data is just not available for all portfolios, especially high quality ones, where data sharing is unlikely to be able to offer a solution. Banks will continue to

have to deploy expert judgement in their grading processes, making comparability of outputs difficult. For this reason, a more flexible portfolio-by-portfolio approach based approach to Pillar 1 model approval is, in our view, required.

A false sense of security has been created by the much-publicised assumption that better risk measurement for determining minimum regulatory capital will constitute good risk management and necessarily make banks safer. We fundamentally believe that what reduces a bank's risk to the financial system is how it measures risk within an appropriate risk framework coupled with expert judgement. This is best achieved through agreement on (and implementation of) robust Pillar 2 processes, founded on sound principles for the measurement of risk and capital.

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| **EXECUTIVE SUMMARY** | | |
| **Competitive Consideration** | What are commenters' views on the relative pros and cons of a bifurcated regulatory framework versus a single regulatory framework? | The narrow scope of application being applied within the US will limit the potential for regulatory stretch; the focus on a smaller number of larger internationally active banks should drive consistency in capital calculations and reduce opportunities for unscrupulous banks to game the regulatory capital calculations given the sensitivity to the capital amounts to PD, LGD and EAD. The biggest disadvantage is the potential for competitive inequality, given the differences in capital requirements between the AIRB approach and Basel 1 at the portfolio level. There will be different winners and losers depending on the portfolio being considered. The biggest risk is that the proposals give rise to a different form of arbitrage, with riskier business being driven towards Basel 1 banks that may be less able to handle them. The scale of the arbitrage opportunity is increased given the higher hurdle (Advanced only for credit and operational risk). |
| | Would a bifurcated approach lead to an increase in industry consolidation? Why or why not?<br><br>What are the competitive implications for community and mid-size regional banks?<br><br>Would institutions outside of the core group be compelled for competitive reasons to opt-in to the advanced approaches? Under what circumstances might this occur and what are the implications?<br><br>What are the competitive implications of continuing to operate under a regulatory framework that is not risk sensitive? | The current round of industry consolidation is being driven by legal changes, scale, efficiency and a trend towards globalisation. It is too early to say whether Basel 2 will accelerate consolidation. A key determinant will be whether the rating agencies allow banks to reduce their actual capital holdings in line with potential reductions in Basel 2 regulatory capital. It does not look like S&P and Moody's will allow this, especially for retail portfolios.<br><br>That said, the greatest pressures for non-mandated banks to "opt in" will be:<br>• Mono-line retail players, where Basel 2 generally results in capital savings<br>• If certain larger products/syndications become restricted to "Advanced" banks |

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| | If regulatory minimum capital requirements declined under the advanced approaches, would the dollar amount of capital these banking organizations hold also be expected to decline?<br><br>To the extend that advanced approach institutions have lower capital charges on certain assets, how probable and significant are concerns that those institutions would realize competitive benefits in terms of pricing credit, enhanced returns on equity, and potentially higher risk-based capital ratios?<br><br>To what extent do similar effects already exist under the current general risk-based capital rules (e.g. through securitization or other techniques that lower relative capital charges on particular assets for only some institutions)? If they do exist now, what is the evidence of competitive harm? | Additional capital restrictions, such as the leverage test/trip wires within the existing PCA, will restrict any pronounced capital reduction.<br><br>However, should a capital reduction occur, the level will depend on 1) the position taken by the external rating agencies (as highlighted above) and 2) the economic outlook, as the alternative (and more likely scenario) to reducing capital is to increase the amount of business being written within the total capital/PCA constraint.<br><br>The market impact should not be overstated, as most banks today do not price off Basel 1. The practice of risk based pricing is already established in many markets. |
| | Apart from the approaches described in this ANPR, are there other regulatory approaches that are capable of ameliorating competitive concerns while at the same time achieving the goal of better matching regulatory capital to economic risks? Are there specific modifications to the proposed approaches or to the general risk-based capital rules that the Agencies should consider? | As we stated within our responses to the Basel Committee's third Consultation Paper (CP3) we believe that the current Basel 2 proposals are unduly complex, and that the framework will impact now and in the future the ability of banks to manage risk, the ability of supervisors to supervise and the capacity of markets to evolve and adapt.<br><br>Despite the late stage, we believe that the Basel Committee can still simplify the proposals over the coming months to the benefit of the banks, the banking industry and regulators alike. In conjunction with the IIF, we are currently working on specific proposals that will be shared with the international regulatory community in the near future. |

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| **US Banking Subsidiaries of Foreign Banking Organizations** | The Agencies are interested in comment on the extent to which alternative approaches to regulatory capital are implemented across national boundaries might create burdensome implementation costs for the US subsidiaries of foreign banks. | It is disappointing that the home: host issues have not been sufficiently addressed, especially as the target audience for the Basel Accord is large, internationally active banks. Unless greater progress is made in discussions between regulators, the current proposals and implementation strategies will require banks to operate parallel systems in order to satisfy the needs of home and host regulators. The lack of agreement on the standards for Pillar 1, restrictions on the implementation options available, allocation under AMA and divergent approaches for Pillar 2 supervision threaten to undermine the level playing field and increase, substantially, the implementation burden for internationally active banks. There is also a real risk that the resulting capital numbers from different jurisdictions will not be comparable, undermining the concept of market disclosure through Pillar 3. Agreement at the AIG level to a non-prescriptive, principles based approach to Pillar I implementation grounded in the "use test" would help to address these concerns.<br><br>Within the US context, the greatest area of concern is the requirement that advanced banks need to apply AMA methodologies for operational risk. Many of the advanced banks in the EU will adopt Advanced for credit risk, but will initially target the Basic Indicator or Standardised Approach for operational risk because 1) operational risk measurement is less well developed and 2) such an approach enables banks to focus on the much larger credit risk requirements.<br><br>Whilst we understand that the US regulators wish to avoid definitional, calibration and boundary issues between credit and operational risk, the decision to restrict choice to AMA is overly harsh and potentially counter productive. The alternative approach is for the US regulators to mandate advanced for credit risk, but be more flexible with operational risk, subject to overall levels of regulatory capital being deemed sufficient. Any boundary/arbitrage concerns could be addressed through Pillar 2. The current position may result in banks who are able and plan to achieve advanced approaches for Basel 2 credit risk being restricted to Basel 1, |

