Basel II

Risk Management

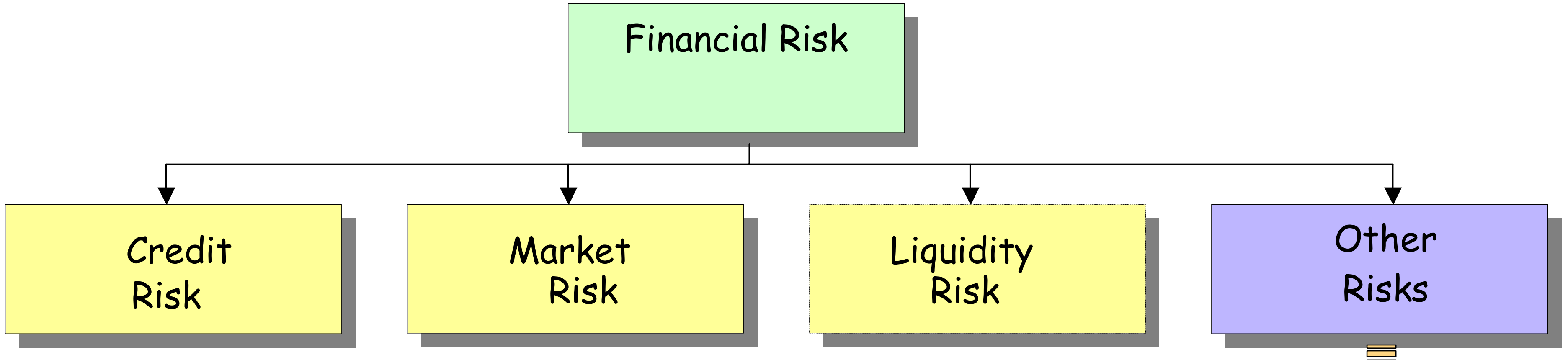
The UK Treasury has launched a consultation on a draft European Capital Adequacy Directive to introduce an international accord to overhaul the banking industry's approach to risk management. The proposed Basel Accord, Basel II, sets out rules whereby banks must have new procedures for measuring and mitigating against credit and operational risk.

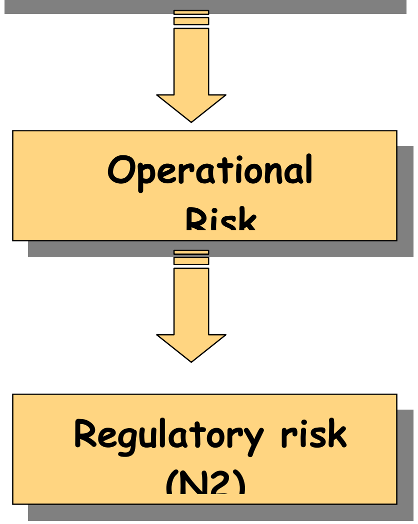
Although Basel II is not expected to be finalised until the middle of 2005, an implementation deadline of 31st December 2006 means that banks need to prepare for the Accord now.

CAD 3

The Commission intends to implement the Accord through a new Capital Adequacy Directive (CAD3), which is expected to extend the scope of the Basel regime to all credit institutions and investment firms. CAD3 will also ensure that the new regime is legislatively implemented throughout the EU, unlike Basel II, which is a non-binding agreement that will only apply to the G-10 signatory countries.

Operational Risk





Operational Risk, Basel Definition

The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Words "direct or indirect risk of loss" removed in order to eliminate risk to reputation and business.

The Framework

Basel II is based on a framework of three pillars; minimum capital requirements, supervisory review and market discipline. These are intended to work together to allow a proper assessment of the risks faced by banks.

Pillar I: Minimum Capital Requirements

Enables banks to utilise internal assessments of the factors that affect their capital requirements, such as Probability of Default, Loss Given Default and Exposure at Default. Modifies the definition of Risk-weighted assets to improve assessment of risk, thereby providing more meaningful capital ratios.

Pillar II: Supervisory Review

Points to the need for banks to assess their capital adequacy relative to overall risks and for supervisors to review and take appropriate action in response to those assessments. Provides for effective management of banks and effective banking supervision.

Pillar III: Market Discipline

Encourages market discipline through greater disclosure and transparency where reliance on internal assessments provides banks with greater discretion in determining their capital needs.

Although the deadline for implementation of Basel II is not until the Q4 of 2006, it is important for companies to begin the planning and implementation now.