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Mrs Danièle Nouy
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel

28 May 2001

Comments on "The New Basel Capital Accord"

Dear Mrs Nouy

UBS AG welcomes the direction taken by the Basel Committee on Banking Supervision (the Committee) since March 31, 2000, when the consultation period on "A New Capital Adequacy Framework" (June 1999) ended. The progress achieved compared to the document issued in June 1999 is considerable – many key comments made by the industry have been incorporated and further developed in The New Basel Capital Accord (the Accord) released on January 16, 2001.

The Accord is, however, still fundamentally work in progress. Thus, while the standardised approach for credit risk is fairly detailed, many aspects of the internal ratings based (IRB) approaches are still at an embryonic stage, and the same is true, by and large, of all but the Basic Indicator approach to operational risk. This limits the extent to which the industry can, at this stage, provide complete feedback based on a full empirical assessment, and also limits the scope of comments in a number of areas.

Nevertheless, we have identified a number of significant problems which, if not addressed, will prevent the Accord from providing the benefits intended by the Committee. Since the conceptual basis is fundamentally sound, and one we can support, we hope that the Committee will be able to resolve these issues before the Accord is finalised.

Our main concerns are summarised in this letter. In the attachment, these and other points are more fully elaborated.

PILLAR 1

Calibration of Overall Capital Charges

The Committee expresses the desire to produce, on average, neither a net increase nor a net decrease in minimum regulatory capital, after allowing for operational risk. It is, however, difficult to see how, in practice, the Committee can calibrate the charges in such a way as to retain the current levels of capital, given the variety of approaches on offer, an uncertain migration path for many of the major banks and the lack of detail currently attaching to many aspects of the proposals.

Moreover, based on our internal estimates and the results of the Quantitative Impact Study, it appears that the new credit charges alone could, depending on the ultimate treatment of impaired assets, leave regulatory capital at best unchanged from current levels, even before the addition of the operational risk charge. We do not believe that this would have been the Committee's intention for a bank with a good quality portfolio, without undue concentration risks in poorer quality assets. Unfortunately, the parallel running of the consultation period with the QIS has left both the industry and the Committee unable to test the concepts fully against real data, to run sensitivity analyses and scenarios, and, thereby, to propose solutions as well as identify problems.

Nevertheless, our internal estimates show that, even excluding impaired assets, the domestic corporate loan book will be heavily penalised irrespective of whether the Standardised Approach (residential real estate not recognised as collateral) or Foundation IRB (risk weights harsher for most counterparts) is used. This highlights the fact that even if, overall, the capital charge can be calibrated to accommodate operational risk without increasing the total, there will be a major redistribution of regulatory capital between businesses, in a way that we find inconsistent with our internal assessments of relative risk. The securities financing business (repos, securities borrowing/lending) is also very adversely impacted by the new charges, especially compared with current rules of the EU and the Swiss regulators.

We therefore recommend that the calibration be thoroughly reviewed and, if necessary, retested before the Pillar 1 charges are finalised.

Cost / Benefit Assessment

Although it is impossible, at this stage, to make a full empirical assessment of the impact of the Accord, it appears that there are inadequate incentives to encourage banks to improve their risk control environment and their risk management and control practices, particularly in the credit risk capital charges. If the capital benefit of moving from the standardised to the foundation IRB approach is to be only 2-3%, it will not be sufficient to cover the costs of meeting the detailed operational requirements and qualitative standards, which will be high. Furthermore, the benefit of moving from the foundation to the advanced IRB approach is capped at 10% for the first two years from implementation date, implying that banks qualifying for the advanced IRB approach will have to perform a burdensome double calculation.

We do not believe these incentives are adequate. There appear, moreover, to be strong disincentives for banks with more than a nominal amount of low quality, unrated assets to move to more advanced methods.

In order to promote and encourage good risk management practice, the Accord must provide greater incentives for banks to migrate to more advanced methods and must avoid the paradox that the most attractive option may be the least demanding in terms of risk management and control.

The Committee should also consider the potential cost of these changes across the whole industry and ensure that they can be justified by the resultant benefits in terms of enhanced safety and soundness in the system.

Aggregation of Capital Charges

The total capital charge is a simple summation of capital charges for the three risk categories, credit risk, market risk and operational risk (and other miscellaneous balance sheet items). This implies that there is no diversification effect between the risk categories – the risks are fully correlated. There is also limited recognition of diversification within the credit and operational risk capital charges.