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| | | which seems inconsistent with the goals of the Basel Committee, especially given the concerns expressed about the inadequacy of the existing framework. |
| **APPLICATION OF THE ADVANCED APPROACHES IN THE US** | | |
| **Other Considerations – General Banks** | The Agencies seek comment on whether changes should be made to the existing general risk-based capital rules to enhance the risk-sensitivity or to reflect changes in the business lines or activities of banking organizations without imposing undue regulatory burden or complication. In particular, the Agencies seek comment on whether any changes to the general risk-based capital rules are necessary or warranted to address any competitive equity concerns associated with the bifurcated framework. | The bifurcated approach may, as discussed above, lead to migration of lower quality assets (those that require more than 8% capital under Basel 2) to the non-mandated banks, who may be less able to manage them. Such an outcome is not in the interests of specific banks or the banking market as a whole. Agencies need to consider what, if any, changes are required within their regulation of these non-mandated banks or whether changes are required to the application of Basel 1 within the US to prevent such a migration. |
| **Majority-Owned or Controlled Subsidiaries** | The Federal Reserve specifically seeks comment on the appropriate regulatory capital treatment for investments by bank holding companies in insurance underwriting subsidiaries as well as other nonbank subsidiaries that are subject to minimum regulatory capital requirements. | We would propose that these are risk weighted at 100%, in line with existing treatment.<br><br>Clarity is sought from the U.S. and overseas regulators as to how the new S.E.C. risk based minimum capital rules for broker dealers and investment banks will be treated relative to those of banking supervisors within consolidated banking groups such as RBSG which also have wholly owned S.E.C. registered and approved broker dealers. |

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| **Transitional Arrangements** | Given the general principle that the advanced approaches are expected to be implemented at the same time across all material portfolios, business lines, and geographic regions, to 1) what degree should the Agencies be concerned that, for example, data may not be available for key portfolios, business lines, or regions?<br><br>2) Is there a need for further transitional arrangements? Please be specific, including suggested durations for such transitions. | 1) The Agencies should be concerned that data will not be available at a level and richness required for robust approaches for all portfolios. Banks do not have the same quantity or sufficiency of data for all portfolios; portfolios do not behave in the same way and cannot, realistically, be assessed on the same basis. This is particularly true for high quality portfolios, where data is not available in the quantity required by the current Basel 2 proposals. Banks will continue to have to deploy expert judgement in various grading systems, which will again make comparison difficult. In addition, particularly given product diversification and advancements in risk management practice, history is not always a good predictor of future performance. Taken together, these points represent the most significant challenges banks face in trying to implement the advanced approaches "at the same time" and to the same standard "across all material portfolios".<br><br>2) Transition arrangements themselves do not overcome the issues discussed above, but the risks would be minimised if:<br>• Banks were allowed to adopt advanced approaches on a portfolio-by-portfolio basis, and be allowed to retain portfolios on Basel 1which are in transition to IRB. The "all or nothing" approach is sub optimal<br>• Banks should be allowed to adopt AMA over a period of, say, 3 years<br><br>It would also be useful if transition arrangements were co-ordinated across different jurisdictions, to avoid variations in approaches and standards. This is an area where the Accord Implementation Group (AIG) could usefully take a lead. |
| | Do the projected dates provide an adequate timeframe for core banks to be ready to implement the advanced approaches? What other options should the Agencies consider? | Whilst Citizen's Bank is not "core" using the ANPR definitions, we would comment that the requirements for credit risk are stretching, but probably achievable. However, achieving AMA for operational risk within the same timescales is unlikely, and would only detract from the work required on credit systems (which, after all, is by far and way the largest risk in regulatory capital terms). Different timescales for credit and operational risk should be considered urgently. |

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| | The Agencies seek comment on appropriate thresholds for determining whether a portfolio, business line, or geographic exposure would be material. Considerations should include relative asset size, percentages of capital, and associated levels of risk for a given portfolio, business line, or geographic region. | The concept of materiality is, in itself, misleading. However we support the U.S. approach of allowing non-material portfolios to remain on Basel 1. What is equally important is whether data is available at a level and richness to provide an accurate (rather than precise) estimate of PDs, LGDs and EAD. If this data is not available, because of the quality of the portfolio or the nature of risk management, banks will continue to have to use expert judgement in their estimation of PD and LGD.<br><br>Should greater flexibility and simplicity not be forthcoming, then we would recommend that materiality is applied consistently across jurisdictions, possibly under the *aegis* of the AIG. |
| | The Agencies seek comment on the conceptual basis of the A-IRB approach, including all of the aspects just described. What are the advantages and disadvantages of the A-IRB approach relative to alternatives, including those that would allow greater flexibility to use internal models and those that would be more cautious in incorporating statistical techniques (such as greater use of credit ratings by external rating agencies)?<br><br>The Agencies also encourage comment on the extent to which the model's necessary conditions of the conceptual justification for the A-IRB approach are reasonably met, and if not, what adjustments or alternative approach would be warranted. | The conceptual basis of the IRB approach for internal risk management and the internal assessment of capital adequacy is sound and in line with evolving risk management practice. RBSG, however, favours the use of these approaches for internal use rather than for calculation of minimum regulatory capital due to the fact that achievement of a robust IRB framework across *all* portfolios for credit risk meeting the use, quantification and validation standards will be difficult to achieve in a consistent manner given a) insufficient number of defaults and b) lack of data histories at present on which to base validation. We believe that internal rating systems including a bank's own estimates of PD, LGD and EAD will continue to have to be used in conjunction with expert judgement given the shortcomings of these approaches for Credit Risk. Disclosed capital and credit quality information based on the IRB approaches will not be directly comparable across peer groups, although many lesser informed users of this information may not realise this and take it at face value. We believe that the regulatory capital framework should encourage rather than stifle advances in risk management practice and should therefore do so in a flexible, non-prescriptive way which recognises the practical realities that banks face when applying the AIRB approaches to their portfolios, business divisions and subsidiaries. |

