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Secretariat of the Basel Committee on
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Bank for International Settlements
Centralbahnplatz 2, 4002 Basel
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By email: baselcommittee@bis.org

Zurich, 11 October 2013

Re: Discussion Paper on "The regulatory framework: balancing risk sensitivity, simplicity and comparability"

Dear Sir/Madam,

UBS would like to thank the Basel Committee on Banking Supervision for the opportunity to comment on the Discussion Paper "The regulatory framework: balancing risk sensitivity, simplicity and comparability". Please find attached our comments on the Discussion Paper.

We would be happy to discuss with you, in further detail, any questions you may have. Please do not hesitate to contact Steve Hottiger on +41-44-234 50 64.

Yours sincerely,

UBS AG

Tom Naratil
Group Chief Financial Officer

Philip Lofts
Group Chief Risk Officer

1. INTRODUCTION

UBS would like to thank the Basel Committee on Banking Supervision ("BCBS") for the opportunity to comment on the Discussion Paper "The regulatory framework: balancing risk sensitivity, simplicity and comparability" ("Discussion Paper").

We are aware that the risk-based capital adequacy approach and in particular the model-based risk-weighted assets (RWA) concept suffer from public criticism, with concerns relating to a lack of comparability and the complexity of the underlying concepts. It is crucial to increase the credibility of the risk-based framework and publicly defend it in order to maintain stability and certainty in the financial system. UBS is committed to the joint goal of the industry and the supervisors to improve the stability of the financial system. In this context, it is of utmost importance to strike the right balance between risk sensitivity, simplicity and comparability as a lack of risk sensitivity would lead to adverse incentives and endanger financial stability.

We stand ready to pro-actively contribute to finding solutions to address related concerns. UBS is keen to work with the regulatory authorities to increase the credibility of the risk-based approach which is absolutely the right concept as it allows for risk sensitivity and sets the right incentives to reduce risks in the financial system. We are convinced that the risk-based approach along with a back-stop leverage ratio as well as the internal model approaches as applied in Basel III is the right combination to ensure financial stability and the efficient provision of financial services to households and corporations.

At the same time, we deem it premature to consider completely re-shaping the Basel framework before Basel III is even implemented consistently across different jurisdictions. The Basel III framework is a major step forward and should be consistently and timely implemented globally as a matter of priority. Basel III, in combination with the ongoing initiatives, such as the FSB's Enhanced Disclosure Task Force (EDTF) and the BCBS assessment on the regulatory consistency of RWAs, will further improve the capital adequacy framework. UBS therefore strongly endorses a more consistent implementation of Basel III along with these BCBS and FSB initiatives as they ultimately help to increase the credibility in the capital adequacy framework. In addition, banks' adherence to established regulatory standards on model risk management (for example, as outlined in the FED SR Letter 11-7 *Supervisory Guidance on Model Risk Management*) will ensure the application of effective model risk management frameworks, including robust model development, implementation and use.

In addition to this comment letter, UBS supports the comments made by the Global Financial Markets Association (GFMA) as well as by the Institute of International Finance (IIF) together with the International Swaps and Derivatives Association (ISDA). In particular, we support the industry associations on their positions with regard to the leverage ratio and the standardized approach as misdirected and ineffective measures to reduce complexity.

Please find below our suggested key principles that a capital adequacy framework needs to fulfill (section 2), our outline of ideas that we think are ways that could help to increase the credibility of the Basel III framework (section 3), as well as our comments with regard to the specific questions set out in the Discussion Paper (section 4).

2. KEY PRINCIPLES FOR A PRUDENT CAPITAL ADEQUACY FRAMEWORK

We believe the following key principles should guide any prudent capital adequacy framework.

A. Risk Sensitivity is the core element of the capital adequacy framework.

UBS agrees with the BCBS's belief expressed in paragraph 3 of the Discussion Paper that a risk-based capital regime should remain at the core of the regulatory framework for banks. Only a risk-based approach incorporates appropriate risk sensitivity and accurate risk measurement by ensuring that capital requirements correspond to actual risks incurred. This ultimately supports financial stability. The development of an overall measure of risk that is both comprehensive and broadly aligned with economic and financial principles is an important objective. In particular, the requirement for use test compliance ensures that firms are required to use models and their output for external regulatory capital reporting, internal risk and capital management. UBS has implemented the requirements of the Basel III framework which put risk sensitivity at its core and reflects many of the lessons learned in the last crisis, ahead of the internationally agreed schedule. Our experience to date has reinforced our conviction that this is the correct approach.

