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Dear Sirs and Madam,

INTERNAL RATINGS-BASED SYSTEMS FOR RETAIL CREDIT RISK FOR REGULATORY CAPITAL; NOTICE

Thank you for the opportunity to comment on your proposals for implementing the Basel IRB Retail Credit rules within the United States.

By way of background, the Royal Bank of Scotland (RBS) has significant exposure in North America, including Retail and Commercial Banking, Asset Finance and Capital Markets operations. The Group's largest single US business, measured by assets, is Citizens Financial Group, Inc. (CFG), a Providence-based commercial bank holding company that operates more than fifteen hundred Citizens Bank and Charter One branch offices in Connecticut, Delaware, Illinois, Indiana, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island and Vermont. Whilst CFG, with over $131 billion in assets, falls outside the 'mandated' banks, it forms part of the next tier expected to opt-into Basel 2.

Given the geographic spread of the RBS group, with a focus on the UK, Ireland and Europe, we are clearly interested in how the proposals will be implemented both within the US and, importantly, identify where proposals differ from those emanating from the EU and our lead regulator, the UK FSA.

Before turning to specific comments to the questions and standards proposed within your Note, we thought you would appreciate some high-level comments on the proposals. Overall, we commend the clarity of the Note, in particular the separation of standards and guidance notes. We have found this approach most helpful.

However, some of the requirements appear relatively prescriptive, which could encourage a 'tick-box' approach to regulation. We believe a more principles based approach would encourage a better dialogue between regulators, which is more likely to achieve the objectives of the Accord. Risk management is, and should be, a mix between art and science – Basel 2 will only work effectively if regulation mirrors this.

Whilst these regulatory standards are designed for a US market, we would like to highlight the importance of consistency around home: host implementation and validation, especially as the Basel proposals are designed primarily for internationally active banks. To highlight one variance, the US days past due default triggers proposed (180 for mortgages and credit cards, 120 for other retail) differ from those chosen by the group's lead regulator. Whilst we do not expect regulators to align their processes completely, mutual recognition between states will be required to avoid such differences creating practical difficulties and additional burdens. If we cannot get it right (and there are a number of ways of doing this badly) then the goals of Basel 2 will be significantly undermined.

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 the remainder of this year. As highlighted in the attached appendix, a more flexible and pragmatic approach to implementation is in all our interests.

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

c.c. Fred Watt, Group Finance Director
Larry Fish, Chief Executive Officer, Citizens Financial Group
Sir Stephen Lamport, Director, Public Policy & Government Affairs
Bob Gormley, Chief Risk Officer, Citizens Financial Group

TITLE	QUESTIONS	RESPONSE
In response to the four specific issues and request for comment around the Paperwork Reduction Act raised in the note:		
Qualifying Revolving Exposures (QRE) Volatility Requirement	This proposed retail IRB guidance does not set forth criteria for defining what will constitute a "low" ratio of loss rate volatility to average loss rate for the purpose of qualification for QRE capital treatment. (See paragraphs 160 to 164 of the proposed guidance.) In developing the NPR, the Agencies will consider various options for addressing this concern and will provide additional information regarding QRE capital treatment. The Agencies seek comment on ways to implement the low volatility requirement for QRE sub-portfolios.	Given the arbitrary nature of the QRE definition, specifically the difficulty in defining a 'volatility threshold', we would recommend that regulators work with appropriate industry groups to agree the definition and threshold test for low volatility average loss rates. The solution should be applicable internationally, given the need to maintain consistency and the level playing field for financial services.
Definition of Default	This proposed retail IRB guidance (paragraph 98) stipulates that a retail exposure will be considered in default if any one of three "loss recognition events" occurs. One of these three events is that "The exposure is put on non-accrual status." The Agencies acknowledge that there is not a requirement for placing delinquent retail exposures on non-accrual status for either Call Report/ Thrift Financial Report purposes or for GAAP. Nonetheless, many banks choose to put certain retail loans on non-accrual and report these as such on their Call Reports/Thrift Financial Reports and financial statements. The Agencies invite comment on this particular element of the proposed definition of default, including detailed explanations of why banking organizations favor or oppose the inclusion of nonaccrual status in the definition of default.	We have no objection to using non-accrual status as a Basel Definition of Default, given that this aligns with bank practice and the requirements of the Basel 2/EU CRD.