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| **ADVANCED INTERNAL RATINGS BASED APPROACH - AIRB** | | |
| **Expected Losses vs. Unexpected Losses** | Should the A-IRB capital regime be based on a framework that allocates capital to EL plus UL, or to UL only? Which approach would more closely align the regulatory framework to the internal capital allocation techniques currently used by large institutions? If the framework were recalibrated solely to UL, modifications to the rest of the A-IRB framework would be required. The Agencies seek commenters' views on issues that would arise as a result of such recalibration. | Given the changes announced in Madrid, we will comment on this issue as part of the Basel Committee's separate consultation, which closes on the 31st December 2003. |
| **A-IRB Capital Calculations** | | |
| **Wholesale Exposure-Definitions and Inputs** | The Agencies seek comment on the proposed definition of wholesale exposures and on the proposed inputs to the wholesale A-IRB capital formulas. What are views on the proposed definitions of default, PD, LGD, EAD, and M? Are there specific issues with the standards for the quantification of PD, LGD, EAD, or M on which the agencies should focus? | The 90 day default definition is arbitrary and does not reflect bank practice in the US as the non-accrual definition of default is a much more realistic measure. The default definition, as currently proposed, will require banks to create new systems just to achieve compliance. |
| **Wholesale Exposure – Formulas** | If the Agencies include a SME adjustment, are the $50 million threshold and the proposed approach to measurement of borrower size appropriate? What standards should be applied to the borrower size measurement (for example, frequency of measurement, use of size buckets rather than precise measurements)? | Annual adjustments should suffice. As the adjustment is a sliding scale, banks should be free to choose either a sliding scale or bucket approach, as long as this is applied consistently within the firm. The Authorities need to consider the implications of further divergence between $ and € exchange rates and the impact on capital requirements, market growth and the consequential impact on consistent risk reporting under Pillar 3. |
| | Does the proposed borrower size adjustment add a meaningful element of risk sensitivity sufficient to balance the costs associated with its computation? The Agencies are interested in comments on whether it is necessary to include an SME adjustment in the A-IRB approach. Data supporting view is encouraged. | The SME adjustment was a political compromise that reflected the importance of the Small Business market as an engine for economic growth, a compromise that was necessary (at the time) for Basel 2 to be accepted as a global standard.<br><br>The suggestion that the adjustment is appropriate given correlation has some merit, but such an adjustment is inconsistent with the concept of a risk-sensitive approach. The cost of computation is not complex, but data capture may be problematic, especially given the boundary with Retail. |

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| **Wholesale Exposure – Other Considerations** | The Agencies invite comment on ways to deal with cyclicality in LGDs. How can risk sensitivity be achieved without creating undue burden? | There is a requirement for annual validation of all risk parameters as well as a requirement for banks to have guidelines in place for action where estimates are outside acceptable bounds of error. In addition, LGD is validated on a default-weighted basis. Regulators should content themselves with assessing this on a Pillar 1 basis, and review conservatism under Pillar 2. |
| | The Agencies invite comment on the merits of the SSC approach in the United States. The Agencies also invite comment on the specific slotting criteria and associated risk weights that should be used by organizations to map their internal risk rating grades to supervisory rating grades if the SSC approach were to be adopted in the US. | Slotting criteria is too granular and prescriptive. Banks should have much greater flexibility in making their own assessment of the transaction, and be able to revert to EL based assessment where PDs and LGDs are intertwined as a result of the transaction structure. |
| | The Agencies invite the submission of empirical evidence regarding the (relative or absolute) asset correlations characterizing portfolios of land ADC loans, as well as comments regarding the circumstances under which such loans would appropriately be categorized as HVCRE. | Not Applicable |
| | The Agencies also invite comment on the appropriateness of exempting from the high asset correlation category ADC loans with substantial equity or that are pre-sold or sufficiently pre-leased. The Agencies invite comment on what standard would be used in determining whether a property is sufficiently pre-leased when prevailing occupancy rates are unusually low. | We accept that a qualifying loan may be classed as HVCRE if the equity or pre-sales/let is not deemed significant. However, there is no automatic boundary or "right or wrong" answer, as the appropriate boundary will depend on the market and the specifics of the deal. Banks themselves should make the assessment, with regulatory oversight required to establish precedent and drive consistency over time. |
| | The Agencies invite comment on whether high asset correlation treatment for one-to four-family residential construction loans is appropriate, or whether they should be included in the low asset correlation category. In cases where loans are pre-sold while others are not, the Agencies invite comment regarding how the "pres-sold" exception should be interpreted. | This should be treated consistently with HVCRE (see above). |

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| | The Agencies invite comment on the competitive impact of treating defined classes of CRE differently. What are commenters' views on an alternative approach where there is only one risk weight function for all CRE? If a single asset correlation treatment were considered, what would be the appropriate asset correlations to employ within a single risk-weight function applied to all CRE exposures? | Given that the high volatility should already be captured in the PD or LGD inherent within the transaction, we question whether the HVCRE is needed at all, on the basis that if the firm is already assessing the risk of the borrower and the transaction, the respective PD and LGD values will reflect the higher risk of the transaction. |
| | The Agencies are seeking comment on the wholesale A-IRB capital formulas and the resulting capital requirements. Would this approach provide a meaningful and appropriate increase in risk sensitivity in the sense that the results are consistent with alternative assessments of the credit risks associated with such exposures or the capital needed to support them? If not, where are there material inconsistencies? | Not Applicable. |
| | Does the proposed A-IRB maturity adjustment appropriately address the risk differences between loans with differing maturities? | Maturity adjustments provide a significant discount to shorter-term commitments with the exception of inter bank exposures in the less than six months category. We do not believe that these need to be amended. |
| **Retail Exposures: Definitions and Inputs** | The Agencies are interested in comment on whether the proposed $1 million threshold provides the appropriate dividing line between those SME exposures that banking organizations should be allowed to treat on a pooled basis under the retail A-IRB framework and those SME exposures that should be rated individually and treated under the wholesale A-IRB framework. | The $1m "hard boundary" is not appropriate and the "hardness" creates some real complexities in implementation. The boundary forces banks to calculate some assets managed, rated and priced as retail, as wholesale only for purposes of capital calculations, thereby violating the "use test" principles. The proposal that retail customers are treated under the retail curve, with adjustments being made within Pillar 2 for those assets which fall outside the $1m boundary, is far more pragmatic. Should the boundary remain, then there would be benefit in having a close alignment between the $ and € amounts so that international comparisons of capital requirements within Pillar 3 are not distorted. |
| | The Agencies are interested in comments and specific proposals concerning methods for incorporating undrawn credit card lines that are consistent with the risk characteristics and loss and default histories of this line of business. | Banks should be allowed to use their own internal EAD models and reflect drawdowns in either LGD or EAD. |

