

Credit risk

Credit risk is managed to achieve sustainable and superior risk-reward performance whilst maintaining exposures within acceptable risk appetite parameters. This is achieved through the combination of governance, policies, systems and controls, underpinned by sound commercial judgement as described below.

- **Policies and risk appetite:** policies provide clarity around the required Group framework for the assessment, approval, monitoring and management of credit risk where risk appetite sets the tolerance of loss. Limits are used to manage concentration risk by single name, sector and country.
- **Decision makers:** credit authority is granted to independent persons or committees with the appropriate experience, seniority and commercial judgement. Credit authority is not extended to relationship managers. Specialist internal credit risk departments independently oversee the credit process and make credit decisions or recommendations to the appropriate credit committee.
- **Models:** credit models are used to measure and assess risk decisions and to aid on-going monitoring. Measures, such as Probability of Default, Exposure at Default, Loss Given Default (see below) and Expected Loss are calculated using duly authorised models. All credit models are subject to independent review prior to implementation and existing models are reviewed on at least an annual basis.
- **Mitigation techniques to reduce the potential for loss:** credit risk may be mitigated by the taking of financial or physical security, the assignment of receivables or the use of credit derivatives, guarantees, risk participations, credit insurance, set off or netting.
- **Risk systems and data quality:** systems are well organised to produce timely, accurate and complete inputs for risk reporting and to administer key credit processes.
- **Analysis and reporting:** portfolio analysis and reporting are used to ensure the identification of emerging concentration risks and adverse movements in credit risk quality.
- **Stress testing:** stress testing forms an integral part of portfolio analysis, providing a measure of potential vulnerability to exceptional but plausible economic and geopolitical events which assists management in the identification of risk not otherwise apparent in more benign circumstances. Stress testing informs risk appetite decisions.
- **Portfolio management:** active management of portfolio concentrations as measured by risk reporting and stress testing, where credit risk may be mitigated through promoting asset sales, buying credit protection or curtailing risk appetite for new transactions.
- **Credit stewardship:** customer transaction monitoring and management is a continuous process, ensuring performance is satisfactory and that documentation, security and valuations are complete and up to date.
- **Problem debt identification:** policies and systems encourage the early identification of problems and the employment of specialised staff focused on collections and problem debt management.
- **Provisioning:** independent assessment using best practice models for collective and latent loss. Professional evaluation is applied to individual cases, to ensure that such losses are comprehensively identified and adequately provided for.
- **Recovery:** maximising the return to the Group through the recovery process.

Basel II

RBS has received agreement (called 'a waiver') from the UK Financial Services Authority to adopt the Advanced Internal Ratings Based (AIRB) approach for calculating capital requirements for the majority of the business with effect from 1 January 2008. The Group, therefore, will be one of a small number of banks whose risk systems and approaches have achieved the advanced standard for credit, the most sophisticated available under the new Basel II framework.

The AIRB approach to Basel II is based on the following metrics.

- **Probability of default ("PD"):** the likelihood that a customer will fail to make full and timely repayment of credit obligations over a one year time horizon. Customers are assigned an internal credit grade which corresponds to probability of default. Every customer credit grade across all grading scales in the Group can be mapped to a Group level credit grade (see page 74).
- **Exposure at default ("EAD"):** such models estimate the expected level of utilisation of a credit facility at the time of a borrower's default. The EAD is typically higher than the current utilisation (e.g. in the case where further drawings are made on a revolving credit facility prior to default) but will not typically exceed the total facility limit.
- **Loss given default ("LGD"):** models estimate the economic loss that may occur in the event of default, being the debt that cannot be recovered. The Group's LGD models take into account the type of borrower, facility and any risk mitigation such as security or collateral held.