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Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
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26 August 2011

RE: Global systemically important banks: Assessment methodology and the additional loss absorbency requirement - consultative document

Dear Sir or Madam,

UBS would like to thank the Basel Committee on Banking Supervision for the opportunity to comment on the consultative document: "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement". Please find below our response to the, from a UBS perspective, most important aspects set out in the paper. This reply is intended to complement the comments made by the Institute of International Finance, which UBS supports in full.

General comments

UBS is committed to the goal of improving the stability of the financial system and agrees on the need for reform following the last financial crisis. We are fully supportive of the efforts of the Basel Committee and emphasize that much progress has already been made, in particular through the Basel III framework.

To make sure that the desired goals of regulatory reform can be achieved, we would like to re-emphasize the need to ensure a comprehensive and internationally consistent regulatory framework. In the specific realm of this consultation, this would imply, amongst others, that the definition of the individual indicators outlined in the assessment methodology is formulated in a way that contributes to equal treatment across jurisdictions and avoids double counting. Furthermore, national specificities as well as in particular accounting differences must be appropriately taken into account. Specific issues in particular with accounting differences are presented in the appendix. Overall, we think that the proposal would be made even stronger by additional indications and clarity on how these overarching goals can be achieved.

From UBS's perspective we feel that the allocation of elements of the proposals between Pillar 1 and Pillar 2 might need to be further clarified and any double-counting or mechanistic relation between both pillars should be avoided.

Additionally, we suggest the implementation of the methodology by the national regulators to be reviewed on a regular basis and benchmarked against international standards. The Basel Committee would be best positioned to set out effective guidelines to harmonise the process. In this regard, we also continue to strongly encourage the continuation of the work on an effective supervisory college process for global banks.

Methodology

On the proposed methodology to identify G-SIBs, while we recognize that the proposal is systematic, part of the assessment methodology and indicators might benefit from further substantiation and details.

UBS in particular strongly believes that the G-SIB's total score would be significantly improved by taking into account the existence of an effective and credible recovery and resolution regime in its home country. The surcharge is predicated in part on a desire to reduce the negative externalities caused by the failure of a G-SIB. To the extent these externalities are reduced through a country's development of an "effective and credible" recovery and resolution plan, it is in our perspective logical that G-SIBs based in that country should have their total scores reduced.

Also, the absence of RWA as an indicator and focus on total exposure only as a proxy for size is, in our perspective, questionable. RWA is the main concept of the Basel Committee that is calculated by every institution and should appropriately reflect the risk profile of a bank. This is also proxy for the ease of transferring (risky) assets during bankruptcy and resolution. Hence, taking RWA into account within the size indicator would help better quantify the risks of a bank's distress or failure to the global economy. Finally, we would like to point out that the paper proposes to use indicators on an absolute level only, whereas for certain indicators, a relative approach may lead to a more accurate result.

Going concern contingent capital

UBS shares the conclusions of the Basel Committee on instruments which convert into common shares (CoCos); in particular as to their behaviour close to the conversion point. However, we believe that the discussion on alternative capital instruments should not focus on a specific instrument (CoCos), but should be extended to a general assessment of various loss absorbing capital instruments, especially write-down instruments.

In particular, while the paper defines contingent capital as i) instruments which convert into common shares (CoCos) as well as ii) instruments with a permanent write-off mechanism, the analysis of features of contingent capital in paragraphs 85 to 87 does not comprise, in our view, the full panorama of potential instruments. Given the different characteristics of CoCos and write-down instruments, we would be interested in hearing the Committee's views in more detail. In our view, several of the perceived disadvantages of CoCos would fall away when analyzing write-down instruments. In particular:

- The caveat in 86 (b): (... "depends on the conversion rate being such that a sufficiently high number of shares are created" ...) is not applicable for a write-down instrument.
- The caveat in 86 (c) (... "the conversion rate would need to be such that a sufficiently low number of shares are created" ...) is also not relevant for a write-down instrument.
- The caveat in 87 (d) (... "incentives for speculators to push down the price of the equity and maximize dilution" ...), is not applicable for a write-down instrument.
- The caveat in 87 (f) (... "the prospect of punitive dilution" ...) is equally not applicable.

Moreover, some of the arguments advanced in the paragraphs 85 to 87 may benefit from further clarifications:

- 87 (a) (uncertainty whether triggers work): We must recognize that there can never be a 100% legal certainty. Part of the work of lawyers and regulators is to ensure that the legal risk is acceptably low.
- 87 (f) (... "as the bank approaches the trigger point there may be pressure on management to sharply scale back risk-weighted assets via lending reductions or assets sales" ...): this argument is in partial contradiction with the recovery plans requirements proposed by national regulators, which require banks to demonstrate viable de-risking plans.

Finally, with regards to the proposed requirements for going-concern contingent capital described in Annex 3, our interpretation is that contingent capital would meet the additional loss absorbency requirements to the degree that it converts into Common Equity Tier 1 and thereby becomes fully loss-absorbent. In other words, if a contingent capital instrument offers a partial conversion into CET1, it could still receive a partial recognition as capital meeting the additional loss absorbency requirements. We suggest that this is clarified in the final BCBS release.