For a bank with diverse business lines, in diverse sectors, across diverse geographical regions, the simple sum aggregation within risk category and across risk categories is likely to lead to a significant overstatement of risk and, therefore, of capital requirements.

There are significant challenges to developing a robust alternative method, some of which are inherent in the Accord itself – lack of clarity as to the intended time frame (holding period) and level of confidence, and the many layers of conservatism built into the current proposals. We do, however, urge the Committee to work with the industry to develop a generic risk sensitive aggregation method and, if this cannot be completed by December 2001, to leave this possibility open when the Accord is published in January 2002.

Accounting Standards

There are many accounting standards globally and although there is growing convergence, there remain significant differences in areas which are pertinent to the determination of regulatory capital. The Accord makes no reference to such differences or to the need to adjust capital calculations where accounting practice differs from that assumed by the Committee in formulating Pillar 1.

We recommend that the Committee should publish the broad accounting principles on which the Accord is based and the adjustments that regulators should make where local accounting standards are materially different.

Credit Risk

In general, we welcome the approach to credit risk in that it offers a spectrum of approaches suitable for institutions of different size and sophistication (although, as we have noted, there are currently serious problems with the overall calibration and with incentives to move from one approach to the next).

Our other principal concerns are:

- the lack of clarity in the Accord on how the carrying value of impaired assets is to be treated under the IRB approaches, and the treatment specified for the QIS which we consider inappropriate. We also note the inappropriately harsh treatment of these assets under the Standardised Approach (SA)
- an apparent lack of consistency between the SA and the Internal Rating Based approaches (IRB) which may, depending on the treatment of impaired assets, set inappropriate incentives for banks *not* to aspire to the IRB. Particularly in the domestic arena, this could unfairly advantage smaller banks compared with internationally active banks who will almost certainly be obliged by their regulators to adopt the IRB approaches
- the potential conflict between the attempt to use economic models to assess credit portfolio risk while ensuring that the current level of capital is retained in the banking system overall. This

appears to cause not only a very conservative bias in the underlying models but also arbitrary adjustments, for which explanations are not always credible. Of particular concern are:

  - the "w" floor, which is onerous and ill-defined
  - the calibration of default probabilities to EL as well as UL in the IRB approaches
  - the multiplier for the weighting function to compensate for PD estimation error and absorption capacity of Tier 2 capital

- the lack of clarity on key aspects of the proposed Internal Ratings Based approaches (IRB), especially with regard to modelling and with respect to certain sub-portfolios (retail, impaired assets, equity in the banking book) which prevent UBS from assessing all implications of the proposal and where, due to time pressure, a second round of consultation is apparently not envisaged, though we would strongly recommend it
- the "all or nothing" condition that commits banks to employing uniform approaches even in circumstances which might render this impossible, impractical or not economically viable
- the detailed requirements for entry into IRB which are too prescriptive and should be replaced by reference to principles against which banks can establish their policies and local regulators can judge them within the framework of Pillar 2
- the lack of a distinct category of small and medium sized enterprises (SMEs) that would have its specific conversion factor for benchmark risk weights, lying between the corporate and the retail sectors
- insufficient recognition of "physical" collateral, especially for mortgage loans where the investment income from a diversified pool of (residential or commercial) tenants is used to service the debt and which constitute a significant part of UBS's loan portfolio in the domestic banking division.
- the unwarranted distinctions made between conventional and synthetic asset securitisations and between issuing and investing institutions, which are not founded on risk. The Accord should simply reflect the effective amounts of risk transferred and retained.

We also believe that the new IRB approaches will lead to increased volatility in regulatory capital requirements, especially for those banks using forward looking calibration assumptions for their rating classes, and that the conservative assumptions built into the measures will exacerbate this problem.

Operational Risk

We welcome the conceptual structure of the evolutionary approach for determining the regulatory capital requirements for operational risk. We also support the tenet that the core methodology should be predominantly quantitative (loss based), and should evolve in a manner consistent with that established for market and credit risk, but we believe that this core quantitative approach should be adjusted for qualitative factors.