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| | The Agencies are interested in further information on market practices in this regards, in particular the extent to which banking organizations remain exposed to risks associated with such accounts. More broadly, the Agencies recognize that undrawn credit card lines are significant in both of the contexts discussed above, and are particularly interested in views on the appropriate retail IRB treatment of such exposure. | Citizen's Bank is a newcomer to the credit card market so has not formulated an economic view regarding the treatment of undrawn exposures. However, experience in the UK suggests that basing capital requirements just on the undrawn limit will result in an over-statement of the credit capital. The other aspect which needs to be taken into account is the behaviour of the customer - a customer who uses a credit card as a payment mechanism and repays the full balance each month, has a very different risk profile than the those customers that use the card as a flexible borrowing facility. In an economic context, the capital treatment would reflect the difference in these customer propositions.<br><br>By way of background, within the UK, RBS analyse draw down history for each pool and determine EAD estimates. |
| **Retail Exposure: Formulas** | For the QRE sub-category of retail exposures only, the Agencies are seeking comment on whether or not to allow banking organizations to offset a portion of the A-IRB capital requirement relating to expected losses by demonstrating that their anticipated FMI for this sub-category is likely to more than sufficiently cover expected losses over the next year. | Given the changes announced in Madrid, we will comment on this issue as part of the Basel Committee's separate consultation, which closes on the 31st December 2003. |
| | The Agencies are seeking comment on the proposed definitions of the retail A-IRB exposure category and sub-categories. Do the proposed categories provide a reasonable balance between the need for differential treatment to achieve risk-sensitivity and the desire to avoid excessive complexity in the retail A-IRB framework? What are views on the proposed approach to inclusion of small-business exposures in the other retail category? | The exclusion of non-revolving products that pass FMI test does seem rational from a risk sensitivity perspective as it may encourage inappropriate product design arbitration and inadvertently increase systemic risk.<br><br>The inclusion of the retail-managed small business exposure is appropriate. |
| | The Agencies are also seeking views on the proposed approach to defining the risk inputs for the retail A-IRB | The calculation requirements are quite rigid, especially around the Definition of Default. As mentioned within the context of Wholesale |

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| | framework.<br><br>Is the proposed degree of flexibility in their calculation, including the application of specific floors, appropriate?<br><br>What are views on the issues associated with undrawn retail lines of credit described here and on the proposed incorporation of FMI in the QRE capital determination process? | businesses, the Definition of Default is too simplistic, especially in the Retail market. There is a real risk that banks will need to adopt two sets of definitions, one for regulatory capital, the other for the effective management of their business, which conflicts with the principles inherent within the Use Test.<br><br>With regards to capital floors, we do not believe the floor proposed for residential mortgages (PD and LGD) have any logic as their adopting will penalises good quality customers.<br><br>We will comment on the FMI elements as part of the Basel Committee's additional consultation, closing on 31st December 2003. |
| | The Agencies are seeking comment on the minimum time requirements for data history and experience with segmentation and risk management systems: Are these time requirements appropriate during the transition period? Describe any reasons for not being able to meet the time requirements. | We believe that data quality is more important than data quantity, and that banks should have much greater flexibility in this area. That said, we support the UK FSA's proposal that banks require a minimum of two year's data within the Retail environment. |
| | The Agencies also seek comment on the competitive implications of allowing PMI recognition for banking organizations using the A-IRB approach but not allowing such recognition for general banks. In addition, the Agencies are interested in data on the relationship between PMI and LGD to help assess whether it may be appropriate to exclude residential mortgages covered by PMI from the proposed 10 percent LGD floor.<br><br>The Agencies request comment on whether or the extent to which it might be appropriate to recognize PMI in LGD estimates. | While the inclusion of PMI is quite sensible, it points to a problem with the 10% LGD floor.<br><br>We believe that PMI should be recognised as part of the LGD models. |

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| | More broadly, the Agencies are interested in information regarding the risks of each major type of residential mortgages exposure, including prime first mortgages, sub-prime mortgages, home equity term loan and home equity lines of credit. The Agencies are aware of various views on the resulting capital requirements of several of these product areas, and wish to ensure that all appropriate evidence and views are considered in evaluating the A-IRB treatment of these important exposures. | The 10% LGD floor on mortgages is not consistent with the risk in that product type, but may have some value for 2nd Mortgage positions. |
| | The risk-based capital requirements for credit risk of prime mortgages could well be less than one percent of their face value under this proposal. The Agencies are interested in evidence on the capital required by private market participants to hold mortgages outside of the federally insured institution and GSE environment. The Agencies also are interested in views on whether the reductions in mortgage capital requirements contemplated here would unduly extend the federal safety net and risk contribution to a credit-induced bubble in housing prices. In addition, the Agencies are also interested in views on whether there has been any shortage of mortgage credit under general risk-based capital rules that would be alleviated by the proposed changes. | Citizens Capital Modelling suggests that for Prime 1st Mortgages, capital holdings of less that 1% are appropriate, for reasonably diversified portfolios. |
| | The Agencies are interested in views on whether partial recognition of FMI should be permitted in cases where the amount of eligible FMI fails to meet the required minimum. The Agencies are also interested in views on the level of portfolio segmentation at which it would be appropriate to perform the FMI calculation. Would a requirement that FMI legibility calculations be performed separately for each portfolio segment effectively allow FMI to offset EL capital requirements for QRE exposures? | The FMI proposals may disappear after the discussions in Madrid. However, such issues are currently under review, and we plan to comment on the FMI elements as part of the Basel Committee's additional consultation, closing on 31st December 2003.<br><br>Should elements of the approach remain, we would welcome a consistent approach being adopted across US and EU jurisdictions. |

