30 November 2003

By E-mail and Overnight Courier

The Financial Services Authority
c/o Katy Martin
Prudential Standards Division
25 The North Colonnade
Canary Wharf
London E14 5HS

Subject: Comments on the Consultation Paper on the Implementation of the New Basel and EU Capital Adequacy Standards

Ladies and Gentlemen:

Enclosed please find MBNA Europe Bank Limited's response to the Financial Services Authority's ("FSA") report and first consultation on the implementation of the Basel and EU Capital Adequacy Standards ("CP 189"). The enclosure provides a response to each of the questions posited by the FSA, which we believe applicable to our business. Please note also that on 14 November, 2003, we submitted our initial response to the request for comment, which outlined our general concerns regarding both the New Basel Capital Accord in general, as presented under the Basel Committee on Banking Supervision's (the "Committee") third consultative paper ("CP 3") and CP 189 (enclosed).

Although both our 14 November submission and this response raise a number of concerns about CP 3 and the FSA's proposed implementation, we support in general the FSA's principles of implementation and believe it to be consistent with the original intent of Basel II. We believe that the development of any new accord must be based on the presumption that it is the individual institution that has the primary role of developing its own systems, controls, and methods for risk-assessment and not the establishment of a series of highly prescriptive and complex rules, enforced through the supervisory process, that will ensure an appropriate risk-based capital allocation. .

We appreciate the opportunity to provide these additional comments to the FSA. If you have any questions regarding this submission or if we can provide further information, please contact Vernon Wright directly by telephone at 001-302-453-2074 or by e-mail at vernon.wright@mbna.com.

Yours truly,

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Robin L. D. Russell
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Enclosures

C:
Stephen Funnell, The Financial Services Authority
The Basel Committee on Banking Supervision
The European Commission
Office of the Comptroller of the Currency (U.S.)
Board of Governors of the Federal Reserve System (U.S.)
Federal Deposit Insurance Corporation (U.S.)
Office of Thrift Supervision (U.S.)
Office of the Superintendent of Financial Institutions (Canada)
Irish Financial Services Regulatory Authority
Banco de España

MBNA Europe Bank Limited's
Comments to the Financial Service Authority's
Consultation Paper on
the Implementation of the New Basel and
EU Capital Adequacy Standards

30 November, 2003

Provided below is MBNA Europe Bank Limited's ("MBNA Europe") comments to the Financial Services Authority's ("FSA") report and first consultation on the implementation of the Basel and EU Capital Adequacy Standards ("CP 189").[1] This response addresses each of the questions or requests for comment we found applicable to MBNA or to our industry. Included with this response to the specific questions, are general comments that address additional issues, not raised as matters requesting comment by the FSA. We note also that on 14 November, we submitted our initial response to CP 189, which highlighted our general concerns about the new Basel Accord (the "New Accord" or "Basel II") as presented under the Basel Committee on Banking Supervision's (the "Committee") third consultative paper ("CP 3"). Please consider our 14 November, 2003 letter as a part of this submission.

Questions

The Standardised Approach to Credit Risk

1. **Do you agree with the choice of Option 2 for the risk-weighting of claims on financial institutions? If not, what arguments can be put forward in support of Option 1?**

   Option 1 simply bases the risk weight of the financial institution on that of the sovereign in the country in which it is incorporated. A more appropriate and risk-sensitive approach is under Option 2, which bases the risk weight of a financial institution on the external rating of the institution itself. It therefore is a more accurate reflection of actual risk.

2. **Do you have any comments on the framework for the requirements on residential mortgages that we have outlined in paragraphs 3.8 and 3.9?**

   We have no specific comments at this time.

3. **Is there interest from firms in the option to risk weight all corporate claims at 100%?**

   We believe that the external credit assessment institution rating for the individual corporate entity is more appropriate, rather than simply applying a flat 100% risk weighting. We would not, however, object to

[1] MBNA Europe Bank Limited is a wholly owned subsidiary of MBNA America Bank, N.A., itself the principal subsidiary of MBNA Corporation (collectively herein referred to as "MBNA").

allowing smaller firms choosing to apply a 100% risk weight for all corporate exposures if it would improve operational efficiency.

4. Do you agree that firms using the standardised approach should hold additional capital if their Pillar 1 credit risk capital requirement is less than under IRB? How might the practical challenges be overcome?

No, we do not agree with this approach. In fact we believe the CP 3 advanced internal ratings based ("A-IRB") capital charge for loans in the qualifying revolving retail exposures ("QRE") sub-category is too high and must be adjusted lower before considering any additional capital requirements. An analysis of MBNA's U.S. credit card portfolio, using asset valuation correlation ("AVC") factors that reflect industry averages, reveals the appropriate portfolio risk weight percentage to be less than the 75% risk weight specified under the CP 3 standardised approach for retail exposures.

The table below compares the total capital requirement per $100 of QREs under the 1988 Capital Accord (the "Current Accord"), the CP 3 standardised approach, the CP 3 A-IRB approach, and the recently announced unexpected losses-only ("UL-only") approach.[2]

Capital Requirements Per $100 of Exposures	Current Accord	CP 3 Standardised	CP 3 A-IRB	A-IRB UL-Only
Credit Risk	$8.00	$6.00	$9.47	$8.12
Operational Risk	N/A	$0.42	$0.42	$0.42
Total Capital	$8.00	$6.42	$9.89	$8.54

The results show that the capital requirement for loans in the QRE sub-category under the CP 3 A-IRB approach would be 24% and 54% greater than the Current Accord and the CP 3 standardised approach, respectively. Even with the proposed changes to UL-only, announced 11 October, and assuming full coverage by loan loss reserves, capital requirements are 33% greater than the CP 3 standardised approach. This result demonstrates clearly that before the FSA considers using the supervisory process under Pillar 2 to match the capital requirements of the standardised approach to the A-IRB approach, they must ensure that the advanced approach is in fact capturing the true economic risk for QREs. Rather than penalising banks that recognise that the standardised approach is more consistent with their own measure of risk, we believe that the FSA and the Committee should work to correct the deficiencies of the A-IRB approach for unsecured retail lending.

For firms that are adopting the standardised approach for all of their exposures, the FSA recognises that it would be unwise for them to estimate the risk characteristics in their portfolios – recognising the practical difficulties firms would face applying a framework they do not use to develop these estimates. In response the FSA suggests an approach that asks firms to consider the credit risk they are exposed to and the FSA would thereafter use this as a basis for making adjustments to the amount of capital they hold under Pillar 2. This approach appears to be entirely open-ended and result driven, without any objective standards to apply. As noted, we believe that the Committee must ensure that the underlying assumptions for the A-IRB approach to unsecured retail lending are correct and that the treatment for these exposures reflect fairly the risks that are at stake.

We note also that this approach would be difficult to implement. If a bank chooses to implement the standardised approach, there will not be an A-IRB benchmark to measure against. Although we agree in

[2] This analysis assumes that expected losses be fully covered by a reserve for loan losses, which is very unlikely in the case of unsecured retail revolving exposures. It also assumes that the alternative standardised approach was used for operational risk. Additionally, the A-IRB credit risk capital requirement assumes a probability of default ("PD") of 5% and a loss given default ("LGD") of 108%. The LGD percentage reflects the risk of additional balance growth prior to default. As a point of reference, average industry charge-off levels in the United States were 6.97% as of second quarter, 2003. Taken from Visa and MasterCard quarterly industry reports.

principle that Pillar 2 is the appropriate area for the FSA to address any risk which it believes has not been adequately addressed elsewhere, as written CP 189 vests far too much discretion with the individual examiner, without sufficient objective standards to apply. As noted, we believe that the Committee must ensure that the underlying assumptions for A-IRB approach to unsecured retail lending are correct and that the treatment for these exposures reflects fairly the risks that are at stake.