We recognise the challenges faced by the Committee in outlining a framework into which the industry can grow and believe that, in general, the right balance exists between options that accommodate less sophisticated institutions and the expected developments in operational risk management and control. However, we have two fundamental problems with the proposals as they currently stand:

- the proposed calibration of the operational risk charge at 20% of current total regulatory capital is inappropriate. Using an expected loss estimate based on empirical experience, UBS

has computed a conservative estimate of unexpected operational risk loss which, at less than10% of current regulatory capital, is well below the 20% proposed. Discussions with our peers suggest that this is not unusual. The percentage indicated by the Committee would place the regulatory capital charge in the realm of stress losses, which is not the declared intention

- the Accord does not allow for migration from the Internal Measurement Approach (IMA) to a Loss Distribution Approach (LDA) from implementation date. UBS believes that banks with more sophisticated systems must be permitted to move from IMA to LDA over time and this option needs to be available from the outset if the industry is to be given proper incentives to improve loss data collection and quantification techniques. We strongly urge the inclusion of LDA in the final text of the Accord.

Several other issues remain to be resolved. In particular the boundaries with credit risk and, to a lesser extent, market risk should be clearly specified and an appropriate treatment of risk transfer through insurance must be found.

The work that remains is considerable and, to respond adequately to this challenge, the timeframe for resolution must be extended beyond the announced consultation period, at least to the end of 2001 and more probably well into 2002. Notwithstanding our commitment to a quantitative approach to operational risk, we believe that the Committee must be prepared to abandon a Pillar 1 capital charge for operational risk if a satisfactory loss-based approach cannot be devised in time for the intended implementation date: it is not acceptable to impose a framework which is not risk sensitive and which will penalise size, in order to meet an arbitrary deadline.

UBS will make every effort to work with the industry and regulatory groups to further the development of best practices and a regulatory framework for operational risk.

PILLAR 2

The Committee has focused on regulatory capital as the means by which the safety and soundness of individual banks is ensured and systemic risk thereby avoided. Clearly, capital is essential to the solvency of a bank and to the market's confidence in it, but reliance solely upon capital is misplaced. Banks can fail while still solvent because they cannot fund themselves. Ensuring that an adequate liquidity framework is in place is therefore of critical importance, and we believe this should be given more prominence under Pillar 2.

UBS supports the basic aims of Pillar 2 in ensuring appropriate internal risk management, measurement and control, adequate internal capital assessment and planning, and compliance with the qualitative requirements associated with the more advanced methods of risk measurement for credit and operational risk. We also strongly support the view that capital is not a substitute for adequate risk management and control, but that increasing the minimum capital requirement to mitigate the effects of identified inadequacies may be an appropriate interim measure pending remediation of such deficiencies.

We do, however, have serious concerns that regulators will, as a matter of course, impose additional capital requirements on banks where there is no well defined weakness or lack of management and control. Pillar 1 covers risks with a high level of confidence, and already includes many buffers for uncertainties. For a bank with sound internal practices and standards, the capital calculated under Pillar 1 should therefore constitute the regulatory capital requirement, with no further buffer, and the circumstances where an additional charge might be imposed should be clearly defined. Other than in these limited circumstances, regulators should not determine the

level of capital that a bank should hold in excess of the regulatory minimum: this is a strategic decision and the responsibility of the bank's management.

UBS recognises that achievement of a more risk sensitive framework inevitably entails qualitative judgements by regulators, but we believe that the Committee should do its utmost to ensure that the implementation of Pillar 2 is consistent across jurisdictions. This extends to ensuring that all relevant regulators have sufficient resources to implement Pillar 2.

The Accord makes no mention of the principle of the "Lead Home Country Regulator". As institutions progress through the spectrum of approaches to credit and operational risk, the level of regulatory supervision increases, with international firms facing a proliferation of Pillar 2 inspections, with a consequent burden on resources and systems. We would welcome explicit reference in the Accord to the principle that the home country regulator is the primary Pillar 2 supervisor, and concrete efforts to enforce the principle internationally.

PILLAR 3

UBS is a supporter and exponent of transparency in banks' financial statements, and of disclosure as a means to promote market discipline. As such we support the philosophy of Pillar 3, but we have significant concerns with the detailed proposals.

Our own disclosure practices are generally seen as among the most comprehensive of our banking and investment services peer group. We can and will continue to enhance our risk disclosure. Nevertheless, we believe the proposals in Pillar 3 are excessive, and have the potential to confuse rather than illuminate – they are more than the external audience can digest.

