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Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland
Sent by email to: baselcommittee@bis.org

27 August 2012

Dear Sirs,

Basel Committee on Banking Supervision ("BCBS") Consultative Document: Fundamental Review of Trading Book

The United Overseas Bank Limited ("UOB") welcomes the opportunity to provide response to BCBS Consultative Paper on Fundamental Review of Trading Book. This letter contains the response of UOB to the initial policy proposals to strengthen capital standards for market risk.

UOB is of the view that many of the proposals are positive steps toward a resilient banking sector. We are concerned, however, that some proposals could have unintended consequences of inconsistencies in market risk measurements, risk concentration, and disincentives to risk discovery.

We are available to discuss further on our response. Please do not hesitate to contact the undersigned should you require further information.

Sincerely,

Lee Wai Fai
Managing Director
Chief Financial Officer &
Acting Chief Risk Officer

Betty Lau
Executive Director
Head, Group Market Risk Management

United Overseas Bank Limited
Response to BCBS Consultative Paper
Fundamental Review of Trading Book

1. Overall Response to Proposals

UOB is of the view that many of the proposals are positive steps toward a resilient banking sector. We are concerned, however, that some proposals could have unintended consequences of inconsistencies in market risk measurements, risk concentration, and reduce the incentives for risk discovery.

The specification of multiple liquidity horizons and constraints to diversification pose challenges in the modeling process and introduce inconsistencies for risk aggregation and mathematically intractable. The proposed change in trading boundary could result in a punitive capital regime that may reduce incentives for Banks to allocate resources to active risk discovery process. The limitation of diversification benefits and a capital floor could lead to undesirable consequence of reduction in inter-risk diversification/hedging (diversification across broad risk classes: Foreign Exchange, Interest Rates, Equity, Credit and Commodity) that could in turn lead to higher concentration risks.

UOB is of the view that the proposals should consider the potential disincentives and be amended to reduce the undesired consequences.

2. Response to Questions

Question 1: Which boundary option do you believe would best address the weaknesses identified with the current boundary, whilst meeting the Committee's objectives?

The practical aspect of maintaining the trading and banking book boundary favors the "trading evidence"-based boundary to address the weaknesses of current trading intent boundary. A regulatory guidance on trading evidence needs to be clear to ensure the consistent application across banks and jurisdictions.

The advantage of valuation based boundary could be less subjective and would align to accounting treatment. However, it has the undesirable consequence of more P&L volatility where banking book exposures are not held for short-term gain. The International Financial Reporting Standards 9 ("IFRS 9") recognizes the distinction between trading and banking exposures and allows fair value of strategic holdings to other comprehensive income. UOB is of the view that these strategic holdings should not be subject to regulatory market risk capital charge. The adoption of valuation based boundary could be implemented with exemptions given to longer term strategic holdings.

Question 2: What are commenters' views on the likely operational constraints with the Committee's proposed approach to capturing market liquidity risk and how might these be best overcome?

The challenge for modeling market liquidity lies in the lack of appropriate data. The level of liquidity differs across asset class and geographical regions. To aggregate risk measures such as Expected Shortfalls ("ES") for different liquidity horizons in itself is theoretically inconsistent. It is therefore UOB's view that market liquidity is best measured separately, through valuation reserves or capital add-ons that is computed on a less frequent basis (e.g. monthly). The regulatory guidance for the implementation should set a minimum standard to ensure a level playing field amongst banks.

UOB also seeks clarity on the liquidity classification for funds. The liquidity classification should ideally be based on fund characteristics such as redemption notice period.

Question 3: What are commenters' views on the proposed regime to strengthen the relationship between the standardised and internal models-based approaches?

The strengthening of the relationship between standardized and internal models-based approach is a positive step. It is, however, an onerous requirement for banks to mandatorily maintain both approaches in parallel. The introduction of a floor could lead to disincentive for banks to spend vast amounts of resources toward the risk discovery process.

UOB seeks clarification on the relationship of inter-risk class correlations under the standardized and internal models-based approaches.

Question 4: What are commenters' views on the Committee's proposed desk-level approach to achieve a more granular model approval process, including the implementation of this approach for banking book risk positions? Are there alternative classifications that might deliver the same objective?

The option for granular model approval process is a positive step which will facilitate transition into internal models-based approach for both trading and banking book. We are however concerned that this approach could limit diversification across desks, in particular where banks have a central hedger, this could lead to a disincentive for banks which have a central hedger to diversify their trading book exposures.

Question 5: What are commenters' views on the merits of the "direct" and "indirect" approaches to deliver the Committee's objectives of calibrating the framework to a period of significant financial stress?

The "direct" approach is less subjective while it may increase computational burden. The "indirect" approach which relies on a reduced set of risk factors will introduce subjectivity that may result in inconsistencies in risk factors for the underlying data sets. For new risk factors, in particular for new equities and bond issues, both "direct" and "indirect" approaches have the same limitations.