Operational Risk

5. Do you agree with our approach to the partial use of the AMA as described in paragraphs 4.9 to 4.15?

In general, we recognise that operational risk management is an emerging risk discipline and appreciate the progress that we see in the evolution towards a balanced, risk-sensitive framework. Our view is that the current state-of-the-art practices for operational risk measurement and modelling, however, have not progressed sufficiently to warrant a specific capital charge for operational risk at this time.

Should a capital charge ultimately be necessary, we believe that a transition period must be established where no capital is specifically devoted to operational risk, thus allowing sufficient time for the banking industry's operational risk measurement discipline to develop and a sound methodology to emerge.

Because most large banks in both the U.K. and the U.S., we believe, currently have strong capital positions under the Current Accord, we see little risk in adopting this interim step. In the meantime, we suggest that the large banks work with their supervisory authorities and other experts in the field to develop a methodology that accurately captures the operational risks that confront each institution.

In the alternative, should the FSA conclude that there should be a specific capital charge for operational risk on the effective date of the New Accord, we would recommend that banks be permitted to use the alternative standardised approach (as described in CP 3, footnote 91). When and if the discipline reaches the demonstrated level of precision we believe necessary, banks could thereafter migrate to the advanced measurement approach ("AMA") at their choosing.

We appreciate the flexibility offered in the AMA that will allow for the natural evolution of industry best practices. However, as is also the case for a number of the credit risk capital requirements, there are certain aspects to the AMA that may undermine the development of industry best practices. We believe that many of the elements of the AMA are arbitrary or are based on scant industry data that may not be reflective of industry reality or experience.

We provide some specific examples of areas where further revision is necessary:

Expected Loss Offset – The sum of the EL and the UL will overstate capital requirements. A bank's EL is already being captured in its pricing, reserving, and budgeting practices. As with credit risk, capital committed to operational risk must be limited to UL and not include those events that are generally considered part of the "cost of doing business" and planned and budgeted for on an annual basis.

Required Elements of Capital Calculation – There should be flexibility in the requirement that banks use internal data, external data, business environment and internal control factors, and scenario analysis in calculating capital levels. We would suggest these four components be recommended as data inputs and adjustment factors for calculation of operational risk capital, but not require that all four elements be used for all loss event types. The very nature of the defined loss event categories requires a different assessment and treatment of the risk that may include some or all of the four prescribed risk measurement elements.

In general we agree with the FSA's intention to provide flexibility while both the FSA and the institutions they regulate develop better and more predictive ways to measure operational risk. However, as banks begin to prepare for capturing and measuring operational risk, additional guidance from the FSA will be necessary. This guidance will be needed well in advance of any substantial investment banks must make when building their new operational risk management framework. Ensuring that the expectations and requirements are fully aligned will redound to the benefit of both the FSA and the institutions it supervises. We endorse the additional questions submitted by the British Bankers Association ("BBA") in response to CP 189 regarding the design of the AMA and incorporate them herein by reference.

6. **Do you agree that partial use between the BIA and TSA should not be permitted on an intra-entity basis?**

We have no specific comments at this time.

7. **Do you agree that there is a case for partial use between the BIA and TSA on an intra-group basis?**

We believe that institutions must be granted as much flexibility as possible in developing a method to capture and measure operational risk accurately.

8. **Do you agree to our proposed approach to the definition and threshold for recording and reporting operational losses?**

We agree with the proposed approach as described. Banks should be given flexibility in setting thresholds for data capture to a materiality standard applicable to the size and scope of their overall business.

Internal Ratings Based Approach to Credit Risk (IRB)

9. **Which issues should we cover in the next stage of the work and what priority should we give them?**

We believe that there are a number of areas that the FSA should examine for the next stage of their work. Specifically:

We believe that the FSA must continue to examine many of the shortcomings that remain in the current draft version of the New Accord. As we have noted previously, we are concerned that the overall approach to the New Accord, espoused by the Committee and endorsed by the FSA, will result in a highly prescriptive set of rules, which will be costly to implement, difficult to comply with and will not achieve the desired results of a risk-sensitive framework with appropriate capital requirements across all product types. As a consequence, we continue to suggest that the Committee and the FSA consider an approach that more closely follows the framework of the standardised approach of Basel II and apply a single framework to all institutions. As part of the FSA's work, we would respectfully suggest that it again examine the overall complexity of Basel II with the goal of developing a new capital accord that achieves the desired goals, while addressing the very real concerns over cost, regulatory burden, and complexity to the point of "perfect impenetrability that makes honest compliance difficult, if not impossible."[3]

Generally we support the FSA's proposals to exercise national discretion as laid out in CP 189, but we believe that the FSA must address the issue of national discretion with its counterparts in other countries. This is a matter of particular relevance for banks that are the subsidiaries of U.S. companies. International comity and home-host differences in the application and interpretation of the Accord will require a level of co-operation and co-ordination we do not witness currently with existing banking regulation and under the

[3] Testimony of John D. Hawke, Jr., Comptroller of the Currency before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology of the Committee on Financial Services of the U.S. House of Representatives, 27 Feb. 2003.

Current Accord. Much more effort and time will be needed to develop an efficient and appropriate means for resolving differences and ensuring international comity and parity.

Although stressed by many other commenters to both the Committee and the national supervisors, we believe it bears repeating - *the deleterious effect of cumulative conservatism cannot be underestimated.* As noted by the Risk Management Association,

> "An analysis of the cumulative conservatism of these prescriptions [which "might not be unreasonable in isolation"] leads to the conclusion that Basel has in mind an exceedingly stringent view of the degree of soundness to which the A-IRB bank should adhere. In effect, CP 3 is saying that there should be only a 1 in 1,000 chance that an A-IRB bank should fail, even during a recession, and even utilising conservative views of the loss probability distributions associated with the portfolio of the bank. Clearly, this has gone too far, and at least some of these conservative prescriptions should be reined in."[4]

We believe the FSA should revisit this overall approach adopted by the Committee and re-examine whether the prescriptive, highly conservative approaches adopted in CP 3 are consistent with the original, underlying premise of the New Accord.

We also remain concerned that the FSA may have significantly underestimated the resources needed to implement the New Accord. For example, it is uncertain whether the FSA will have enough people with the highly specialised skills needed to approve all the IRB waiver applications the authority is expecting, and to regulate the use of firms' IRB models via the scorecard data etc, given that each model will be different for each individual firm. At the 7th Annual Supervision Conference hosted by the BBA on 9th October, 2003 it was indicated that the German regulator anticipates needing 300 additional staff for the implementation of Basel. CP 189 indicates that the FSA will recruit only 20 additional staff.

10. Is our general approach – setting out our detailed interpretation of the requirements in the revised Accord/RBCD – helpful? Have we given enough – or too much – detail? Will self-assessment be possible in practice?

We thank the FSA for detailing their requirements in this manner and we are pleased to note that the FSA has chosen a "no compulsion, no prohibition approach" to A-IRB, such that firms may choose which approach they wish to follow.