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| | The Agencies are seeking comment on the retail A-IRB capital formulas and the resulting capital requirements, including the specific issues mentioned. Are there particular retail product lines or retail activities for which the resulting A-IRB capital requirements would not be appropriate, either because of a misalignment with underlying risks or because of other potential consequences? | A specific solution / carve out is required for US Governmen Student Loans. Whilst they are technically in default after 90- US Government guarantees the debt at 99c in the $ once the f been in default after 270 days. A pragmatic solution is require Authorities wish to avoid excessive capital requirements agai products or unintended consequences regarding the availabilit of funds to this important market. |
| **A-IRB: Other Considerations** | The Agencies recognize the existence of various issues in regard to the proposed treatment of ALLL amounts in excess of the 1.25 percent limit and are interested in views on these subjects, as well as related issues concerning the incorporation of expected losses in the A-IRB framework and the treatment of the ALLL generally. Specifically, the Agencies invite comment on the domestic competitive impact of the potential difference in the treatment of reserves described. | We will include commentary on this point in our response to t Committee on Expected and Unexpected Loss treatment, due December 2003. |
| | The Agencies seek views on this issue, including whether the proposed US treatment has significant competitive implications. Feedback also is sought on whether there is an inconsistency in the treatment of general specific provisions (all of which may be used as an offset against the EL portion of the A-IRB capital requirement) in comparison to the treatment of the ALLL (for which only those amounts of general reserves exceeding the 1.25 percent limit may be used to offset the EL capital charge). | We will include commentary on this point in our response to t Committee on Expected and Unexpected Loss treatment, due December 2003. |
| **Purchased Receivables** | The Agencies seek comment on the proposed methods for calculating credit risk capital charges for purchased exposures. Are the proposals reasonable and practicable? | As a Group, we do not have purchase receivables exposures in However, should we be in this market, we would be concerned was a $100,000 limit on any single exposure in a pool under th treatment. In addition, we do have a problem with the provisio the UK market, given that the provisions work for invoice disc but do not apply to factoring. We are taking these issues forwa local regulator shortly. |

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| | For committed revolving purchase facilities, is the assumption of a fixed 75 percent conversion factor for undrawn advances reasonable? Do banks have the ability (including relevant data) to develop their own estimate of EADs for such facilities? Should banks be permitted to employ their own estimated EADs, subject to supervisory approval? | Please refer to comments above. |
| | The Agencies seek comment on the proposed methods for calculating dilution risk capital requirements. Does this methodology produce capital charges for dilution risk that seem reasonable in light of available historical evidence? Is the A-IRB capital formula appropriate for computing capital charges for dilution risk? | Please refer to comments above. |
| | In particular, is it reasonable to attribute the same asset correlations to dilution risk as are used in quantifying the credit risks of corporate exposures within the A-IRB framework? Are there alternative method(s) for determining capital charges for dilution risk that would be superior to that set forth above? | Please refer to comments above. |
| | The Agencies seek comment on the appropriate eligibility requirements for using the top-down method. Are the proposed eligibility requirements, including the $ 1 million limit for any single obligor, reasonable and sufficient? | Please refer to comments above. |
| | The Agencies seek comment on the appropriate requirements for estimating expected dilution losses. Is the guidance set forth in the New Accord reasonable and sufficient? | Please refer to comments above. |

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| **Credit Risk Mitigation Techniques** | The Agencies seek comments on the methods set forth above for determining EAD, as well as on the proposed backtesting regime and possible alternatives banking organizations might find more consistent with their internal risk management processes for these transactions. The Agencies also request comment on whether banking organizations should be permitted to use the standard supervisory haircuts or own estimates haircuts methodologies that are proposed in the New Accord. | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for CRM before commenting further. |
| | Industry comment is sought on whether a more uniform method of adjusting PD or LGD estimates should be adopted for various types of guarantees to minimize inconsistencies in treatment across institutions and, if so, views on what methods would best reflect industry practices. In this regards, the Agencies would be particularly interested in information on how banking organizations are currently treating various forms of guarantees within their economic capital allocation systems and the methods used to adjust PD, LGD, EAD, and any combination thereof. | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for CRM before commenting further. |
| | The Agencies invite comment on this issue, as well as consideration of an alternative approach whereby the notional amount of a credit derivative that does not include restructuring, as a credit event would be discounted. Comment is sought on the appropriate level of discount and whether the level of discount should vary on the basis of, for example, whether the underlying obligor has publicly outstanding rated debt or whether the underlying is an entity whose obligations have a relatively high likelihood of restructuring relative to default (for example, a sovereign or PSE). Another alternative that commenters may wish to discuss is elimination of the restructuring requirement for credit derivatives with a maturity that is considerably | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for CRM before commenting further. We do, however, support the work that ISDA and the RMA have done in this area. |

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| | longer – for example, two years – than that of the hedged obligation. | |
| | Comment is sought on this matter, as well as on the possible alternative treatment of recognizing the hedge in these two cases for regulatory capital purposes but requiring that mark-to-market gains on the credit derivative that have been taken into income be deducted from Tier 1 capital. | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for CRM before commenting further. We do, however, support the work that ISDA and the RMA have done in this area. |
| | The Agencies have concerns that the proposed formulation does not appropriately reflect distinctions between bullet and amortizing underlying obligations. Comment is sought on the best way of making such a distinction, as well as more generally on alternative methods for dealing with the reduced credit risk coverage that results from maturity mismatch. | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for CRM before commenting further. We do, however, support the work that ISDA and the RMA have done in this area. |
| | The Agencies are seeking industry views on the PFE add-ons proposed above and their applicability. Comment is also sought on whether different add-ons should apply for different remaining maturity buckets for credit derivatives and, if so, views on the appropriate percentage amounts for the add-ons in each bucket. | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for CRM before commenting further. We do, however, support the work that ISDA and the RMA have done in this area. |
| **Equity Exposure** | The Agencies encourage comment on whether the definition of an equity exposure is sufficiently clear to allow banking organizations to make an appropriate determination as to the characterization of their assets. | We support the general principle proposed within ANPR, that Equities are defined by substance and not form. |
| | Comment is sought on whether other types of equity investments in PSEs should be exempted from the capital charge on equity exposures, and if so, the appropriate criteria for determining which PSEs would be exempted. | The treatment of a PSE should be the same for lending and equity purposes. If a PSE is treated as a Sovereign for lending purposes, the same should apply within the equity portfolio. |