Question 6: What are commenters' views on the merits of the desk-based and risk-factor-based aggregation mechanisms to deliver the Committee's objectives of constraining diversification benefits?

The risk-factor aggregation is better understood and constraint in diversifications better aligned with standardized approach, while desk-based approach is consistent with how the trading business is managed. The application of diversification constraints by trading desks that have multi-asset class could lead to aggregation that is theoretically inconsistent. We are also concerned that curbs (desk-based or risk-factor-based) in diversification benefits will create a disincentive for banks to diversify or hedge their trading book exposures and thereby lead to possible buildup in concentration risks.

The stressed ES for market risk capital measure could sufficiently address the concerns on VaR shortfalls and market dislocations during financial stress.

Question 7: How can regulators ensure robust supervision of integrated market and credit risk modelling? In particular, how would an integrated modelling approach affect other elements of the proposed framework (eg the choice of the quantile parameter for ES, the P&L attribution and backtesting processes, etc)?

The integrated approach is more consistent but more data intensive. It remains a challenge to derive a market consistent migration matrix. For a shorter liquidity horizon, the use of an integrated approach is preferred notwithstanding the difficulties in migration specification.

The inter-risk class diversification constraints will pose challenges for the integrated approach where correlations between interest rates and credit spreads could be mis-specified.

The use of a historical migration matrix is in line with actuarial methods. That is, the separate approach is technically easier to implement. For backtesting purposes, the liquidity horizon may be shortened to be consistent with the P&L measure.

Question 8: What are the likely operational constraints with moving from VaR to ES, including any challenges in delivering robust backtesting, and how might these be best overcome?

The proposal to use ES as a single measure of market risk capital in place of Value at Risk ("VaR")/Stressed VaR is a positive step. It is UOB's view that the historical simulation approach for ES is superior versus the variance-covariance ("VCV") and Monte Carlo ("MC") approaches. The scaling factor, derived from parametric distribution function for VCV approach does not add value. The simulated paths for MC are dependent on the underlying distribution function assumption and may not evidence the advantage of ES which could be observed from historical stress data. In the context of historical simulation, regulatory guidance for minimum observations for the tail average is also necessary to ensure a level playing field.

The use of ES in place of VaR does not necessarily address the shortfalls in VaR. The use of Stressed ES, however, does provide the measure for a higher market risk capital for capital adequacy purposes during periods of financial stress and a more superior measure to the existing VaR/Stressed VaR measure. The aggregation of ES for different time horizons (different liquidity horizons) is theoretically inconsistent. We are of the view that inter-risk class should be computed based on a consistent time horizon and correlations used for aggregation can be adjusted through copula liked attributes. The liquidity adjustments can be separately addressed through valuation reserves or capital add-ons.

The use of VaR for desk level risk appetite limit would be practical as an expectation on extreme tail loss may not provide a plausible reference for day to day market risk management purposes. ES is applicable for group/entity capital allocation purposes. It is therefore UOB's view that the total replacement of VaR is not practical.

UOB seeks clarification on the application of "anti-thetic" principal in the computation of Stressed ES, and the measure of market risk capital with the use of Stressed ES. That is, Stressed ES to replace the current VaR/Stressed VaR approach versus ES/Stressed ES. UOB is of the view that the use of stressed ES is the appropriate market risk capital measure.

In the backtesting context, a break exceeding VaR @ 99% might not be considered a true break if sufficiently measured/captured by the ES. This approach would be in line with the conditional VaR definition for ES.

Question 9: Which of the two approaches better meets the Committee's objectives for a revised standardised approach?

The partial risk factor approach would better meet the Committee's objectives. Going back to first principles, the key objectives of having a standardised approach are to provide a method for calculating capital requirements for less sophisticated banks (which are likely to be non-systemically important), minimize model risks and achieve greater consistency of capital requirements. Accordingly, it would seem more important to place emphasis on model simplicity, which is best achieved with the partial risk factor approach.

UOB seeks clarification on the measure for categorizing of trading instruments into risk "buckets" in the implementation of partial risk factor approach.

The fuller risk factor approach uses sensitivity stress results to determine gross risk positions and aggregates them assuming no diversification within the same asset class is computationally intensive. This could result in disincentive for trading desks in hedging and managing their risks.

UOB seeks clarification on the granularity of risk "buckets" per risk class and how instruments are mapped into these buckets.

<u>Question 10:</u> Do commenters propose any amendments to these approaches?

UOB is of the view that

i) The market liquidity is best measured separately, through valuation reserves or capital add-ons that are computed on less frequent basis (e.g. monthly). The regulatory guidance for the implementation should set a minimum standard to ensure a level playing field.
ii) The stressed ES is an appropriate market risk capital measure.