We are also pleased to note that the FSA has adopted the transitional arrangements for A-IRB, which were contained in CP 3, such that the collection period for retail data is reduced to two years during the transitional years. This would seem to be a sensible approach given the issues that many firms will have in regards to the A-IRB approach concerning data, its collection, testing and validation, and appropriateness etc.

The use of self-assessment also seems to be sensible and consistent with the approach the FSA has taken in the past. Our concern is whether the FSA will have sufficient resource and the relevant expertise to review and approve these scorecards.

11. Do you agree that firms using the standardised approach for some of their portfolios should hold additional capital if their Pillar I credit risk capital requirement is less than under IRB?

Please see our response given to Question No. 4, above.

4 Letter from the Risk Management Association to the Basel Committee on Banking Supervision, ¶¶ 5, 10 (31 July, 2003).

12. **Have we covered the appropriate subjects? Do you have any general comments on our approach or on issues relating to more than one of the subjects covered in annex 3? Have we developed a consistent and balanced approach to requirements on how firms take into account the effects of potential economic downturn?**

Our concerns in this area will be covered by the more specific comments given to the questions presented in Annex 3.

Governance Issues – Overall Framework

13. **Is our approach to governance issues clear? How do you envisage boards and senior management in practice meeting their responsibilities in respect of the use by firms of advanced approaches that meet our minimum requirements?**

We agree with the approach to build on guidance already issued in existing regulation. Our approach to corporate governance and to the independence of the risk management function is consistent with what is outlined in paragraphs 403 and 626 of CP 3. We believe that senior management has the ultimate responsibility for ensuring that appropriate risk management is in place and has the necessary independence. We further believe that the board of director's role is primarily to provide effective oversight of management. It is the role of the board to ensure that management is in compliance with policy and that management takes the appropriate steps to monitor and control credit and operational risk. In addition, the board should receive regular reports to monitor credit and operational risk, including major events and activities. We also believe that it is the exclusive responsibility of management to oversee the development of the overall risk framework and to present that framework to the board for its review and approval. Management should be responsible for allocating resources and for ensuring that the company meets its operational risk objectives.

The Application Process

14. **Do you have any feedback on any of the issues raised in this chapter?**

We note the requirement to apply for a waiver in order to adopt the advanced approaches. We agree with the preferred approach of a 'lead regulator' model. Since MBNA's 'lead regulator' is the OCC, we would expect the FSA to accept our application to the OCC for the advanced approaches and to work with the OCC in granting our waiver.

We are concerned about the possibility of publishing the full details of waivers granted. The specific requirements for a waiver, once defined, may include information not currently or in the future required to be disclosed. Such information could constitute a competitive advantage to other firms, particularly those not required to make equivalent disclosures. We agree with disclosure of firms granted a waiver inclusive of basic information. Further disclosure should be left to Pillar 3 of the Accord.

Cost Benefit Issues

15. **What are the main drivers of cost in implementing the revised Accord/RBCD? What are the main drivers of the expected IT changes? Is it an increase in capacity or is it a different system that you require? What is the role of the operational risk requirements in such a change? Are there any decisions that we can make on the substance or the timing of our implementation that would lead to lower costs across all or part of the industry?**

It is somewhat difficult at this time to comment specifically on the costs of implementing and operating under the New Accord given that those requirements are now only being proposed. These proposals will directly drive the costs associated with the New Accord. Nevertheless, it is clear that the costs will be significant, certainly in the multiple tens of millions of dollars for MBNA. These costs are not limited to the initial implementation as we expect the ongoing costs to also be quite significant. At this point it is not clear whether there will be any real tangible benefit to MBNA as a result of these efforts in the way of improved risk management, loss experience or other efficiencies. In fact, it appears that the current advanced approaches, with their cumulative conservatism, will demand an unwarranted increase in regulatory capital for unsecured retail portfolios. If risk management benefits are not achieved, these additional costs will ultimately lead to increased cost to the consumer, or worse, deny certain segments of consumers the ability to obtain credit from a regulated financial institution.

We believe the major implementation cost driver will result from the new operational loss requirements. From a credit risk perspective, our models are already well developed and appear to closely meet proposed requirements. Although operational risks in a retail environment are, low compared to credit risk, under the New Accord they will require the most significant investment. Major operations and systems costs will be driven by the need for new applications (e.g. systems to document processes, controls and risks; provide management reporting; and calculate operational loss exposure) and models versus data storage as the data generally already exists and storage is relatively inexpensive. Significant cost savings could be realised by eliminating, reducing or delaying requirements related to operational risk, or implementing an approach that is more flexible and based on the institution's lines of business.

Another potential cost issue will arise should MBNA be required to adopt different approaches in different countries or be subject to differing implementation requirements or dates. Flexibility is desired to allow global systems to be implemented in a timeframe that enables us to maximise efficiency in implementation.

16. What effects do you think the revised Accord/RBCD may have on competition in the UK and international financial services markets? Have you identified potential impacts on the wider economy?

An area of concern for MBNA Europe is that under the provisions of the U.S. advanced notice of proposed rulemaking, certain U.S. firms will be required to use the A-IRB approach and the AMA. If this includes U.K. subsidiaries of U.S. firms then there will be a resultant competitive distortion with other U.K. regulated banks. The A-IRB approach for credit risk produces a capital requirement for QREs with a 5% probability of default and 108% loss given default ("LGD") (includes risk of undrawn credit lines) that is 33% higher than the standardised approach (Please see our response given to Question No. 4, above). These types of distortions must be corrected before the New Accord is finalised.

There is a also a risk that banks may be forced to adopt an approach which is inappropriate for them given the cost or the level of expertise required, thus penalising them with a disproportionately higher capital charge due solely to the approach used rather than underlying risk. These banks may also suffer additional costs in implementing advanced approaches that they would not have normally chosen to adopt. Given this disparity, U.K. resident firms will have a competitive advantage based solely on a variation in the method by which the Basel requirements are applied.

We also have concerns about the procyclicality effects of the New Accord. Moreover, we are concerned that if the distortions are not corrected for unsecured retail lending, the cost of borrowing for consumers will increase and segments of the consumer population will no longer be served by regulated institutions. Any adverse effect on the consumer segment of the economy will affect the larger economy as a whole. We believe that these concerns have not been given the level of consideration they require and that economists and central bankers, as well as national supervisors, should consider fully the impact the New Accord may have on consumers and on the economy as a whole

We agree that there are some aspects of the New Accord that will be beneficial to our industry, including greater standardisation in definitions of default, and increased transparency and comparability. Nevertheless, those benefits are not outweighed by our overall concerns about cost, regulatory burden, and complexity.

17. What benefits do you see in practice in the implementation of the revised Accord/RBCD? Do you expect firms to see these proposals as a catalyst for improved risk management? Do you expect firms to switch their decision systems to the new calibrations or to run a parallel system – one for regulatory purposes and the other for their internal business purposes? By what order of magnitude will the alignment of regulatory and business requirements reduce compliance costs for firms? If you are a firm considering adoption of an advanced approach, how are you assessing the benefits, e.g. when preparing project plans? How do you assess the NPV of your project

Account level PD, LGD, and EAD are essentially corporate lending concepts; they are not specific measures that we use to manage unsecured retail lending businesses, although we employ similar concepts. We manage account acquisition plans through modelling economic net present values by sector & channel (including forecasting charge offs), underwrite individual accounts judgementally, deal with period earnings through detailed forecasting of charge-offs at the portfolio level, and handle day-to-day account management (credit lines, risk based repricing) through application, credit bureau information and behaviour scoring. We focus on unsecured retail lending so capital allocation between business lines is not as important an issue compared to large diversified commercial banks. We thus do not expect to reap any material benefits from A-IRB, nor do we see these proposals as a catalyst to improved risk management, but rather expect to see a parallel system in operation. Although PD, LGD, and EAD are not specific measures in use at MBNA, we believe that a rating system grounded in our existing methods will pass the use test, should we be required to implement A-IRB.