A radical overhaul of the risk sensitive capital adequacy framework as discussed in a number of sections of the Discussion Paper would undo some 15 years of mostly sensible enhancements to the Basel framework, which were adopted to address shortcomings in the rather simple original formulation of the Basel Accord of 1988. In particular, we disagree to give up risk sensitivity for simplicity. Considerations of how to balance simplicity and complexity should be centered on the question of how to capture true risks in a cost-effective and well-understood way.

The regulatory framework should motivate banks to properly manage their risks, by encouraging appropriate hedging mechanisms and other risk management techniques. In particular, regulatory capital rules should not create disincentives for banks to prudently manage their risks, or conversely incentivize them to arbitrage the rules. UBS therefore particularly disagrees with two measures which would result in a substantial loss of risk sensitivity: the use of a more binding leverage ratio and a renewed emphasis on applying standardized approaches to risk-weighted assets. Neither of these are sufficiently risk sensitive as they fail to recognize significant differences in risk profiles through their incorporation of very crude assumptions and simplifications. We agree with the industry associations that the leverage ratio is an essential part of the Basel III framework and support the efforts to impose a leverage ratio as a means to reinforce the risk-based requirements with a simple, non-risk-based 'backstop' measure. However, transforming the leverage ratio into the binding risk measure would be a mistake and would misalign incentives against the desired achievement of appropriate risk-based outcomes. As outlined in the IIF response, the leverage-based approach alone can lead to wrong incentives, magnify downside risks to financial stability and constrain certain credit activities.

B. Internal models are the foundation of the risk-based approach.

Internal models have been introduced by the regulators and the industry to promote accurate reflection of true risks, ensure that the banks' incentives from internal risk management and from regulatory capital requirements align, and reduce systemic risk as banks will act in a less correlated way. Therefore, internal models are the foundation of an effective risk-based capital adequacy approach. The recent financial crisis did not reveal a shortcoming of this approach.

The standardized approach is not sufficiently risk sensitive as the standardized risk weighting may diverge substantially from the actual risks potentially generated by certain assets. It reduces risk management to a limited number of drivers which are supposed to measure the risks, but do not necessarily do so. Simple factors such as a credit rating, for example, are not necessarily sufficient to reflect true risks of a position. The standardized approach inadequately differentiates risks among borrowers which superficially fulfill the same criteria. As a result, the crudeness of the approach can result in many assets with dissimilar actual/economic risks being assigned the same risk weight, whilst permitting superficial changes in the form of an asset or transaction to result in substantially different capital requirements being assigned to what is essentially the same risk.

A standardized approach would likely discourage banks from developing sophisticated but costly risk management systems as they would be delinked from capital requirements so that ultimately risk taking could increase. The industry has invested large amounts in the development and maintenance of reliable internal models and the requirements stemming from pillar 2 on internal risk management. The use of more standardized approaches, driven by a desire for simplicity, would mean a step backwards in the direction of Basel I which had several notable shortcomings. First, under Basel I the incentives of the regulatory requirement and the internal risk management did not align. The current framework with internal models and use tests helps to align internal risk management and regulatory requirements. Second, Basel I led to information asymmetries between the regulators and the industry in terms of actual risk measurement and management, which the current approval and use test requirements of internal models help to reduce as the regulators have the possibility to review what assumptions the individual banks use and how they manage individual risks. Third, the standardized approach encouraged regulatory arbitrage, which a risk-based approach does not.

One proposal has been for the parallel disclosure of RWAs according to the internal models and the standardized approach. Our concern with this is that it will encourage various stakeholders, including analysts and journalists, to focus on the easy to understand approach, which will likely erode the relevance of the risk sensitive framework over time and result in actual risks being misinterpreted by market participants.

C. Diversity in risk measurement and management increases financial stability.

The regulators' primary aim, as expressed in the BCBS paper, is to strengthen the regulatory framework against systemic risk. Systemic risk is exacerbated when banks are positioned and act in an aligned way. Regulatory actions that aim at motivating banks to act in a more-aligned way would therefore result in an increase of systemic risk. Since banks will be motivated to manage to whatever set of metrics regulators use to govern them, regulators should ensure that those rules actually motivate banks to act in such a way as to reduce systemic risk, whilst also encouraging them to manage their individual risks most optimally.