TITLE	QUESTIONS	RESPONSE
3. Loss Given Default (LGD) Estimation	When the loss severity of a retail portfolio exhibits significant cyclical variability, this proposed retail IRB guidance states that a bank must estimate an LGD that reflects periods of high credit losses for the particular portfolio (e.g., mortgages). The period of high credit losses may be different for each retail portfolio. (See standard RS– 22 and paragraph 127.) The Agencies invite comment on various issues related to estimating LGD for such periods: • How should ''periods of high credit losses'' (also referred to as periods when credit losses are ''substantially higher than average'') for a portfolio be defined? • What methods could be used to estimate an LGD appropriate to such periods? • Should the LGD adjustment for high credit losses reflect the likely LGD when credit losses are high at the product or portfolio level for the particular bank (legal entity), or for a nationally diversified portfolio? • How will a bank ensure that the LGD will reflect any unique or predictive risk characteristics of individual segments or small groups of segments if the period of high credit losses is defined at an aggregated level? • If segments are defined across multiple legal entities, how will the banking organization ensure that the capital levels accurately reflect the unique risk of assets held by each legal entity? The Agencies, through the Basel Committee on Banking Supervision, are undertaking additional work to clarify LGD estimation.	The Basel Committee consultations on downturn LGD are currently in progress and the RBS is contributing to various trade-body responses. Within the US, a large proportion of retail exposures can be categorised as "super prime" which have not experienced a "period of high credit losses" historically, nor are expected to do so in the future. In response to the specific questions on LGD estimation, we suggest a definition of "periods of high credit losses" for a portfolio should reference the ratio of losses in a minimum of twelve months in relation to a period of 5/7 years, with the minimum ratio being set at a given level, e.g. 2 times. Pragmatism is required to achieve a balance the LGD estimation for individual segments as compared to the aggregate level. In particular, there needs to sufficient loss cases to estimate a sufficiently robust LGD. The issue of cross-entity segmentation and parameter estimation is not specific to downturn LGD estimation and, we believe, needs to be addressed with reference to PD and EAD.

TITLE	QUESTIONS	RESPONSE
4. Criteria for assigning Exposures to Retail Categories	Because each risk category has its own risk-weight function, assignment to different risk categories results in different capital requirements. A variety of loan types, especially real estate loans, could be placed in more than one retail or corporate IRB risk category. The Agencies request comment on whether the criteria for assigning exposures to retail categories are appropriate for the credit risk of the exposures. For example, is four units the appropriate limit on the number of units in a residential property to meet the definition of a residential mortgage loan? In addition, are small business loans appropriately categorized based on whether they are primarily or partially secured by residential real estate?	As required within the Basel 2 rules, the RBS group will apply conservatism in the assigning of exposures to retail categories. We consider the criteria for assigning exposure to retail categories reasonable although we would recommend some flexibility at the boundary where systems implications are significant in terms of cost and/or complexity.
Paperwork Reduction Act	Commenters on this proposed retail IRB guidance are asked to provide any estimates that they can reasonably determine about the time, effort, and financial resources that will be required to develop and maintain the plans, reports, and records discussed in the proposed guidance. Commenters also are requested to specify whether the described capital and methodological standards would necessitate the acquisition or development or new compliance/information systems or the significant modification of existing compliance/information systems. The Agencies also invite comment on: (1) Whether the collections of information contained in the proposed guidance are necessary for the proper performance of each agency's functions, including whether the information has practical utility;	We do not have data at this level of granularity at this time, especially as the focus is on retail only guidance and portfolios. However, on a qualitative basis, we foresee significant expenditure and headcount to support the emerging standards.

