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Secretariat of the Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel  
Switzerland

27 September 2013

**Re: Basel Committee on Banking Supervision Consultative document on The non-internal model method for capitalising counterparty credit risk exposures**

Dear Sir/Madam,

UBS would like to thank the Basel Committee on Banking Supervision for the opportunity to comment on the Consultative document on The non-internal model method for capitalising counterparty credit risk exposures. Please find attached our response to the consultation.

We would be happy to discuss with you, in further detail, any comments you may have. Please do not hesitate to contact Thomas Pohl on +41 44 234 76 70.

Yours sincerely,  
UBS AG

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**UBS Response to the Basel Committee on Banking Supervision Consultative Document on The non-internal model method for capitalising counterparty credit risk exposures**

**INTRODUCTION**

UBS would like to thank the Basel Committee on Banking Supervision (BCBS) for the opportunity to respond to the Consultative Document on The non-internal model method for capitalising counterparty credit risk exposures. Please find below our comments on the key principles as well as the specific questions set out in the paper.

We broadly welcome the proposal to develop a single non-internal model method (NIMM) that is being considered to replace both the Current Exposure Method (CEM) and the Standardized Method (SM) in the Basel risk-based capital framework. Overall, it represents an improvement over the existing non-modelled approaches for calculating exposure at default (EAD) for derivatives as it better reflects differences between margined and non-margined transactions and takes better account of hedging and netting benefits. However, we have concerns about the proposed application of the NIMM in different areas of the Basel framework and note that there are several elements of conservatism built into the proposal which are likely to result in capital requirements that do not reflect the risk of the exposures (e.g. 1.4 scaling factor, flooring the replacement cost at zero, restrictions on diversification benefits).

Furthermore, it is important to note that NIMM only calculates EAD and the risk weight applicable to the EAD is a crucial determinant of the relevant capital requirement. We believe that the NIMM proposal should exist as a broader concept whose parameters can be adapted to suit different contexts rather than a one size fits all approach.

It is equally important to ensure that the proposed method is suitable for a wide variety of derivatives transactions and acts to reduce undue complexity.

**Below please find our Technical Observations:**

- **Alpha Multiplier:**

In paragraph 14, an alpha scalar of 1.4 is used to calculate EAD under NIMM, where  $EAD = \alpha \cdot (RC + PFE)$ . Using the same multiplier of 1.4 as applied in IMM suggests that NIMM supervisory factors are not calibrated to reflect the risk factors observed in a stressed environment. UBS would appreciate further insight in relation to the reasoning and methodology behind the use of the 1.4 alpha. Transparency regarding the methodology used to calibrate the supervisory factors and correlations would be beneficial to determine the appropriateness of the proposed alpha scalar.

Furthermore, the alpha scalar itself should be differentiated based on its application. For instance, for the capital treatment of bank exposures to CCPs, the initial margin collateral which is an exposure to CCP as opposed to risk reduction should be waived from applying the alpha scalar.

- **PFE Add-On Multiplier:**

In paragraph 42, PFE is defined to have two components; (i) an aggregate add-on across asset classes and (ii) a multiplier that allows for the recognition of excess collateral or negative mark-to-market value for the transactions. We agree the concept of using a multiplier to recognize excess collateral and negative mark-to-market as a part of PFE calculation. However, we believe the reasoning to use 5% as the floor in the formula in paragraph 85 should be outlined in order to justify the appropriateness of the level. In the instance of application to CCPs, the floor should be lowered to zero since CCPs only receive collateral from clearing members and not the other way around.

- **Netting Sets:**

The introduction of netting sets for each asset class in the NIMM approach is welcomed and should allow for netting benefits across related trades where netting eligibility exists. Regarding the asset class level, we note the following:

Add-on for Interest Rate Derivatives: Approach 1 outlined in paragraph 56, in which some offsetting across maturity buckets is allowed, is the preferred approach. We also believe offsetting should be allowed across currencies within the interest rate asset class.