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| | The Agencies seek comment on what conditions might be appropriate for this partial exclusion from the A-IRB equity capital charge. Such conditions could include limitations on the size and types of businesses in which the banking organization invests, geographical limitations, or maximum limitations on the size of individual investments. | No comment |
| | The Agencies seek comment on whether any conditions relating to the exclusion of CEDE investments from the A-IRB equity capital charge would be appropriate. These conditions could serve to limit the exclusion to investments in CEDEs that meet specific public welfare goals or to limit the amount of CEDE investments that would qualify for the exclusion form the A-IRB equity capital charge. The Agencies also seek comment on whether any other classes of legislated program equity exposures should be excluded from the A-IRB equity capital charge. | This proposal is largely consistent with current market best practice. |
| | Comment is specifically sought on whether the measure of an equity exposure under AFS accounting continues to be appropriate or whether a different rule for the inclusion of revaluation gains should be adopted. | We would support any further alignment between US treatment and IASB. |
| **US Supervisory Review** | The Agencies seek comment on the extent to which an appropriate balance has been struck between flexibility and comparability for the A-IRB requirements. If this balance is not appropriate, what are the specific areas of imbalance, and what is the potential impact of the identified imbalance? Are there alternatives that would provide greater flexibility, while meeting the overall objective of producing accurate and consistent ratings? | The balance seems appropriate and for the most part adequately flexible. However, we would ask the agencies to recognise that it will be necessary to accommodate situations under AIRB in which the use and risk quantification processes can be achieved to a greater extent than the validation processes due to either a low level of defaults or the fact that a bank is in the process of building data histories for a particular portfolio. The litmus test should be whether firms “use” and can demonstrate that they have an acceptable amount of experience with the internal estimates for the approval and management of credit risk. |

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| | The Agencies also seek comment on the supervisory standards contained in the draft guidance. Do the standards cover all of the key elements of an A-IRB framework? Are there specific practices that appear to meet the objectives of accurate and constant ratings but that would be ruled out by the supervisory standards related to controls and oversight? Are there particular elements from the corporate guidance that should be modified or reconsidered as the Agencies draft guidance for other types of credit? | We welcome the examples of acceptable and unacceptable practice for the calculation and validation of the parameters that are used in the capital calculation formulae.<br>In particular, we note, and support, the ANPR commentary that the calculation methodologies set out in the Basel Committee's 3rd Consultative Paper represent only a sub-set of the possible calculation methodologies, and that banks are free to use any calculation and validation methodologies which meet the qualitative and quantitative standards required. We commend this attitude to other national regulators.<br>We seek further clarification from the Agencies as to the way in which the application and assessment process will operate in practice for those banks which opt in to the Basel 2 approaches, and in particular, the way in which issues regarding differences in approaches from parent to subsidiary will be treated by the Agencies. |
| | In addition, the Agencies seek comment on the extent to which these proposed requirements are consistent with the ongoing improvements banking organizations are making in credit-risk management processes. | One of the initial objectives of the Basel Committee was to provide incentives for banks to enhance their measurement and management of risk through changes to the minimum capital framework. We believe that this could be more effectively achieved through a simpler Pillar 1 and Supervisory agreement on principles for the management of risk and capital under Pillar 2.<br><br>The rules based approach to Pillar I will be more likely to result in the stifling of innovation in risk management, particularly given that the banks already use approaches that surpass Basel 2 in sophistication. Improvements in risk management can be fast moving. Without greater flexibility built into the Accord and national implementation strategies, sections of the new rules run the risk of being obsolete by 2007. However, the principles for the effective management of risk and capital (Pillar 2) need to stand the test of time. |

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| **Operational Criteria** | The Agencies seek comment on the proposed operational requirements for securitization. Are the proposed criteria for risk transference and clean up calls consistent with existing market practices? | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| **Determining Capital Requirements – General Considerations** | Comments are invited on the circumstances under which the retention of the treatment in the general risk-based capital rules for residual interests for banking organizations using the A-IRB approach to securitization would be appropriate. | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| | Should the Agencies require originators to hold dollar-for-dollar capital against all retained securitization exposures, even if this treatment would result in an aggregate amount of capital required of the originator that exceeded KIRB plus any applicable deductions? Please provide the underlying rationale. | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| | The Agencies seek comment on the proposed treatment of securitization exposures held by originators. In particular, the Agencies seek comment on whether originating banking organizations should be permitted to calculate A-IRB capital charges fro securitizations exposures below the KIRB threshold based on an external or inferred rating, when available. | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| | The Agencies seek comment on whether deduction should be required for all non-rated positions above KIRB. What are the advantages and disadvantages of the SFA approach versus the deduction approach? | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| **Capital Calculation Approaches** | The Agencies seek comment on the proposed treatment of securitization exposures under the RBA. For rated securitization exposures, is it appropriate to differentiate risk weights based on tranche thickness and pool granularity? | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |

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| | For non-retail securitizations, will investors generally have sufficient information to calculate the effective number of underlying exposures (N)? | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| | What are views on the thresholds based on N and Q, for determining when the different risk weights apply in the RBA? | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| | Are there concerns regarding the reliability of external ratings and their use in determining regulatory capital? How might the Agencies address any such potential concerns? | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| | Unlike the A-IRB framework for wholesale exposures, there is no maturity adjustment within the proposed RBA. Is this reasonable in light of the criteria to assign external ratings? | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| | The Agencies seek comment on the proposed SFA. How might it be simplified without sacrificing significant risk sensitivity? How useful are the alternative simplified computation methodologies for N and LGD? | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| | The Agencies seek comment on the proposed treatment of eligible liquidity facilities, including the qualifying criteria for such facilities. Does the proposed Look-Through Approach – to be available as a temporary measure – satisfactorily address concerns that, in some cases, it may be impractical for providers of liquidity facilities to apply either the "bottom-up" or "top-down" approach for calculating KIRB? It would be helpful to understand the degree to which any potential obstacles are likely to persist. | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |

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| | Feedback also is sought on whether liquidity providers should be permitted to calculate A-IRB capital charges based on their internal risk ratings for such facilities in combination with the appropriate RBA risk weight. What are the advantages and disadvantages of such an approach, and how might the Agencies address concerns that the supervisory validation of such internal ratings would be difficult and burdensome? Under such an approach, would the lack of any maturity adjustment with the RBA be problematic for assigning reasonable risk weights to liquidity facilities backed by relatively short-term receivables, such as trade credit? | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| **Other Considerations:** | Should the A-IRB capital treatment for securitization exposures that do not have a specific A-IRB treatment be the same for investors and originators? If so, which treatment should be applied – that used for investors (the RBA) or originators (the Alternative RBA)? The rationale for the response would be helpful. | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| | The Agencies seek comment on the proposed treatment of securitisation of revolving credit facilities containing early amortization mechanisms. Does the proposal satisfactorily address the potential risks such transactions pose to originators? | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| | Comments are invited on the interplay between the A-IRB capital charge for securitization structures containing early amortization features and that for undrawn lines that have not been scrutinized. Are there common elements that the Agencies should consider? Specific examples would be helpful. | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| | Are proposed differences in CCFs for controlled and non-controlled amortization mechanisms appropriate? Are there other factors that the Agencies should consider? | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |

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| | When providing service cash advances, are banking organizations obligated to advance funds up to a specified recoverable amount? If so, does the practice differ by asset type? Please provide a rationale for the response given. | Given the changes announced in Madrid, we await further guidance on the Basel Committee's proposals for simplifying the Securitisation proposals before commenting further. |
| **AMA Framework of Operational Risk** | The Agencies are proposing the AMA to address operational risk for regulatory capital purposes. The Agencies are interested, however, in possible alternatives. Are there alternative concepts or approaches that might be equally or more effective in addressing operational risk? If so, please provide some discussion on possible alternatives. | RBS Group welcomes the introduction of the AMA concept, with its emphasis on principles and the recognition, for supervisory purposes, of a bank's internal approach to operational risk. We also believe that AMA is an appropriate target for large, internationally active banks.<br><br>We have concerns that the decision of the Agencies simply to offer the AMA could have significant implementation issues. It may help to offer a concrete example in this regard. Let us assume that our US subsidiary, Citizens is able to qualify for A-IRB at the point of implementation, but is not yet able to meet the AMA standards (although has future plans to do so). Under the current proposals Citizens would be required to remain on Basel I. This has a negative impact for both the bank and supervisors: the bank suffers from not adopting the A-IRB (and attendant benefits), while the Agencies suffer as an institution is kept on a supervisory regime, which, by their own admission, is worthy of replacement. In this instance, we would propose that where an institution is able to move to one of the advanced approaches and has a plan to adopt the other, some transitional arrangement be made available. A simple approach would be for credit elements to move to AIRB and for an operational risk charge to be based on the Basic Indicator or Standardised approach until ready to move to AMA. This would avoid the burden for both banks and the Agencies of adopting interim steps for short periods of time.<br><br>We would also offer a comment on the assessment of capital adequacy. The AMA framework encourages banks to adopt an approach to the measurement and management of operational risk that is relevant internally, covers the full range of risks and activities and which will improve risk management at a business line level. We support these aims. We are concerned, however, that such an approach is not consistent with |

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| | | the current calculation of capital adequacy (on a legal entity basis). It will be extremely difficult for most banks (who organise and manage risk on business line basis) to run separate AMA based calculations for legal entities. Even if sufficient empirical data could be collected to support this, to perform scenario analysis and control assessments on a legal entity basis would cut across current practices. As a result we believe that within the AMA framework, banks should be able to allocate a capital requirement to legal entities, based on capital calculated on a business line basis. This will require an allocation key to be part of the AMA model and subject to approval by supervisors. We would propose that a standard allocation mechanism be set out in the regulation, and that banks would default to this mechanism in the absence of a bank-specific alternative. We have explored these ideas further through the Institute of International Finance Working Group on Operational Risk, and would refer the Agencies to the materials to be submitted to the Risk Management Group of the Basel Committee. |
| **AMA Capital Calculation** | Does the broad structure that the Agencies have outlined incorporate all the key elements that should be factored into the operational risk framework for regulatory capital? If not, what other issues should be addressed? Are any elements included not directly relevant for operational risk measurement or management? The Agencies have not included indirect losses (for example, opportunity costs) in the definition of operational risk against which institutions would have to hold capital; because such losses can be substantial, should they be included in the definition of operational risk? | RBS Group accepts that each of the four elements outlined (internal loss data, relevant external data, an assessment of the business environment and internal control factors and scenario analysis) play a part in the assessment of operational risk and the calculation of regulatory capital. The multiplicity of causes of operational risk and the wide range of operational risk events means that it is appropriate to consider a range of data sources in reaching an assessment of risk. Reliance purely on one source is unlikely to provide a sufficient indication of operational risk exposure. However, we do not believe that the exact way in which these data are used or supervisors should specify their specific sources. For instance, there are numerous techniques for assessing the business environment and internal control factors, (e.g. KRIs, self assessments and scorecards) and we would not wish to see any supervisory prescription on which technique is used.<br><br>We note that the capital requirement for operational risk is based on consistency with a 99.9% confidence interval over a one-year holding |

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| | | period. We believe this wording of 'consistent with' is important, and should be applied to a bank regardless of the specifics of its internal approach. For instance, it would be easy for supervisors to apply this test more harshly to those banks that place emphasis on the more quantitative inputs into an AMA model (i.e. banks adopting an 'LDA' based AMA) compared to banks placing emphasis on the more qualitative inputs (for instance, the 'Scenario' or 'Risk Driver' based AMAs). Supervisors must ensure that the standards are applied equally and reflect the prudential requirements, not the particular model they are presented with.<br><br>We note the reference to holding capital for unexpected and expected losses and would expect this wording to be updated in light of the recent Basel Committee announcement to recalibrate the Basel 2 Accord.<br>We believe that the regulatory definition of operational risk is a sound basis for loss data collection and the calculation of minimum regulatory capital. Internally, for management purposes, RBS Group has adopted a wider definition of operational risk, which includes indirect financial impacts. |
| **Overview of the Supervisory Criteria** | The Agencies seek comment on the extent to which an appropriate balance has been struck between flexibility and comparability for the operational risk requirement. If this balance is not appropriate, what are the specific areas of imbalance and what is the potential impact of the identified imbalance? | As noted above, RBS Group supports a supervisory approach to operational risk based around principles rather than prescription. It will be necessary to accept that in such a framework, differences in internal methodologies between banks could lead to different regulatory capital numbers for the same intrinsic operational risk exposure. We accept that this is necessary and preferable to an 'advanced' approach in which a bank's internal data is simply fed into a supervisory equation to generate a capital number (as was previously proposed under the Internal Measurement Approach). We note that banks will be required to make their internal loss data available to supervisors on a consistent basis (based on 7 loss event categories) and this will give supervisors one basis for comparing approaches. |