With appropriate modifications, the New Accord has the potential to produce regulatory capital calculations that are more risk sensitive. However, risk management practices will continue to evolve at a faster pace than prescriptive regulatory rules. Unless the regulatory agencies implement an accord that is based on internal risk management practices, there will always be a need for parallel systems. Please see also our response given to Question No. 9, above.

Annex 3 IRB Detailed Proposals

Qualifying Criteria

18. Is our proposed approach to phased roll-out described, including the use of Pillar 2 sufficiently clear? Do you support this approach?

The approach is clearly described and would appear to be reasonable and consistent with Basel II. In the case of MBNA Europe, as a subsidiary of an U.S. bank we would be subject to the partial use criteria implemented by the "equivalent" supervisor in the U.S. Indeed the whole model validation exercise would be conducted in the U.S. and therefore much of the following would not be directly relevant to MBNA Europe.

19. Do you support the proposed permanent exemption treatment for sovereign, bank and investment firm exposures?

We would support a permanent exemption of sovereign, bank, and investment firm exposures. For exposures that are not material and not part of a bank's core business, we would support mapping the A-IRB risk inputs to the ratings generated by external credit rating agencies. This would simplify the evaluation of the exposures that are not part of a bank's principal business. A separate threshold would need to be established to determine what assets would qualify for this exception.

CAD 3 stipulates that this exemption would only be made available to 'smaller' institutions. The FSA makes no reference to a size criterion in CP 189. We would appreciate clarification as to the significance or otherwise of the omission.

20. Are the 15% materiality and other permanent exemptions sufficiently clear? Do you support adopting the EU treatment for Specialised Lending?

We oppose any arbitrary threshold percentage to determine materiality. The supervisor should be granted the authority to make a determination of materiality based upon first-hand knowledge of the institution. Institutions should be evaluated on a case-by-case basis by the supervisor in determining whether to exempt a portfolio, business line, or geographic region from the A-IRB approach.

We would also ask for clarification on situations where the home supervisor has a different interpretation of materiality to the host supervisor. What would happen in these situations?

21. Is the approach to roll-out described, including the roll-out period, sufficiently clear? Who should publish roll-out plans?

The approach to roll-out and the roll-out period are both clearly described; we support the proposed approach. However, please note that with respect to Annex 3.28, we remain opposed to any automatic adjustment for differences in capital requirements between standardised and A-IRB approaches as far as QRE's are concerned, unless and until the anomalies noted in the current A-IRB approach to QRE's are corrected. Please see our response given to Question No. 4, above.

We do not believe that publication of roll-out plans will serve any significant prudential purpose. We believe that it is a decision for individual firms whether to publish their roll-out plans, based on each firm's assessment of the benefit this might confer. In any event, we suggest that further debate on this point be considered as part of the consultation on Pillar 2.

22. Do you agree with the proposed approach, including the distinction between 'core' and 'broader' activities? Have we distinguished appropriately between 'activities? Do you have any suggestions as to the type of documentary evidence that firms may be able to provide in support of the proposed scorecard?

We agree with the proposed approach, including the distinction between 'core' and 'broader' activities. To conform with the spirit of the use test, it should be permissible for firms to submit the relevant sections of their procedure manuals in support of the draft use test scorecard without having to rewrite these simply for validation purposes. In this regard we again question the validity of the FSA's assessment of its additional resource requirements to implement the New Accord. Please see also to our response given to Question Nos. 9 and 14, above.

23. Do you think our approach is sufficiently clear and detailed at this stage? Could we be more specific about our approach?

Given where we are in the process, we believe that the process is sufficiently clear and detailed. We do not believe it would be beneficial to be any more specific at this point in the process.

With respect to, "**Provisioning**" in Annex 3.51, we note that our provisioning policy is based on incurred losses as defined by generally accepted accounting principles in the U.S. ("U.S. GAAP") and by account management practices as mandated by the U.S. regulatory agencies, rather than by EL in the New Accord. Clearly the same risk characteristics would inform both sets of numbers.

24. Do you agree with our proposed adoption of national discretions for all exposures other than Corporate, Bank and Sovereign portfolios on Advanced IRB? What evidence do you feel firms will be able to provide supports an application for IRB approval for portfolios where they are not using the rating system at the time of application?

We have no specific comments at this time.

25. Are the parallel running requirements sufficiently clear to enable firms to set their implementation timetable?

The parallel running requirements are clearly described and we support the proposal of parallel running for one year prior to implementation as a useful calibration exercise.

We are unclear on the meaning of the FSA's reference to an "enhanced QIS exercise", found at paragraph 3.57. We would suggest that the implementation of a QIS 4 prior to adoption of a final accord would be more appropriate in that the results of such a study could be considered in the final drafting of the New Accord.

We would also question the requirement to include exposures not due for roll-out for an additional three years (i.e. 2009) on the grounds that the data used in 2006 may not be sufficiently accurate/developed at that stage to be of any real value in the calibration exercise.

26. Do you support a mix of mandatory, regulator set targets and optional, firm set targets that can be shaped to reflect a firm's operations?

We agree with the general approach as described in the Annex. The true test of this approach, however, will be seen when more detailed specifics are published such that we can assess how these measures will apply to MBNA Europe. Our specific areas of concern include:

i. Any requirement for "sign offs" and the underlying approval process should be consistent with and no different from what is required by the home regulator. More onerous or distinctly different protocols would bring little value and add needless regulatory burden.

ii. Paragraph 3.75 implies an annual process. Under the Current Accord, the FSA requires that the risk asset ratio ("RAR") be calculated and returned quarterly, but that we can monitor our RAR on a daily basis, through proxies rather than running the full, detailed calculation. Will the approach under the New Accord likely be similar?

27. Do you feel there are key areas missing from the draft scorecard, or are there target areas that you feel should not be included?

The proposed scorecard appears reasonable at this stage. We agree with the approach of reaching a mutual conclusion as to what the contents should be based on each institution's situation. The proposed components are similar to those proposed by national supervisors in the other countries in which we operate. We would appreciate the ability to agree a solution that can be consistently deployed across all of our international operations to the satisfaction of all the regulators rather than be required to adopt unique solutions in each country.

Validation

28. Do you have any comments on the proposed validation standards; and on the draft self-assessment scorecard appended to this annex?

We agree that firms should take primary responsibility for validating their ratings systems and have no specific comments on the proposed validation standards at this time.

The draft format of the scorecard appears reasonable. We have no specific comments at this time.

29. Do you agree that a differential approach to credit risk model validation is appropriate?

We agree that a differentiated approach is best, allowing firms to justify their use of data in their own way, for each category of exposure. CP 189 correctly points out the "rich data availability" of retail portfolios and the relatively lower loss rate volatility associated with credit card portfolios. We support the conclusion that unsecured retail exposures behave very differently than corporate exposures and allowances should be made for those differences. We also ask that the FSA not hold validation of retail exposures to a higher standard than corporate exposures simply due to abundant data availability.