TITLE	QUESTIONS	RESPONSE
	(2) What would be an accurate estimate of the burden of the proposed information collections; (3) Ways to enhance the quality, utility, and clarity of the information to be collected; (4) Ways to minimize the burden of the information collections on respondents, including the use of automated collection techniques or other forms of information technology; and (5) Estimates of capital or start-up costs and costs of operation, maintenance, and purchases of services to provide information. Respondents/record keepers are not required to respond to any collection of information unless it displays a currently valid Office of Management and Budget (OMB) control number.	

RS	QUESTIONS	RESPONSE
In response to the fifty eight proposed regulatory standards applied to retail IRB in the note:		
SEGMENTATION		
RS-1	Banks must segment exposures into pools with homogeneous risk characteristics. Banks must separately segment exposures in each distinct product line within each of the three retail risk categories (mortgage, QRE and other).	This standard is more prescriptive than the Accord as it stipulates product segmentation whereas Basel allows a combination of product and/or collateral types. For example, small business exposures may be offered in instalment and/or revolving product forms and banks may seek to combine these product types into a single group, segmented by collateral type.
RS-2	Defaulted assets must be segmented on the basis of risk characteristics predictive of loss and recovery rates.	This regulatory standard is more prescriptive than the Basel 2 requirements. It is unclear what the US authorities are trying to achieve as this segmentation has no impact on Risk Weighted Assets applying to defaulted asset. Prescription could result in unintended consequences for firms. Flexibility in the management of collections processes is in all our interest.
RS-3	A retail IRB risk segmentation system must produce segments within each retail risk category that adequately differentiate risk and produce reliable estimates of the IRB risk parameters.	Agreed.
RS-4	Banks must clearly define and document the criteria for assigning an exposure to a particular retail risk segment. The risk factors used for IRB risk segmentation purposes must be consistent with internal methods of assessing credit risk for retail exposures.	Agreed.

RS	QUESTIONS	RESPONSE
RS-5	Banks must develop and document their policies to ensure that risk driver information is sufficiently accurate and timely to track changes in underlying credit quality and to migrate exposures between segments.	Broadly accepted, although some flexibility will be required at the product level.
RS-6	Banks must review their segmentation system at least annually and have clear policies to define the criteria for modifying the system.	Whilst the requirement for a 'policy to define the criteria etc' is not required by the Basel Accord, it is a pragmatic step to reduce the risk of cherry picking by firms. However, regulators must allow some flexibility regarding how firms implement change control, especially in around M&A activities, new product development and changes in scoring systems models. Basel 2 and its application must not be allowed to stifle innovation in good risk management practice. The proposal to view the approach annually is pragmatic and in line with the Basel 2 requirements.
RS-7	Banks that design their risk segmentation systems to realize the benefits of guarantees or other risk mitigants must be able to support their approach.	Agreed.
VALIDATION		
RS-8	Banks must validate that their retail IRB risk segmentation process separates exposures into segments with homogeneous risk characteristics that generate reliable long-run estimates of the IRB risk parameters.	The standard is acceptable, but should be reworded 'Banks must demonstrate that their retail IRB risk segmentation…' to remove any confusion regarding validation standards. We would argue, in line with validation 'principle 4' proposed by the AIG, that there is no single validation method. Risk management is an art and a science and some management judgement (for example, changes in risk management practice and the general economic environment) needs to be allowed in the generation of 'reliable long-run estimates'.

RS	QUESTIONS	RESPONSE
RS-9	The ongoing validation process must include the review of developmental evidence, ongoing monitoring, and back-testing.	Agreed, given the supporting statement (paragraph 52) that recognises the flexibility required around back-testing when firms are improving their risk management systems.
RS-10	Banks must establish internal tolerance limits for differences between expected and realized outcomes that require appropriate managerial review.	We agree with the need to establish internal tolerance limits as part of on going parameter monitoring.
QUANTIFICATION		
RS-11	Banks must have a fully specified process covering all aspects of retail quantification. The quantification process must be fully documented and updated periodically.	The wording of the standard is very broad. We recommend that the wording references Retail IRB segmentation systems and loss characteristic estimation only.
RS-12	Quantification must be based upon the best available data for the accurate estimation of IRB risk parameters.	We agree with principle, but are concerned that 'best available' is open to different interpretation and could, if interpreted literally, encourage firms to implement the most expensive solution. It would be more appropriate to base the standard on 'relevant, material and legal data' for the accurate estimation of IRB risk parameters.
RS-13	The sample period for the reference data must be at least five years and must include periods of portfolio stress.	Agreed, but regulators need to provide some flexibility, for example around new product development or M&A activity (especially if the target bank remains on Basel 1).
RS-14	Mapping must be based on a robust comparison of available data elements that are common to the existing portfolio and each reference data set.	Agreed.
RS-15	Mappings must be reviewed regularly and updated as necessary.	Agreed.