Add-on for Foreign Exchange Derivatives: As outlined in paragraph 60, each currency pair constitutes a hedging set with no offsetting allowed and no differentiation made in supervisory factors. We believe partial offsetting should be allowed for across currency pairs. Furthermore, supervisory factors and correlations should be determined on netting set level. No allowance for offsets across currency pairs is a highly conservative treatment for foreign exchange derivatives that are mostly highly liquid.

Add-on for Commodity Derivatives: Four broad categories of commodities are introduced in paragraph 76 as hedging sets with one and the same correlation factor of 40% introduced on the summary table of add-ons in paragraph 96. Given the cyclical nature and higher volatility of commodity products, it would make sense to vary the correlation factor by hedging set. We would also appreciate additional detail on the calibration method to enable us to better assess its appropriateness.

- **Supervisory Delta Adjustments:**

We welcome the introduction of a delta adjustment to notional calculations of options used in NIMM, which is a significant improvement relative to CEM. However, the generic delta of +/- 0.5 across non-linear instruments introduced in paragraph 48 can misstate the risk exposure level of these products significantly depending on the moneyness and structure of the options. Consequently, we recommend the use of delta adjustments per contract as determined by the firm (consistent with the Standardized Method approach for Market Risk) and subject to approval by local regulators. If an internally determined delta adjustment framework is not acceptable to the BCBS, we believe a more comprehensive outline of delta factors should be developed, based on the moneyness of the option contracts, to better estimate risk exposure levels.

- **Supervisory Factors and Correlations**

The supervisory factors introduced in the NIMM proposal, as set out in paragraph 96, are a significant improvement on the current framework as margined and non-margined contracts are differentiated. Furthermore, correlation factors are outlined for improved netting eligibility. Understanding the calibration of the add-on factors is very important in order to comment on

the appropriateness and conservatism of the proposed add-on levels. However, we believe it is a significant improvement on CEM.

### Comments on individual consultation questions

**Q1. Should the Basel Committee replace the CEM and SM with the NIMM in all areas of the capital framework? What are the benefits and drawbacks of using the NIMM in each of these areas?**

#### UBS response

As outlined above, welcome the proposal for NIMM as a step in the right direction. As an alternative to the current exposure method (CEM), it is clear that NIMM has the potential to perform better as a measure of exposure. However, we have concerns about the potential use of NIMM in certain areas of the Basel framework.

In addition to Risk Weighted Assets calculation, NIMM is proposed to replace CEM for the Leverage Ratio and Large Exposures reporting. Whilst we welcome use of NIMM under such areas of capital framework, we believe its parameters (e.g. alpha) should be capable of being adjusted to ensure NIMM appropriately reflects the relevant risk. The results of the BCBS QIS should be used to calibrate the appropriate factors for use in these areas. In particular, in NIMM's use in the capitalization of bank exposures to CCPs, the application of any alpha factor and PFE multiplier should be adjusted to reflect appropriate capital requirements for bank exposures to CCPs. In the absence of a differentiated approach between centrally cleared derivatives and OTC Derivatives, we are concerned that central clearing would become economically unviable for all market participants, which goes against the regulatory objective of incentivizing central clearing for reduction of systemic risk within the financial industry.

**Q2. Is the proposed approach of retaining the general structure of the CEM with respect to replacement cost and the potential future exposure add-on appropriate? Is the division of the broad asset classes appropriate?**  
**Q3. Are there specific product types that are not adequately captured in the outlined categories?**

#### UBS response

We support the general structure of replacement cost and potential future exposure add-on components in NIMM with caveats highlighted in the paper in relation to the appropriateness of the proposed static factors. The broad asset classes defined in the

proposal are appropriate for use. However, we believe further diversification across asset classes should be introduced. In particular, diversification between Foreign Exchange and Interest Rate asset classes need to be considered as well as diversification between hedging sets within an asset class.