30. Can you propose specific quantitative tests for assessing the accuracy of PD estimates for any, or all, portfolio types?

We agree that any credit risk model needs appropriate validation. However, we believe it is too early to propose specific quantitative tests to validate the accuracy of PD estimates for unsecured revolving exposures. Unlike corporate portfolios, retail portfolios are comprised of millions of small exposures with higher, but more predictive expected losses. Because of the high degree of granularity and stable loss trends in unsecured retail portfolios, we expect a variety of statistical techniques will effectively validate the accuracy of PD estimates.

31. Can you propose specific quantitative test for assessing the discriminative power of rating systems for any, or all, portfolio types?

Please see our response given to Question No. 30, above.

32. Do you agree that the areas outlined in Annex 3.127 should constitute the key aspects of any future standard?

The proposed five stage approach, focusing on sensitivity, review, internal guidance, documentation, and novel approaches appears reasonable at this time and consistent with earlier comments from the Basel Committee.

33. Is our proposal detailed in Annex 3.135 to 3.140 and how it would work sufficiently clear? Do you support it?

As with internal models, we support a process for validating external models. At this stage, we believe the proposal as outlined is reasonably clear. However, we ask the FSA to consider clarifying the difference between an external model and external data. For example, although unclear from the Annex, a generic credit score related to a retail exposure used as one variable that contributes to a portfolio segmentation analysis, we believe should be considered external data, and not an external model. We remain uncertain as to the position of the FSA on this question. At this stage, we believe the proposal as outlined is reasonably clear.

34. Do you agree with our proposals on external data (Annex 3.141 and 3.142)? What do you think are the key items of data? Are there some pieces of data that should be mandatory?

We support the FSA's recommendation of further research. Generally, we oppose prescriptive approaches that would require firms to use specific data. Firms should have the flexibility to choose to use data that is relevant to their risk model processes as long as the model results are properly validated.

However, we would like to take the opportunity of commenting on CP 189 to reiterate our concern that full, reciprocal data sharing amongst lenders is not yet a reality in the U.K., unlike for example the U.S. A number of U.K. banks only contribute part of their retail portfolio data to the credit reference agencies, whilst generally enjoying full access to CRA data themselves. MBNA employs a judgmental approach to underwriting applications for credit cards or consumer loans, which obviates these limitations, but we feel that full data sharing is a sound objective for both the FSA and firms to pursue. For retail portfolios, whether on standardised, foundation or A-IRB, we believe that all credit reference agency data is very important both for the underwriting process and for on-going account management. We believe this issue should be resolved before any data is made mandatory.

35. Do you agree with this assessment of the role of the firm (Annex 3.143)? Would you like to propose what measures might be appropriate to demonstrate understanding?

We have no specific comments at this time.

36. Do you believe what is described in Annex 3.144 to 3.149 to be an appropriate process for firms to adopt?

We have no specific comments at this time.

37. Do you agree with the provisions described in Annex 3.150 to 3.152? Are there mitigating circumstances that should be considered?

We have no specific comments at this time.

38. Would you find it helpful if we published information on the range and type of external data available and used by 'good practice' firms? Do you have any suggestions as to what data should be included?

Generally, we believe it would be helpful to publish information on the range and type of external data available and used within the industry. We do not, at present, have any specific suggestions as to what data should be included.

39. Are there any areas that have not been addressed in the draft vendor information pack that it would be useful to include?

We have no specific comments at this time.

40. Do you agree with our proposed approach outlined in Annex 3.162-3.166? Are there circumstances whereby an alternative approach might be justified?

The proposed approach is generally consistent with our approach to segmentation. We segment our portfolio based upon a number of internal risk models and systems that equate to probability of default bands. Our portfolio segmentation process is continuously refined and improved as we develop additional ways of improving our understanding of how customer behaviour impacts risk. We expect that this process will continue and become even more sophisticated as we approach and begin implementation under the New Accord. We caution the FSA against too much reliance on generic scoring systems as the sole or primary determinants of risk. Through our experience, we know that the reliance on a single risk score alone will not ensure effective credit risk management. A risk score is only one of the pieces of information we use in segmenting risk within a portfolio. We combine a risk score with other tools and information to predict more accurately the risk associated with an individual account. Through this approach, we are able to more accurately segment our portfolio and implement more refined risk management strategies.

We are concerned at the open-ended nature of the requirement under 'Key Points' in Annex 3.157 that firms have to justify *not* using items of internal or external data. Unless confined to a small number of key variables, this could become a very 'dilettante' approach.

41. Do you feel that our 'scorecard' approach adequately addresses the issues?

The scorecard detailed appears to adequately address all the necessary factors in order to assess the segmentation of the portfolio.

42. Do you have any suggestions for how we might allocate 'scores' to the individual parts of the above template in order to facilitate self-assessment?

We have no specific comments at this time.

Technical Clarification

43. Are there mitigating circumstances where default information in one product area should not be considered relevant or available information? If so, what are these? If this includes cost/benefit considerations we would like to see supporting evidence to better understand that position.

Paragraph 3.188 states that where the firm treats obligations separately for risk management purposes, we propose to allow the definition of default to apply at the obligation level. We would support this interpretation.

44. Have we made the relationship between indication of unlikeliness to pay and the existence of risk mitigants clear?

We have no specific comments at this time.

45. Do you have any evidence that suggests a lower number of days (than 180) might be a better measure?

MBNA Europe strongly supports the use of a 180 day definition for default. This fits with our current processes and complies with the U.S. regulatory definitions for QREs. Indeed, the use of a different definition would cause significant calibration issues for the data we intend to use in our model.

For some of our other consumer loan products, which are classified as an "other retail" exposure, we define default at 120 days. Under current practice as dictated by the U.S. regulatory agencies, bankrupt credit card customers' balances are charged off by the calendar month end in which 60 days has elapsed since receipt of notification of the bankruptcy filing, which leads to earlier recognition of default. Balances on deceased credit card customers' accounts are charged off in the month in which the loss is determined, usually the month in which we discover that there is no estate or that the estate has insufficient funds to cover the debt. However, in all the above cases recognition prior to 90 days is unlikely. We propose to use these definitions in our model under the New Accord. The use of a different definition would be inconsistent with the way in which we manage the business.

46. What alternative approaches not identified in Annex 3.198 to 3.203 should be considered?

We believe that the FSA has captured the two main alternatives. In the case of MBNA Europe, for revolving retail loans, we use a definition of default of 180 days past due, with past due being defined as the number of days the payment is beyond the point at which the customers "grace period" expired. (Thus in the paragraph 3.201 example, this account would be considered 60 days delinquent.) This definition is imposed by our parent company regulator and is the basis for all of our credit risk management. To apply a different definition would cause significant calibration issues for the data we intend to use in our model and would be inconsistent with business operations.

We note also that there is no risk of understatement of charge offs or overstatement of delinquent balances at month end by the "missing month", as our processes ensure that any account reaching 180 days past due, as measured from the cycle date immediately following the due date, is charged off before the end of that month.

47. Are there mitigating circumstances that firms would like to propose that could be applied without adding undue complexity?

We have no specific comments at this time.

48. Do you support the approach outlined in Annex 3.210 to 3.212? If not, what would be an alternative approach?

We have no specific comments at this time.