Therefore, we encourage regulators not to define highly prescriptive means of determining bank capital requirements, regardless of whether those prescriptions are simple or complex, but instead to encourage a diversity of such treatments, whilst motivating each bank to optimally manage its own risks. This leads to a preferred outcome that each bank best serves the public interest by managing its risks on the basis of its own internal risk assessment and encourages risk diversification. If by contrast, all banks apply the standardized approach this will increase the risks in the system as the use of standardized models will lead to the fact that there is no diversification across the banks in risk assessment and measurement.

It is important to note that the model diversity and flexibility of banks is already today limited as there is the requirement for use test compliance and thorough external model validation and approval procedures. Contrary to the public opinion, this flexibility resulted in the fact that banks frequently add a margin of conservatism to risk parameters, as the BCBS in its banking book RWA analysis noted.

D. A regulatory framework needs to be reliable, stable and consistent for the market participants.

UBS agrees with the BCBS that a "full, timely and consistent implementation of Basel III remains fundamental to building a resilient financial system, maintaining public confidence in regulatory ratios and providing a level playing field for internationally active banks", as outlined in paragraph 6 of the Discussion Paper. We are therefore concerned that the BCBS questions its own Basel III approach even before it is fully implemented in all jurisdictions. We have strong concerns that we currently seem to be moving further away from a level playing field. Despite tremendous efforts being expended to create global standards, regulatory fragmentation seems to deepen as certain jurisdictions tweak the rules to maintain or improve their competitive position, or worse allow delays in the implementation of Basel III. It is important to create awareness of the costs that international inconsistency creates. This uneven international playing field particularly penalizes early movers who embraced Basel III and increased their capital base and cost of conducting business as a result. The banking industry has invested large amounts to be able to fulfill all Basel III requirements according to the defined timeframe. Changing the regulatory framework now will make these large investments obsolete and further increase the regulatory cost burden of the industry. It is important to rely on a credible and stable regulatory environment where banks can adjust their business model accordingly, in particular since the financial markets are still fragile and the role of banks in financing businesses and economies is essential. Regulatory uncertainty can limit the efficient allocation of capital, reduce credit supply and increase the financing costs of households and corporations.

The BCBS, and other regulatory bodies such as IOSCO and FSB, are playing an important role in promoting harmonization of global regulatory standards. Specifically, we strongly encourage the international and national regulators to collaborate more effectively and to define international standards against which the internal models are validated and approved. Nevertheless we acknowledge that to improve comparability it may be necessary to limit some discretion in the way that internal models are deployed, for example by standardizing time series or confidence intervals. However, this should not result in a trade off of risk sensitivity.

E. A regulatory framework needs to be credible.

In order to maintain stability and certainty in the financial system, credibility of the risk sensitive capital adequacy framework is important. In this respect, we ask the BCBS and other regulators to play a more active role in defending the internationally agreed capital adequacy framework and in educating the public on the requirement of a risk sensitive framework for the reflection of true risks. In particular, the incorrect perception that banks minimize their capital requirements needs to be corrected. The industry applies standards that were set and models that were reviewed by the supervisors. In particular, the role that external model validations play is not sufficiently stressed in the public debate. Nevertheless, we agree that there is a need to take measures to increase the credibility of the risk sensitive and internal model approaches. We outline some proposals in the following section.

3. POTENTIAL MEASURES TO INCREASE CREDIBILITY

UBS is keen to work with the regulatory authorities in order to increase the credibility of the risk-based approach which, as already stated, we firmly believe to be conceptually correct. To be clear, we endorse a consistent implementation of Basel 3 in combination with other ongoing initiatives, such as the Enhanced Disclosure Task Force (EDTF) and the BCBS assessment on the regulatory consistency of RWAs, which will increase the credibility of the risk-based capital adequacy approach. In addition, we would like to underline two areas where additional measures could increase the credibility of the risk-based approach.