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| | The Agencies are considering additional measures to facilitate consistency in both the supervisory assessment of AMA frameworks and the enforcement of AMA standards across institutions. Specifically, the Agencies are considering enhancements to existing interagency operational and managerial standards to directly address operational risk and to articulate supervisory expectations for AMA frameworks. The Agencies seek comment on the need for and effectiveness of these additional measures. | Operational Risk as a distinct discipline has drawn together strands of risk management that have existed for many years (Internal systems and controls, outsourcing management and business continuity planning). To the extent that existing standards are superseded or enhanced by new proposals then these should be aligned. It is also important to be clear where any boundaries between guidance and requirements are set and properly aligned. |
| | The Agencies also seek comment on the supervisory standards. Do the standards cover the key elements of an operational risk framework? | The supervisory standards cover the key elements of the supervisory framework. It is important that the standards relating to the individual inputs S.15-S.24 are not used by supervisors to prescribe the type of approach adopted by a bank, but rather to allow an evaluation of the suitability of the inputs into the bank's approach.<br><br>We would seek clarification on whether S.28 will be updated in light of the Basel Committee decision on unexpected loss. We offer comments on S.30 below. We note that in S.31 (paragraph 72) there is reference to public reports of operational risk measurement and management results. We assume that the minimum public reporting for operational risk has been specified in the Disclosure section of the ANPR, and that this reference is to voluntary public disclosure.<br><br>Section XI (S.32 and S.33) refers to the testing and verification of the operational risk framework. The section rightly suggests that (internal and external) audit functions have a role in this regard. However, we are not convinced that the audit function is well equipped to test 'adjustments empirical operational risk capital estimates' or all the assumptions underlying the model. We would expect these functions to be performed by a quantitative team. So, whilst we accept the wording of the two supervisory standards, we would not wish to see this translated into a presumption that internal or external audit will satisfy these standards. This comment is also relevant to the following question. |

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| | The Agencies are introducing the concept of an operational risk management function, while emphasizing the importance of the roles played by the board, management, lines of business, and audit. Are the responsibilities delineated for each of these functions sufficiently clear and would they result in a satisfactory process for managing the operational risk framework? | RBS Group has developed an internal governance framework that is consistent with the approach set forth in the ANPR. We have a central Enterprise Risk function, which is responsible for the design of the operational risk framework and which is answerable to senior committees of the board. Within each of our 8 business divisions there is an independent risk function, which works with line of business management to implement the operational risk framework. The implementation and operation of the framework is subject to independent review by internal audit. We therefore accept that the framework set forth in section V (S1.-S7.) is appropriate. We do not believe that further prescription on the part of supervisors on the respective roles of the independent operational risk management function, the board, the line of business management, or audit is necessary or desirable. We would re-iterate our comment above that some of the specific tests set forth in section XI might not be most appropriately performed by internal audit. |
| **Elements of an AMA Framework** | The Agencies seek comment on the reasonableness of the criteria for recognition of risk mitigants in reducing an institution's operational risk exposure. In particular, do the criteria allow for recognition of common insurance policies? If not, what criteria are most binding against current insurance products? Other than insurance, are there additional risk mitigation products that should be considered for operational risk? | In ongoing consultation with the supervisory community (Basel) we have questioned why separate criteria for recognition of insurance should be set forth. Rather we would prefer to see insurance included in a bank's 'assessment of the business and control environment', one of the four key components of the AMA framework.<br><br>We have also questioned where the 20% limit on capital reduction has been derived from. We have seen no empirical evidence to support this limit.<br><br>If separate criteria for the recognition of insurance were to be included in the regulations, then we would offer the following comments.<br>The first requirement on the claims paying ability creates a 'cliff effect' of qualification/non-qualification. We wonder if a haircut linked to the rating scale might be more appropriate.<br><br>We also note that the first requirement excludes cover offered by captive insurers. In light of the fact that capital from such captives is excluded |

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| | | from the base for assessing capital adequacy this seems to be a 'double whammy' and would suggest that this requirement be revisited.<br>We do not agree that a haircut relating to time to maturity (as suggested by footnote 8 of the third bullet in paragraph 68) is appropriate. We have seen no evidence to suggest that time to maturity is an indicator of likelihood of payout. We would propose to delete this requirement.<br><br>We are concerned that the current requirements set forth in section IX do not take full cognisance of the reality of insurance markets. There is a significant risk that the requirements as currently drafted will have the double negative effect of distorting the current insurance markets, without providing supervisors with any prudential benefit. We believe this is an area that requires significant further research. |
| **Disclosure Requirements** | The Agencies seek comment on the feasibility of such an approach to the disclosure of pertinent information and also whether commenters have any other suggestions regarding how best to present the required disclosures. | We are concerned about the potential lack of alignment between the Basel and IASB rules, which could lead to duplication and inconsistent risk reporting within the Report and Accounts and through the Pillar 3 requirements. We stress the importance of aligning these two regimes as far as possible, to remove this additional burden and inconsistency.<br><br>Whilst there is no current requirement to incorporate Pillar 3 disclosures within the Report and Accounts, we question whether market best practice will allow for un-audited risk disclosure.<br><br>However, we genuinely believe that the approach to Pillar 3 is too prescriptive. Whilst we support (and welcome) greater risk disclosure, we believe that this should be taken forward on a principles based approach, with the Pillar 3 requirements being generated over time based on market best practice. We also believe that the Pillar 3 requirements should come into full effect later, once the transition periods adopted have worked their way through. |

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| | Comments are requested on whether the Agencies' description of the required formal disclosure policy is adequate, or whether additional guidance would be useful. | Please refer to the comments above. |
| | Comments are requested regarding whether any of the information sought by the Agencies to be disclosed raises any particular concerns regarding the disclosure of proprietary or confidential information. If a commenter believes certain of the required information would be proprietary or confidential, the Agencies seek comment on why that is so and alternatives that would meet the objectives of the required disclosure. | Please refer to the comments above. |
| | The Agencies also seek comment regarding the most efficient means for institutions to meet the disclosure requirements. Specifically, the Agencies are interested in comments about the feasibility of requiring institutions to provide all requested information in one location and also whether commenters have other suggestions on how to ensure that the requested information is readily available to market participants. | Please refer to the comments above. |