RS	QUESTIONS	RESPONSE
RS-16	Banks that combine estimates from internal and external data or that use multiple estimation methods must have a clear policy governing the combination process and should examine the sensitivity of the results to alternative combinations.	Agreed.
RS-17	A bank must have a clear, well-documented policy for addressing the absence of significant data elements in either the reference dataset or the existing portfolio.	Agreed.
RS-18	For estimating the IRB retail risk parameters, qualifying banks must use the IRB definition of default.	Agreed.
RS-19	Estimates of PD must be empirically based and must represent the average over time of segment default frequencies on an account basis. The effects of seasoning, prepayments and attrition must be considered in the PD estimates.	This standard is super-equivalent to the Basel proposals, which are restricted to seasoning effects.
RS-20	PD estimates for all retail segments cannot be less than 0.03 percent (3 basis points).	We recognise that this is requirement of the Basel Accord and is designed to ensure that all exposures carry some capital requirement. However, we are concerned that the cumulative effect of the conservative assumptions may result a regulatory capital requirement which bears little connection to economic reality.
RS-21	The estimates of LGD must reflect the concept of "economic loss."	Agree in principle, subject to a pragmatic approach to calculation.
RS-22	The estimated LGD must reflect loss severities during periods of high credit losses	We recommend that regulators revisit this standard following the Basel Committee discussions and consultations around stressed LGDs. The standard needs to be aligned with the final proposal.
RS-23	IRB banks have a minimum LGD of 10 percent for residential mortgages.	As stated in response to RS-20, we recognise that this is requirement of the Basel Accord and is designed to ensure that all exposures carry some capital requirement. However, we are concerned that the cumulative effect of the conservative assumptions may result a regulatory capital requirement which bears little connection to economic reality.

RS	QUESTIONS	RESPONSE
RS-24	If banks choose to reflect the risk-mitigating effect of private mortgage insurance (PMI) for residential mortgages in their risk estimates, they must do so by incorporating these insurance benefits into the quantification of segment-level LGD.	Agreed.
RS-25	The bank must provide an estimate of EAD for each segment in its retail portfolio.	Agree in principle, assuming this aligns with the Basel Accord's acknowledgement that the same EAD can be applied across more than one pool/segment.
RS-26	The estimated LEQ must reflect estimated net additional draws during periods of high credit losses	We recommend that the regulators revisit this standard following the outcome of the Basel Committee discussions and consultations around stressed LGDs. The standard needs to be aligned at a global level. Without this work, we question the validity of having to use high credit-loss period LEQs where there is no correlation between PD and LEQ severity.
RS-27	Quantification of the IRB risk parameters must be adjusted appropriately to recognize the risk characteristics of exposures that were removed from reference data sets through loan sales or securitizations.	Agreed, but we would suggest including materiality to the requirement for adjustment.
QUANTIFICATION – SUBSECTION ON VALIDATION		
RS-28	A validation process must cover all aspects of IRB retail quantification.	Agreed.
RS-29	A bank must establish policies for all aspects of validation. A bank must comprehensively validate risk segmentation and quantification at least annually, document the results, and report its findings to senior management.	Agreed.