49. Do you agree that an earlier number of days and/or additional/stricter indicators of unlikely to pay may be used as a measure of default where this can be justified, despite the consistency implications?

Please see our response given to Question No. 45, above.

50. Can you suggest ways in which non-conventional products could be included in QRE, other than by explicit approval, in a way that guards against regulatory arbitrage?

In light of the Committee's 11 October announcement that the A-IRB capital requirement would be based on the UL-only portion of the A-IRB calculations, there will be little opportunity for institutions to engage in regulatory capital arbitrage for QREs.[5]

51. Are the approaches to setting exposure boundaries appropriate? Are there other issues we should address?

We have no specific comments at this time.

52. Do you support our proposed approach on the allowable assessment horizons of rating systems?

Generally we support the proposed approach but we would welcome further discussion with the FSA on how it might apply in practice to the credit card sector. Credit cards are unique in that there is no contractual maturity to provide a floor to the assessment horizon. Measuring migration over a minimum 3-year period, as suggested at Annex 3.237, would have the advantage of allowing measurement to start from January 2004 for those firms wishing to move to A-IRB on 1 January 2007. This is also consistent with the FSA's comments at Annex 3.101 regarding the relative ease of estimation of losses on credit card portfolios "even with only a few years' worth of data".

We operate a Point-in-Time system and currently have no plans to migrate to a Through-the-Cycle system. We have no reason to believe that a PiT system is more vulnerable to fluctuations in the economic cycle than a TtC system would be, given the low observed volatility in our credit losses.

53. Do you support our proposal set out in Annex 3.248 to 3.250? If not, can you suggest other ways in which some or all of the procyclicality impact might be addressed in Pillar 1, rather than Pillar 2, of the revised Accord/RBCD?

We recognise the need to incorporate a level of conservatism to ensure that the risk being undertaken is appropriately captured. However, we are very concerned that the cumulative effect of these decisions already results in Pillar 1 capital requirements far in excess of minimum regulatory levels and thus do not support the proposals. Examples are the need to use risk parameters that reflect the worst part of the business cycle (i.e. hold additional capital) in order to protect against procyclicality, capital charge on credit lines that are uncommitted and cancellable, asset correlation assumptions that are higher than industry averages, not enough recognition of the value of future margin income for unsecured retail lending etc.

From a sector point-of-view we do not support your proposal for the following reasons:

i. The need to hold additional capital today to offset future pro-cyclical effects is questionable given (a) the equilibrium model inherent in the business (as the economic environment deteriorates, pushing up default levels, monetary authorities loosen monetary policy, reducing interest rates) and (b) the ability to price and repeatedly reprice the QRE portfolio.

ii. The FSA itself accepts that credit card portfolios exhibit lower loss volatility than other portfolios (Annex 3.101).

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[5] Although this new treatment reflects the industry practice of measuring economic capital, it nevertheless fails to recognise the industry norm that unsecured retail products are priced to cover EL. MBNA will be responding to this new proposal by the deadline of December 31, 2003.

54. Do you support adoption of the national discretion on data requirements (Annex 3.254 to 3.255), which also covers LGD, EAD and EL for Retail exposures?

We support the adoption of this national discretion in relation to the data collection period for retail exposures. The use of two years data allows firms, initially, to more easily adopt the A-IRB approach from January 2007.

55. Is it sufficiently clear why the approach described in Annex 3.266 to 3.269 has been chosen? Do you have any suggestions for when/how 'outlier years' can be identified?

If MBNA's experience is anything to go by, volatility of post charge off recoveries is not likely to be a significant issue for managers of large retail portfolios who systematically sell charged off debt immediately post charge off under long term forward flow arrangements. By their commercial nature these arrangements tend to produce stable recovery rates over the cycle.

We support the FSA's view that firms may use an alternative measure where it can be demonstrated that this more accurately reflects underlying recovery expectations. For example, MBNA's U.K. card portfolio shows a consistent recovery rate with a standard deviation less than 2.5% and volatility of net charge off for U.K. card portfolio is well below 0.35% for the past three years. Also, the pre-tax net interest margin after net credit losses is more than seven standard deviations from our monthly net credit losses. If a bank's retail portfolio can demonstrate a consistent recovery rate and the margin is sufficient to cover EL, the bank should be allowed to use a specific LGD based on the bank's own estimates.

56. Is our proposed approach to zero LGD's sufficiently clear? Do you have any insights into how a minimum floor may be set?

We have no specific comments at this time.

57. Do you agree with this approach to the selection of appropriate discount factors? If not, how would an alternative discount rate be arrived at?

We feel that a zero discount factor is appropriate to our business, and will discount accordingly. We have no issues with the approach as currently proposed.

58. Is this approach to the considerations for defaulted assets sufficiently clear? Are there circumstances where defaulted assets could be considered 'risk free'?

In the case of MBNA Europe we charge off the full balance of the defaulted loan. To the extent that post charge off recovery rates are very stable and do not move with the economic cycle (please see our response given to Question No. 55, above) and represent a net reduction in charged off amounts, we believe that it is realistic to assume that the unprovisioned amount *is* risk free in these circumstances.

59. Do you agree that development of EAD models, and associated stress tests, should be a matter for firms in the first instance?

We agree that the development of EAD models is a matter for each individual bank to develop in a way which best approximates the reality of its business. The FSA should not be prescriptive on exactly what is most appropriate, in the first instance.

60. Do you feel that guidance on the interpretation and application of the stress tests, where used as an input into the Pillar 2 capital assessment, would be helpful? Do you have any recommendations on where it is most important to have guidelines, and what these could include?

The guidance on the interpretation and application of the stress tests would be useful to ensure a common understanding and a level playing field. This should also help ensure that there is no duplication with procyclical adjustments under Pillar 1.

We would wish to have the scope to apply dynamic methods to satisfy the requirements of CP 3 paragraph 397, as the ability to reprice and to reduce limits on our QRE portfolio are both very attractive features.

Again, we would draw the FSA's attention to the cumulative conservatism built into the New Accord, and specifically as it relates to QREs. Please see our response given to Question No. 53, above. We would ask the FSA to take a holistic view when developing stress tests.

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14 November 2003

By E-mail and Overnight Courier

The Financial Services Authority
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Prudential Standards Division
25 The North Colonnade
Canary Wharf
London E14 5HS

Subject: Comments on the Consultation Paper on the Implementation of the New Basel and EU Capital Adequacy Standards

Ladies and Gentlemen:

This letter is MBNA Europe Bank Limited's initial response to the Financial Services Authority's ("FSA") report and first consultation on the implementation of the Basel and EU Capital Adequacy Standards ("CP 189"). In accordance with an e-mail dated 5 November 2003 from Stephen Funnell, our line supervisor at the FSA, we will be submitting a more detailed comment, including our response to the 60 questions raised in CP 189, where appropriate, by 30 November 2003. We appreciate the opportunity to provide comment on the New Basel Capital Accord (the "New Accord" or "Basel II") in general, as presented under the Basel Committee on Banking Supervision's (the "Committee") third consultative paper ("CP 3") and CP 189.

MBNA Europe Bank Limited is a wholly owned subsidiary of MBNA America Bank, N.A., itself the principal subsidiary of MBNA Corporation (collectively herein referred to as "MBNA"). MBNA's primary business is retail lending, providing credit cards and other retail lending products to individual consumers. At 30 September, MBNA reported assets net of securitisations totaling $58.7 billion and managed assets, including securitised loans of $141.1 billion.

