UBS AG
P.O. Box
8098 Zurich

Group Governmental Affairs

Steve Hottiger
Bahnhofstrasse 45
P.O. Box
Tel. +41-44-234 50 64
Fax +41-44-234 32 45
steve.hottiger@ubs.com

www.ubs.com

Sent by email to baselcommittee@bis.org

Secretariat to the Basel Committee on Banking
Supervision
c/o Bank for International Settlements
CH-4002 Basel
Switzerland

25 November 2011

Re: Capitalization of bank exposures to central counterparties

Dear Sir or Madam,

UBS would like to thank the Basel Committee on Banking Supervision for the opportunity to comment on the consultative document: "Capitalisation of bank exposures to central counterparties" (Basel 206). Please find below our response to the, from our perspective, most important aspects set out in the document. Next to this letter, we further support the joint response provided by the BBA, FOA, GFMA, IIF, and ISDA.

General comments and core concerns

UBS is a leading global provider of futures and options execution and client clearing services, with the futures business clearing 40 million contracts per month. We execute across more than 75 exchanges globally and provide clearing services in 65 markets, including all major exchanges, such as CME, ICE, LCH, TSE, and SGX. UBS is represented on the risk committees of the major exchanges. UBS is a top 5 futures clearing merchant (FCM) in the US, as ranked by customer balances.

UBS is on record as a supporter of the benefits of migrating OTC derivatives to central clearing. We have invested significantly in the associated infrastructure and have been pro-active in seeking to educate our clients about the upcoming changes.

UBS is compelled to respond to BCBS 206 out of concern for the proposal's potentially far-reaching effects on the futures business, on bank clearing members and the risks to which they are exposed, and on the risk management practices associated with central clearinghouse arrangements.

While we support the principles that underlie BCBS 206, the importance and complexity of the proposal imply the need for the BCBS – in conjunction with the CPSS and IOSCO – to take additional time in 2012 to ensure that the proposal will not have unintended consequences, in particular on the incentives to migrate transactions from OTC to central clearing.

Our core concerns can be summarized as follows:

- The CEM calculation at the heart of the proposal is insufficiently risk-sensitive. In our view, it would be wholly inappropriate were a CCP to adopt the CEM approach to determine its product margins or the size of its default fund.

- The proposed 100% capital requirement on default fund contributions that are deemed the equivalent of required equity at the CCP is not justified on risk grounds.

- BCBS 206 is unique relative to other BCBS capital proposals since it will influence the nature of risk management practice at CCPs in addition to its effects on reported bank capital ratios. Because of the unique linkage to risk management practice at key elements of the financial market infrastructure, the consequences of distortions and inaccuracies in this proposal are even more important than in other areas of capital regulation.

- Proposed capital requirements related to non-qualifying CCPs appear deliberately punitive, with the intention to spur CCPs to adopt the measures needed to become qualifying CCPs. While this policy objective is understandable in the big picture, it needs to be considered in the context of the final CPSS / IOSCO standards, including any transitional arrangements associated with those standards. Since the standards are not yet available in final form, it is difficult to assess what impact this punitive element could have, especially on the incentives to provide clearing services in emerging markets.

- In this regard and more broadly, we are concerned that BCBS 206 implicitly assumes that banks have the ability to unilaterally dictate changes in risk management practices at CCPs. Based on our experience, this is not the case.

- In regard to the risk of a client default, BCBS 206 makes no distinction in the close-out period that banks should apply relative to bilateral OTC contracts. This is inconsistent with the efforts undertaken by CCPs and their members to establish defined, robust close-out procedures. Providing zero recognition of such efforts will clearly undercut the incentives to invest in these procedures and reduces the incentive to migrate trades to CCPs.

- The proposal does not clearly differentiate between the cases where a clearing member guarantees a CCP's performance to the client and where it does not. Failure to distinguish these cases ignores real differences in underlying risk, sows potential confusion and moral hazard with clients, and in the worst case might be seen by courts as evidence that such a guarantee exists even where clearing members have taken steps to avoid such a result.