RS	QUESTIONS	RESPONSE
RS-30	Banks must use a variety of validation approaches or tools; no single validation tool can completely and conclusively assess IRB quantification. A bank's validation processes must include the evaluation of logic, ongoing monitoring, and the comparison of estimated parameter values with actual outcomes.	We recognise that different techniques are relevant in different portfolios, and support the inherent flexibility being provided to firms. Validation should not be seen as a "one-size-fits all" process; what is important is an appropriate dialogue between the regulators and the firm.
RS-31	Banks must evaluate the developmental evidence, or logic, involved with the development of the risk segmentation system and the quantification process.	Agreed, but we would expect onsite examiners to have some judgemental flexibility on application.
RS-32	Banks must conduct ongoing process verification on the developed risk segmentation system and quantification process to ensure proper implementation.	We agree with the principle of the standard but would expect this to be applied proportionately, given the importance of each part of the segmentation system and quantification process
RS-33	Banks must benchmark their risk quantification estimates against other sources.	We question whether this is practical. It may be possible to use external benchmarks for some product types, e.g. FICO scores, but appropriate benchmarks (especially for LGD and EAD) are not always be available. Therefore, we would recommend that the standard is amended to say *"Banks must benchmark their risk quantification estimates against other sources, where applicable".*
RS-34	Banks must develop statistical tests to back-test their IRB risk quantification processes. Banks must establish tolerance limits for differences between expected and actual outcomes, and banks must have a validation policy that requires and outlines remedial actions to be taken when policy tolerances are exceeded.	As highlighted under regulatory standard 10, we agree with the need to establish internal tolerance limits as part of on going parameter monitoring. We do believe it unnecessary to perform the same level of testing and review to monitor model performance as is required during annual validation and reviews. Experience to date suggests that it is sometimes difficult to assess where tolerance limits should be set. Regulators should recognise this and allow firms to evolve their practice after implementation of Basel 2 requirements.

RS	QUESTIONS	RESPONSE
DATA MAINTAINANCE		
RS-35	The bank must collect and maintain sufficient data to support its IRB retail credit risk system.	Agreed, subject to a flexible application of the word 'sufficient'.
RS-36	Banks must retain all significant data elements used in the IRB retail credit risk system for at least five years and must include a period of portfolio stress. This data requirement applies to all loans and lines that were open at any time during this period.	Agreed as at the end of any transition period outlined in the Basel Accord.
RS-37	Banks must retain refreshed data elements related to key credit risk drivers, performance components, and loan disposition consistent with advanced credit risk management standards and commensurate with the risk and size of the program.	Agreed. It is good to note that the US regulators are not looking to adopt a "one-size fits all" approach, recognising that solutions need to appropriate for the bank under consideration.
RS-38	Banks must maintain data to allow for a thorough review of asset sale transactions.	Agreed.
RS-39	Retained data must be sufficient to support IRB validation requirements.	Agreed.
RS-40	Banks must ensure that outsourced activities performed by third-party vendors are supported by sufficient data to meet IRB requirements.	Whilst we agree that an IRB models need to be validated, we question whether this level of rigour is possible for third party inputs. External providers of data and origination may not be prepared to share their data and/or methodology.
RS-41	At each reporting period, aggregate exposures across all risk segments must be reconciled to ensure that all exposures are accounted for appropriately.	Agreed. As understanding by firms and regulators develop, we would expect to see further guidance on materiality.

RS	QUESTIONS	RESPONSE
DATA QUALITY AND INTEGRITY		
RS-42	Banks must develop and document the process for ensuring data integrity and for delivering, retaining, and updating inputs to the IRB data warehouse. Also, banks must develop comprehensive definitions for the data elements used for each credit group or business line (a "data dictionary").	The standard should focus on controlling the quality and integrity of data. How this is achieved (e.g. through 'the data warehouse, a series of data warehouses or other appropriate technical solution) should be left to the firm.
RS-43	Banks must maintain detailed documentation on changes over time to the risk segmentation system and the quantification process, including data elements, method, and supporting processes.	Agreed.
RS-44	Banks must store data in a format that allows timely retrieval for analysis and validation of risk segmentation methods and parameter quantification processes. Data systems must be scalable to accommodate the growing needs of the business lines, the centralized data functions, and risk analysis over time.	Agreed.
RS-45	If data gaps occur, banks must specify interim measures to quantify IRB risk parameters and must establish a plan to meet the data maintenance standards.	Agreed, subject to applying an appropriate materiality threshold.
CONTROL AND OVERSIGHT		
RS-46	IRB banks must implement an effective system of controls and oversight.	Agreed.
RS-47	Banks must have an independent risk management function that provides oversight of retail lending activities.	Agreed.