Also, we note that write-down instruments absorb losses prior to shareholders and this may create unwelcome incentives for shareholders to increase risks. Accordingly, it is important to restore the capital structure upon a financial recovery. This could be achieved through features that allow investors in write-down instruments to participate in the future recovery of the bank.

However, overall, as described above, write-down instruments do not present many of the risks presented in the paper. On balance, UBS believes that a more detailed analysis for write-down instruments should enhance the level of the discussion and show that write-down instruments should be considered as a G-SIB surcharge instrument.

Thank you again for the opportunity to engage in this discussion and for considering our suggestions. In case of questions or comments, please do not hesitate to contact Steve Hottiger, Managing Director, Head Group Governmental Affairs, on +41-44-234 5064 or steve.hottiger@ubs.com.

Yours sincerely,

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Appendix: Specific accounting / presentation differences

The following may impact cross-jurisdictional claims/liabilities, size (to the extent based on reported assets or gross revenues), intra-financial system assets/liabilities:

- **Offsetting (balance sheets)** - Derivatives liabilities are offset against derivative assets in the balance sheets of US GAAP preparers to the extent that a master netting arrangement exists between counterparties and is enforceable in the event of default. In addition, certain forms of collateral are offsettable against associated derivative positions. Under IFRS, offsetting is permitted only when both the right and the intent to net settle are present. As many, if not most, forms of margining are deemed to be collateral rather than settlement, IFRS preparers will generally present substantially larger portions of their derivatives portfolio on a gross basis than their US peers. Data indicate that the balance sheets of some US banks would increase by over 1 trillion USD were they to apply IFRS netting.
- **Offsetting (balance sheets)** - Banks reporting under US GAAP offset securities financing (e.g., repos) liabilities against securities financing assets to the extent that they are subject to a master netting arrangement (enforceable in bankruptcy) and are cleared via market systems that constitute the "functional equivalent" of net settlement. Under IFRS, netting is only permissible when the entity has both the right and the intent to settle net. In practice, many IFRS preparers analogize to the US parameters of functional equivalence as justification for concluding that the "intent" criterion is met. However, in general, banks reporting under US GAAP are likely to report smaller asset balances than their IFRS peers.
- **Offsetting (income statement)** - Diversity may exist among financial sector preparers with respect to the presentation of costs and revenues. Commercial banks tend to offset brokerage and similar costs against revenues, while investment banks may be biased toward gross presentation. This is more of a matter of industry practice than divergence between GAAPs.
- **Leveraged Leases** - Under IFRS, Leveraged Leases are generally treated as "finance leases", with the corresponding lease receivable and financing arrangements presented gross on balance sheet. Under US GAAP, special treatment is afforded to these arrangements, allowing lessors to net financing and deferred tax liabilities against the lease receivable. Thus, to the extent that a bank engages in significant amounts of leveraged lease activity, its reported assets will be substantially lower under US GAAP than IFRS.
- **Deferred Tax Assets** - Under IFRS, Deferred Tax Assets are recognized in their entirety to the extent they exceed a probability threshold. Under US GAAP, reserves are reported against Deferred Tax Assets for the non-probable portion. Thus, in this respect, an IFRS preparer would report a relatively larger asset balance than if it were reporting under US GAAP.

The following may impact the complexity indicator:

- **Held for Trading Classification** - Substantial differences may exist among IFRS and US GAAP preparers with respect to assets designated as HFT. In general, the classification is considered to be more restrictive under IFRS than US GAAP, which may lead to greater use of the designation (and thus larger balances) by US banks. However, US GAAP preparers with traded loans will likely report fewer as HFT than their IFRS peers, as the trading line is generally restricted to securities only.

RECOGNITION DIFFERENCES:

The following may impact cross-jurisdictional claims/liabilities, size (to the extent based on reported assets or gross revenues), intra-financial system assets/liabilities:

- **De-recognition** - Both balance sheet size and profit & loss are impacted by the criteria for de-recognizing financial assets and liabilities. Substantial differences may arise between

IFRS and US GAAP preparers due to fundamental differences in approach; IFRS relies on a primarily risk & rewards oriented approach, whereas US GAAP utilizes a control approach. It is difficult to assess whether one or the other creates a particular financial reporting bias.

- **Consolidation** - Currently, IFRS and US GAAP preparers must apply substantially different criteria in determining whether to consolidate an investee, especially when the investee is a special purpose or structured vehicle. Under IFRS, the analysis incorporates a variety of factors, including both risk & reward and control. Under US GAAP, the consolidation determinants are based solely on control. This may result in substantial balance sheet and profit & loss differences between IFRS and US GAAP entities. However, similar to de-recognition, the determination of a bias in one direction or another (i.e., consolidation v. non-consolidation) is highly dependent on facts and circumstances; i.e., it is difficult to make a generalization as to the impact on balance sheets or income statements between GAAPs. In the future, ASC 820 and IFRS 10 are largely harmonized, therefore differences should be reduced.

MEASUREMENT DIFFERENCES:

<u>The following may impact cross-jurisdictional claims/liabilities, size (to the extent based on reported assets or gross revenues), Intra-financial system assets/liabilities:</u>

- Financial Instruments (e.g. Day 1 profit and loss)
- Impairment of Financial Assets (e.g. differences in industry practice, treatment of non-accrual loans)
- Post Retirement Benefits