The Committee should clearly distinguish between disclosure to supervisors and disclosure to the broader market, with a wide set of data being openly available to supervisors, who will assess the fitness of internal approaches for the different levels of sophistication envisaged in Pillar 1.

Banks should publicly disclose the Pillar 1 approaches they are authorised to use. If, in addition, regulators publish their assessment standards, there will be public appreciation of banks' risk management and control standards. This would have a powerful disciplinary impact, and would also allow an assessment of the consistency of regulatory supervision.

Disclosure to the broader market should allow investors and analysts to assess the quality of internal risk management and control processes, and to grasp the risk/reward profile of an institution by means of standardised, comparable and comprehensive disclosure of exposures, sensitivities and loss experience.

We also think it is most important that the Committee works closely with the accounting standard setting bodies, as well as the industry, to achieve a co-ordinated disclosure framework that meets the needs of all market participants.

FURTHER CONSULTATION

As we have noted, much of the content of the Accord is work in progress, and yet no further consultation or QISs are planned for credit risk following the May 2001 deadline before completion and release of the final Accord.

As a result, important aspects of the Accord which are not yet fully developed will be finalised without the industry being given the opportunity to provide formal comment, informed by a quantitative assessment of the final proposals. Moreover, it is unclear how an appropriate calibration can be achieved from a QIS based on an incomplete specification.

The Accord will shape the regulatory landscape for the longer term, and the importance of getting the details right cannot be overstated. UBS strongly recommends formal issuance of interim papers for consultation on areas that have not been fully developed in the current proposal, and the adoption of a flexible approach to the December 31, 2001 deadline: it would be unfortunate if adherence to a somewhat arbitrary timetable resulted in fundamental flaws in this most important framework.

LEVEL PLAYING FIELD

The Accord continues to apply mainly to banks and not to all systemically relevant financial institutions. UBS believes that this prevents the Committee from achieving its two key goals, namely enhancement of competitive equality and promotion of the safety and soundness of the financial system, since problems arising in firms outside the scope of the Accord can have knock on effects amongst banks, both domestically and internationally. We therefore urge the Committee to renew its discussions with other regulatory bodies to try to achieve a more unified regulatory approach across all systemically relevant firms.

FURTHER ENHANCING SAFETY AND SOUNDNESS IN THE FINANCIAL SYSTEM

In our response to the 1999 paper, "A New Capital Adequacy Framework" we critically analysed the philosophy underpinning the current capital regime and suggested a way to complement this approach to improve its ability to promote the safety and soundness of the financial system – see our letter "Comments on the consultative paper A New Capital Adequacy Framework", of March 30, 2000.

We noted that the current approach to regulatory capital does not consider the role of earnings in absorbing losses in the first instance, despite ample empirical evidence to the contrary. We argued that focusing only on capital as a buffer against losses net of earnings overlooked two important aspects:

- first, that an internationally active financial institution with a well diversified income stream derived from both trading activities and franchise business, which experiences significant losses from any source, will face funding and liquidity difficulties long before it becomes insolvent, i.e. long before its capital is put at stake.

  This means that the primary source of international systemic risk should be seen as the potential for a sudden drying up of liquidity and heightened price volatility in particular markets or a funding crisis at a particular firm, rather than the under-capitalisation of any particular group of banks as was the case in the mid 1980s. Recent events in financial markets support this observation
- second, that these firms already manage the link between risk and capital in a way that seeks to limit the total risk to their earnings from all material risk factors by assessing the firm's potential exposure to a set of stress scenarios.

We suggested that a more appropriate way to assess a firm's capital requirement would be to explore the firm's potential exposure to certain predefined stress loss events, and evaluate the extent to which its non trading earnings provide adequate protection against such occurrences.

We proposed that the regulatory capital requirement should be set so as to enable a firm to survive an initial stress event and to remain solvent for long enough thereafter to allow an effective regulatory work out strategy to be put into effect, thereby focusing more explicitly than at present on the importance of liquidity management practices at firms and the potential link between a liquidity problem and a capital problem.

We would very much appreciate, once the current round of discussions is complete, having the opportunity to discuss these views (which are shared by other firms) with you, and to explore ways in which the Accord could be adapted to address these concerns in the future.

If you have any questions on the matters we have raised in this letter or the attached paper or would like to discuss any of them further with us please contact:

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Yours sincerely

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Enclosure