In aggregate, these concerns lead us to conclude that the proposal would benefit from further review and revision. If enacted as proposed, we fear that clearing member capital requirements will be uneconomic and excessive and that this will result either in a reduced supply of clearing services, an increase in their pricing, or both.
Regardless, we do not believe the result will encourage migration of OTC transactions to central clearing.

CEM calculation is not risk-sensitive

The current exposure method (CEM) groups all transactions into five product classes and three tenor classes. Within these subsets, all transactions are treated the same. To understand the magnitude of this simplification, it is useful to compare the categories with products currently traded.

- With respect to interest rates, the tenor dimension of the CEM applies to the tenor of the futures contract and not the tenor of the underlying. Thus, 10 year Treasury note contracts and 1 month eurodollar contracts are treated the same if the futures tenor is the same.

- All currency pairs are treated the same regardless of historical volatility.

- All equity contracts are treated the same, whether related to an equity index or a single stock.

- The Other Commodities category will treat identically contracts in such diverse areas as agricultural commodities, credit-linked products, oil, natural gas, electricity, and weather.

In addition, the only recognition of portfolio diversification effects within the CEM is through the net-to-gross ratio or NGR, which resembles a rule of thumb more than a true risk calculation.

While we appreciate the desire to impose consistency in these calculations, establishing the CEM as an important benchmark for all CCPs globally sacrifices too much risk-sensitivity and will have unintended consequences.

We believe that the BCBS should undertake a more thorough comparison of candidate approaches, including the standardized calculation and calculations developed by CCPs themselves, in the context of real CCP portfolios. By comparing these approaches in detail, we believe the BCBS will be in a much stronger position to propose a hypothetical capital calculation for CCPs that better balances consistency with risk sensitivity.

100% capital requirement on CM default fund contributions not justified on risk grounds

We also have concerns with the calculations that translate the hypothetical CCP requirement into clearing member capital requirements.

First, BCBS 206 introduces two new features of this calculation – the concentration and granularity adjustments – that receive very little explanation in the text of the proposal.

Second, and more important, we question the automatic imposition of a 100% capital requirement on clearing member default fund contributions that are not in excess of the CCP hypothetical capital calculation. This calculation implies that such contributions should be considered the equivalent of required equity at the CCP.

However, the 100% requirement is well beyond the normal requirement for traded equity or even private equity investments. In our experience, default fund contributions have exhibited much less risk than equity investments overall.

In our view, there is likewise little basis for such a requirement on the grounds of "reciprocal cross holdings" or similar argument, since the CCP requirement is purely hypothetical in the first place.

The scale of the default fund charge in the proposal is certain to have a material impact on the costs of providing clearing services. It is therefore critical in our view for it to be well-justified on risk grounds and we do not believe it passes that test.

1250% risk weight for non qualifying CCPs is punitive

The 1250% risk weight for all exposures related to non qualifying CCPs is apparently designed to encourage all CCPs to meet the new CPSS / IOSCO standards. However, it is important to recognize that such a high risk weight is typically associated with assets whose loss rates average 5% per year or higher. We are not aware of any CCPs with default fund contribution annual loss rates of this magnitude.

While not discounting the policy objective served by a deliberately high capital requirement for non qualifying CCPs, it is important to emphasize the potential consequences in the short to medium term, depending on the speed with which CCPs around the world can adapt to new standards. We fear that the burden of this incentive policy will fall most heavily on emerging market jurisdictions and that increased costs for clearing will discourage foreign investors at the margin from participating in these markets.

Conclusion

We greatly appreciate the opportunity to comment on BCBS 206. For the reasons stated, we believe it is critically important for the BCBS to take more time to improve the risk sensitivity of the proposal. Without this additional effort, we believe that it will have unintended consequences, in particular on the cost of clearing and the incentives to migrate OTC contracts to central clearing.

Yours sincerely,

Darryll Hendricks
Head Investment Bank Strategy

Steve Hottiger
Head Group Governmental Affairs