MBNA has been an active participant throughout the development process of the New Accord. We have participated in Quantitative Impact Study 3 ("QIS 3") and the operational risk loss data collection exercise in order to help the Committee measure the regulatory capital impact of Basel II. Throughout this process, we have consistently expressed serious reservations with many aspects of the New Accord, including its overall complexity, capital distortions created by the advanced internal ratings-based ("A-IRB") approach for unsecured retail credit exposures, creation of a capital charge for operational risk, securitisation treatment, and disclosure requirements. Other than the creation of the qualifying revolving retail exposure ("QRE") formula, which recognises the importance of future margin income, very little has changed in areas important to active credit card issuers and even the QRE formula does not achieve an appropriate capital/risk balance. Although CP 189 is focused very much on implementing CP 3 "as is" (or "as was" in the light of the Madrid compromise of October 2003, see below), we hope that our concerns will be considered fully and that an approach will develop that addresses cost, complexity, regulatory burden, and competitive impact.

We note that since the releases of CP 3 and CP 189, the Committee announced four principal areas where significant changes to the Basel II framework are expected.[1] In its press release and the accompanying attachment, the Committee provided only a general description of how it now intends to have the New Accord treat expected and unexpected losses. It also invited interested parties to provide comment on these changes by December 31, 2003. Other than a general statement, no other information was provided. We believe that it would be helpful for the overall development effort of the New Accord for the Committee to provide additional information that more fully specifies these changes and their proposed application, as this could have a significant impact on the FSA's approach to implementing the New Accord.

Without that it will be difficult for the regulatory agencies to both collect meaningful commentary on the proposed changes and to ensure that no institution or business line is unreasonably impacted. Although we support in general the changes announced by the Committee, without additional information as to how these changes will be applied and calibrated, we are limited in our ability to evaluate fully the new proposals and provide the kind of meaningful commentary we believe these changes deserve.[2] Without knowing more, we believe that the scope of the proposed changes also suggests the need for an additional QIS prior to adoption of the final rules.

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[1] The four areas are: "[1] changing the overall treatment of expected versus unexpected credit losses; [2] simplifying the treatment of asset securitisation, including eliminating the 'Supervisory Formula' and replacing it by a less complex approach; [3] revisiting the treatment of credit card commitments and related issues; and [4] revisiting the treatment of certain credit risk mitigation techniques." The Committee did not offer information concerning items 2-4, where additional changes are expected. We anticipate that further guidance will be provided for these three areas.

[2] We would welcome the opportunity to provide additional comment to the Committee and the national supervisors once they have had the opportunity to consider the proposed changes and provide appropriate regulatory guidance on how to apply these changes. We believe that this would be most appropriately accomplished through an additional round of consultation.

We support the primary goal of increasing risk sensitivity and of creating a process for better differentiating risk and assigning appropriate capital to those exposures. We remain concerned, however, that the internal ratings based approach contained in CP 3 will result in a highly prescriptive set of rules which will be costly to implement and comply with and may not achieve the desired results of a risk-sensitive framework with appropriate capital requirements across product types.

This letter addresses our general concerns with both CP 3 and the FSA's CP 189. Enclosed herein at *Appendix A* is MBNA America Bank, N.A.'s response to and comments on the advanced notice of proposed rulemaking on the implementation of the New Accord issued by the U.S. regulatory agencies. This attachment contains the specific comments and detailed analysis supporting our general CP 3 comments below.

CP 3

We have continuing concerns with CP 3 centered in four general areas: (1) the treatment of unsecured retail credit, (2) the conservative assumptions and treatment of uncommitted credit lines affecting originators in asset securitisations, (3) inclusion of a specific capital charge for operational risk, and (4) the cumulative conservatism of the assumptions contained in the overall approach.

Treatment of Retail Credit

The A-IRB approaches will significantly impact institutions with material unsecured retail exposures. The conservative capital treatment for unsecured retail exposures should not be used by the Committee to offset lower regulatory capital requirements for other asset types without understanding their relevant risks and business models. The seemingly arbitrary approach to unsecured retail lending may cause significant competitive harm. Before the New Accord is finalised, it is critical to undertake an additional QIS to ensure that the risks for unsecured retail lending are captured accurately and an appropriate capital treatment is applied that correctly measures the underlying risks of unsecured retail lending.

The Committee in presenting CP 3 has evidently ignored the substantial differences between revolving retail credit portfolios and corporate credit portfolios. Applying a corporate credit model (which is based on single credit exposures) to retail credit portfolios (which are managed as pools of individual exposures) has not been sufficiently tested or validated. Any credit model that is ultimately adopted for retail lending must be sound and more than simply a modified version of the corporate credit model. The unique attributes of the retail framework (definition of default, portfolio segmentation, predictable expected losses, loans priced to cover expected losses, uncommitted/undrawn lines, asset value correlation, etc.) carry a level of complexity that merits further review and study.

Under the IRB approach, capital requirements for unsecured retail loans are higher than both the 1988 Capital Accord (the "Current Accord"), and the standardised approach of Basel II. We believe that this result contradicts the New Accord's stated objective that the IRB approaches would result in more effective risk measurement and, therefore, lower capital requirements than the standardised approach. Our internal analysis has determined that, from a portfolio point of view, the economic risk of the A-IRB approach should be less than the CP 3 standardised approach for unsecured retail lending. As such, substantial recalibration of the A-IRB will be necessary to correct these major differences.

Banks should hold capital for unexpected losses only. Although the Committee has now announced its intention to separate the treatment of unexpected losses and expected losses, how this change will be applied requires additional clarification by the Committee and the national supervisors. We are concerned with the Committee's conclusion that expected one-year losses must be measured against the loan loss reserve and that any shortfall would be taken as a deduction of 50% from Tier 1 capital and 50% from Tier 2 capital. This approach appears to ignore completely the effect of future margin income ("FMI") as an offset to expected losses. The Committee needs to recognise the value of FMI in covering expected losses, or any shortfall between expected losses and loan loss reserves, before any deduction to capital is applied. The lack of differentiation in the treatment of FMI between retail and corporate loans is particularly onerous to unsecured retail lending, which is priced to cover higher, though more predictable, expected losses relative to corporate loans (the average probability of default ("PD") in a portfolio of unsecured retail loans is typically larger than the average PD of a portfolio of corporate loans).

The potential risk of additional draws from uncommitted retail credit lines that can be terminated at will by a lender does not warrant a charge for additional capital. The risk associated with undrawn, uncommitted lines for unsecured retail loans is very low, particularly when they are closely monitored and readily cancelable by the lender. In MBNA's case, for example, over 90% of available U.K. credit card lines are in accounts with expected PDs less than 2%.

The asset value correlation ("AVC") factors are not consistent with our own (U.S.) experience. We suggest that each institution should be permitted to establish its own AVC factors. At the very least, the Committee should lower the range of AVC factors to 2% - 5% for QREs, with a corresponding reduction for other retail exposures.

Asset Securitisation

The requirement that originators hold *more* capital than investors for similar risk exposures is overly conservative and unnecessary. We believe that originators should not be burdened with higher capital requirements compared to investors in equivalent risk positions.