Under asset classes of Interest Rates and Foreign Exchange, however, maturity buckets and cross-currency netting eligibility are proposed above for consideration.

Regarding the adequate capture of specific product types, we believe all product types are well covered; however, the risk level of structured products under each product type might be inadequately captures with a rules based method like NIMM.

**Q4. Does the above approach reflect the replacement cost of margined transactions? Are there any other collateral mechanics that the Basel Committee should consider?**

UBS response

The NIMM replacement cost calculation assumes that a collateral group and a netting set are identical. Whenever this assumption is satisfied, the definition of RC in NIMM as the value of the trades in the netting set minus the net collateral does not present any special difficulties. However, if the terms of the collateral agreement such as the threshold, the minimum transfer amount, and/or the initial margin threshold is non-zero, the definition of NIMM must be modified. This is consistent with Basel II/III caps and it is also implied in the shortcut method in Basel II/III. The framework should ensure that banks are not worse off by using a legal agreement rather than not using such an agreement.

**Q5. Of the options under consideration for recognising offset across hedging sets, which treatment is preferred? What number of maturity buckets is appropriate to consider?**

**Q6. Is the proposed approach of using a different methodology for determining the add-on for each asset class appropriate? Is each proposed add-on methodology for each asset class effective at capturing the main risk driver of that asset class?**

#### UBS response

Regarding the preferred treatment for recognising offset across hedging sets, for interest rate derivatives add-ons, approach 1 would be of preference, which allows for some offset across maturity buckets.

We propose an increase of maturity buckets to more than three, and potentially six, to adequately reflect the risk bucketing of these products. An appropriate correlation structure should also be formed to support an increase in maturity bucketing.

Regarding the methodology for determining the add-on for each asset class, we believe that under a rules based method such as NIMM, the use of different methodologies for each asset class is appropriate. Please see the netting sets section for our technical observations on the granularity of factors under asset classes. We would appreciate additional detail on the calibration of the factors to enable us to opine further on their appropriateness.

The asset class netting should go further. As outlined before, the netting sets should expand to include cross – interest rate correlations (net across different currencies) as well as netting across FX and Interest Rates.

**Q7. Are the proposed minimum time risk horizons for each transaction category (unmargined, non-centrally cleared, centrally cleared) appropriate? Should the Basel Committee consider factors other than the IMM for determining the appropriate time risk horizon for the NIMM (e.g. harmonising with other international or national legislation)?**

#### UBS response

We support the proposed approach, which is consistent with IMM.

**Q8. Do the suggested formula and 5% floor appropriately recognise the benefits of overcollateralisation?**

#### UBS response

We understand that the question of differentiated applications of NIMM is still open. As it stands the 5% does not adjust for different contexts. We believe additional transparency is required in relation to the empirical analysis performed to justify the proposed level.

The proposal does not consider sufficient benefit for trades that are deep in clients favour, in particular unsecured transactions. Flooring the RC to 0 overstates the risk on unsecured trades, and does not give sufficient benefit to overcollateralization.

**Q9. Is the proposed approach to aggregate across asset classes appropriate?**

UBS response

UBS supports aggregation across asset classes, and further diversification within an asset class itself. We support the proposed considerations to diversify between Equity and Credit. We also believe there should be diversification between Interest Rates and FX asset classes.

**Q10. Are there any risk factors that should be included in their own category or accounted for in another manner?**

UBS position

More time and analysis is required on live portfolios to opine in detail.

**Q11. Is the proposal to introduce the multiplier in order to allow reduction of the PFE add-on in the IMM shortcut method appropriate?**

UBS response

We believe the use of the multiplier in IMM would be a consistent approach to follow and support its application. The multiplier provides an offset benefit for over collateralization and negative mark-to-market. However, we believe further transparency is required around the use of 5% floor in the multiplier formula outlined in paragraph 99 so that industry can better assess its appropriateness.