RS	QUESTIONS	RESPONSE
RS-48	Banks must have an effective loan review function for retail credit portfolios.	Agreed.
RS-49	A quality control function must confirm that all retail lending activities follow established policies.	We support the principle. However, firms need flexibility around which unit or units undertake this analysis. The quality control function could include staff from within an independent risk function, internal audit or some form of third party review. Given different organisation structures, it is not appropriate to be prescriptive here.
RS-50	Management information systems (MIS) must be sufficiently comprehensive to monitor and measure credit quality and performance and to allow proactive and effective risk management.	Again, we support this in principle. However, it is important that MIS is appropriate to the underlying risk culture of the firm and not imposed by some form of regulatory dictate. The list provides in para 230 contains data that might be applicable (and you correctly preface this with the comment 'generally') but we would not support this being used as some form of tick-list to support or maintain compliance of AIRB standards.
RS-51	Adequate controls and monitoring systems must be in place to effectively supervise all third parties involved in the lending process.	Agreed.
RS-52	Bank policies must identify individuals responsible for all aspects of the retail IRB credit risk system.	We would prefer this standard to focus on the management responsibility (i.e. the role) rather than the individual (i.e. the role holder) – this is far more practical and less bureaucratic for large firms likely to apply (or be mandated) for Advanced status.
RS-53	Banks must have a comprehensive, independent review process that is responsible for ensuring the integrity of the IRB risk segmentation system and quantification process.	Agree, in line with the Basel proposals under para 443.
RS-54	IRB banks must have a transparent retail IRB process.	Agreed, at appropriate. However, we believe that firms should be allowed to assume some level of knowledge on the part of external parties when applying these requirements.
RS-55	Retail IRB risk parameter estimates must be consistent with risk estimates used to guide day-to-day retail risk management activities.	Agreed, this central to the use-test requirements stipulated by the Basel Committee. The key is that risk management metrics are aligned and consistent.

RS	QUESTIONS	RESPONSE
RS-56	Internal and external audit must annually evaluate compliance with the retail IRB capital regulations and supervisory guidance.	Basel allows firms to audit models through internal audit or some other suitably qualified independent function. This is appropriate - it puts the focus on 'internal auditing' internally rather than being prescriptive around who undertakes the work. Restricting this work to 'Internal Audit' will result in firms having to duplicate scarce resources across risk and audit or force risk management into a more mechanistic tick-box approach. Neither outcome will help firms/regulators achieve the objectives of Basel 2. The extension of these requirements to external auditors is a significant additional burden, over and above that required by Basel or the AIG's proposed principles of Validation (principle 6 refers). We recognize that auditors need to agree RWA figures as part of their overall assessment, but it is unrealistic to believe that they should replicate the work already undertaken internally. Regulators have sufficient powers under Pillar 2 to ensure that firms are sufficiently capitalised without resorting to external validation as proposed.
RS-57	The full board or a designated committee of the board must review and approve key elements of the IRB system.	Agree in principle, but unlikely to work effectively as stated. All firms are structured differently – they may have divisional, State or firm specific boards and committees. Some firms may have different boards for different brands, but operate the common processes. It is likely that elements of the IRB system could be agreed at different forums. Rather than being prescriptive (which could result in the unintended consequence of forcing firms to alter their internal structures, which is beyond the scope of what Basel is trying to achieve) regulators and firms should agree on an appropriate governance structure for all firms.
RS-58	Senior management must ensure that all components of the IRB system, including controls, are functioning as intended and comply with the risk-based capital regulation and supervisory guidance.	Agreed.