Undrawn, uncommitted credit lines related to revolving accounts included in securitisation transactions should not require capital. In typical revolving securitisation structures, both current drawn balances and future Customer draws, are securitised. During the revolving period, investors do not have the ability to choose whether or not to purchase newly originated loans, nor do they have the ability to purchase only low-risk receivables. Rather, investors are required to purchase receivables, on a pro-rata basis, from all accounts in the securitisation vehicle. If the Committee is trying to allocate capital for the risk of amortisation, that risk is already captured through the proposed new early amortisation capital requirement.

Operational Risk

Operational risk management is an emerging discipline; the current state-of-the-art practices for operational risk measurement are still in their very early stages. As such, we question the wisdom of a specific capital charge for operational risk at this time. We see little harm in waiting to apply any change as an interim step since most larger banks have more than adequate capital in place to cover both credit risk and cushion against operational risks. It is imperative that banks be given adequate time to evolve their operational risk measurement practices before any capital charge for operational risk goes into effect.

Consistent with our recommendation for credit risk and with the Committee's decision to rely solely on unexpected losses for the measurement of risk-weighted assets, any application of operational risk capital charge must be limited to unexpected losses, and not include expected losses, including, for example, credit card fraud losses.

Direct calculation of specific risk results to a 99.9% confidence level, with a verifiable degree of accuracy, will not be possible for most business lines given the lack of available data or will result in an extremely conservative capital charge, which would not make economic sense for the institution.

Cumulative Conservatism

We recognise the need to incorporate a level of conservatism to ensure that the risk being undertaken is appropriately captured. However, we are very concerned that the cumulative effect of these decisions result in Pillar 1 capital requirements that no longer reflect minimum regulatory levels. Examples are the need to use risk parameters that reflect the worst part of the business cycle (i.e., hold additional capital) in order to protect against procyclicality, capital charge on credit lines that are uncommitted and cancelable, asset correlation assumptions that are higher than industry averages, not enough recognition of the value of future margin income for unsecured retail lending, etc.

CP 189

We are generally supportive of the FSA's overall approach and the proposed exercise of discretions. However, we have three fundamental concerns with CP 189: (1) development of detailed implementation requirements prior to final adoption, (2) the implementation timetable itself, and (3) the proposed requirement that firms using the standardised approach hold the greater of capital under the standardised approach or the IRB approach. These concerns are addressed below.

Development of detailed implementation requirements prior to final adoption

CP 189 is centered upon the actual implementation components of and requirements for qualification under the advanced approaches. It appears to assume that the New Accord will be adopted "as is" or only as directed by the European Commission or the Committee and that input regarding needed changes to the New Accord will not be considered or pursued by the FSA. This appears to be true even though the New Accord has neither been formally adopted by the Committee nor approved by the appropriate supervisory or legislative authorities of each country. We are concerned that the FSA may have predetermined the result of the final form of the New Accord, without fully considering the views of affected institutions – thus calling into question the soundness of the entire process. We believe that the FSA should work to finalise the accord, considering fully the concerns raised by the institutions they regulate, before embarking upon an implementation plan.

Implementation timetable

We remain concerned that the implementation timetable established by the Committee and supported by the FSA may not consider the vigorous debate underway regarding critical elements of the New Accord, particularly the retail lending segment. We continue to believe that before deadlines can be established and before institutions must be required to make the changes to conform to the requirements of the New Accord, final adoption is necessary by the appropriate supervisory and legislative authorities is necessary. Moreover, given the recent changes announced by the Committee and the significant concerns raised (by both major financial institutions and governments, particularly the U.S. Congress[3]), regarding the overall direction of the New Accord, principally with respect to complexity, expense, and regulatory burden, we believe that it may be premature to embark upon an expensive and detailed effort to meet the current requirements of the New Accord, when those requirements may change in the future. Based on the foregoing we believe that the FSA must remain flexible about the implementation date and the dates in which financial institutions must achieve certain milestones.

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[3] See Letter from the U.S. House of Representatives Committee on Financial Services Comments to the U.S. Banking Regulators on the Advanced Notice of Proposed Rulemaking on the Proposed Revisions of the Basel Capital Accord (Nov. 3, 2003) (enclosed herein at *Appendix B*).

Additional capital requirements where applying the IRB approach produces a higher capital charge for banks using the standardised approach

The FSA is considering whether to impose an additional capital requirement for firms using the standardised approach if their Pillar 1 capital requirement is less than it would be under the IRB. We believe that this proposal ignores the underlying faults in parts of the IRB approach and creates a construct that may grant bank examiners too much subjective discretion in determining the "appropriate" amount of capital.

Assuming that the Committee has correctly calibrated the capital requirements under the standardised and the IRB approaches, there should be little difference between the two. However, as MBNA America has noted in both its comments on CP 3 and on the U.S. Agencies' advanced notice of proposed rulemaking, there remain significant deficiencies with the IRB treatment of unsecured retail credit.[4] MBNA America's experience reveals that the capital requirements for credit card loans under the A-IRB approach are significantly higher than under either under the Current Accord or the standardised approach. Moreover, from an economic risk perspective the standardised approach is more closely aligned with its own internal models. Rather than penalising banks that recognise that the standardised approach is more consistent with their own measure of risk, we believe that the FSA and the Committee should work to correct the deficiencies of the A-IRB approach for unsecured retail lending.

For firms that are adopting the standardised approach for all of their exposures, the FSA recognises that it would be unwise for them to estimate the risk characteristics in their portfolios – recognising the practical difficulties firms would face applying a framework they do not use to develop these estimates. In response the FSA suggests an approach, that asks firms to consider the credit risk they are exposed to and the FSA would thereafter use this as a basis for making adjustments to the amount of capital they hold under Pillar 2. This approach appears to be entirely open-ended and result-driven, without any objective standards to apply. As noted, we believe that the Committee must ensure that the underlying assumptions for the A-IRB approach for unsecured retail lending are correct and that the treatment for these exposures reflects fairly the risks that are at stake.

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[4] See MBNA's Comments to Advanced Notice of Proposed Rulemaking on the Implementation of the New Basel Capital Accord, at p. 13 (Nov. 3, 2003) (enclosed herein at *Appendix A*).

We appreciate the opportunity to provide these comments to the FSA. If you have any questions regarding this submission or if we can provide further information, please contact Vernon Wright directly by telephone at 001-302-453-2074 or by e-mail at vernon.wright@mbna.com.

Yours truly,

Vernon H.C. Wright
Chief Financial Officer
MBNA Corporation

Robin L. D. Russell
Chief Corporate Finance Officer
MBNA Europe Bank Ltd.

Kenneth F. Boehl
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Enclosures:

Appendix A – MBNA's Comments to Advanced Notice of Proposed Rulemaking on the Implementation of the New Basel Capital Accord (Nov. 3, 2003).

Appendix B – Letter from the U.S. House of Representatives Committee on Financial Services Comments to the U.S. Banking Regulators on the Advanced Notice of Proposed Rulemaking on the Proposed Revisions of the Basel Capital Accord (Nov. 3, 2003)

C:
Stephen Funnell, The Financial Services Authority
The Basel Committee on Banking Supervision
The European Commission
Office of the Comptroller of the Currency (U.S.)
Board of Governors of the Federal Reserve System (U.S.)
Federal Deposit Insurance Corporation (U.S.)
Office of Thrift Supervision (U.S.)
Office of the Superintendent of Financial Institutions (Canada)
Irish Financial Services Regulatory Authority
Banco de España