First, there are large national discretions and a limited collaboration between regulatory authorities. Currently, banks have to comply with requirements regarding internal models that differ between the different national regulators. This leads to the situation that banks have to apply different versions of the same internal models in order to comply with the specific requirements of different national authorities. This is an undesirable situation for the banks as well as for the regulators. We therefore strongly encourage international regulators to agree among each other on a set of standards against which internal models are validated and approved. Supervisors should work together more effectively in order to strive for consistent standards and for greater efforts to be invested in cross-sectional reviews of the types now being conducted. We would expect regulators to have a common internationally agreed approach in terms of the requirements under pillar 1, while allowing for greater subjectivity under pillar 2. This would also allow the national regulators to have a better understanding of the mechanics and increase comparability while maintaining sufficient flexibility for banks to manage their risks most effectively.

Second, UBS strongly supports the idea of regularly applying models to standardized hypothetical portfolios, as proposed in Paragraph 53 of the Discussion Paper. These exercises allow both the regulators and the banks to compare model outputs and to identify outlying results. Armed with that information, banks can more closely review their models which appear to be out of line with their peers, and regulators can target their inquiries accordingly, particularly in respect of material models.

In addition, over the past few years, significant guidance has been provided by regulators to the banking community on model risk management, for example in the FED SR Letter 11-7 *Supervisory Guidance on Model Risk Management*. This guidance addresses the key aspects of an effective model risk management frameworks including robust model development, implementation and use. This guidance requires "effective challenge" of models. It also asserts that materiality is an important consideration in model risk management and requires that where models and model output have a material impact on business decisions, including risk management and capital and liquidity planning, a bank's model risk management framework should be more extensive and rigorous. Clearly, banks adherence to these guidelines, closely and consistently monitored by the regulatory authorities, should provide confidence in and thereby reinforce the credibility of the application of a risk-based model approach.

4. SPECIFIC COMMENTS TO THE QUESTIONS

Q1: Does the current framework, with its reliance on the risk-based capital at its core, appropriately balance the objectives set out in paragraph 29?

Overall, the Basel III framework balances the objectives well. It is a sound minimum standard that puts risk sensitivity at its core and includes a comprehensive set of measures, including capital, leverage, and liquidity requirements.

We believe that a risk-based capital regime should remain at the core of the capital adequacy framework. In particular, the framework is well-designed as it allows for the use of internal models and defines the leverage ratio as a backstop measure. Despite its risk sensitive nature, it still allows for a significant degree of comparability, in particular as the Basel III accord allows for much less national discretion than earlier accords. If implemented consistently, the framework would allow for a level playing field, and this to a greater extent than simpler approaches, such as the standardized or the leverage ratio approach, where similar risk exposures are not subject to similar capital requirements. Nevertheless, one of the key concerns remains the inconsistent implementation and missing level playing field. Also the Basel III framework allows the banks to align capital requirements with risks and therefore avoids distortions in risk-taking incentives. The risk-based capital regime incentivizes robust risk measurement. Banks have invested heavily in the development of measurement of credit, market, and operational risk.

Q2: Are there other objectives that should be considered in reviewing the international capital adequacy framework?

The true reflection of risks should remain the primary objective of the framework. Additional supporting/subordinate objectives would be valuable:

- Cost effectiveness and ease of implementation: Regulation needs to be suitable to achieve the identified aim, but be the least restrictive alternative available to achieve this aim. The Discussion Paper's focus on simplicity may partially address the objective of cost effectiveness and ease of implementation. However, this subordinate objective should not restrict risk sensitivity in any way.
- Reliability and stability of regulation: As addressed in our key principles, the regulatory environment needs to be reliable and stable.

Q3: To what extent does the current capital framework strike the right balance between simplicity, comparability and risk sensitivity, given the costs and benefits that greater risk sensitivity brings?

In UBS's view the current capital framework strikes the right balance between risk sensitivity, simplicity and comparability. Risk sensitivity must remain at the core of the capital adequacy framework. To a large extent, the current capital framework based on risk sensitivity complemented by a backstop leverage ratio strikes the right balance. The introduction of Basel III has improved and will further improve the capitalization of banks. As noted above, it is important that the framework is consistently implemented which requires on-going efforts on the part of the Basel Committee and the supervisors on the country level. The Regulatory Consistency Assessment Program (RCAP) studies and other monitoring exercises are valuable in order to achieve a global level playing field.

The Basel III framework is more comprehensive than earlier accords as it includes a number of new ratios, such as NSFR and LCR that measure the balance sheet and funding structure. Also, the ongoing reviews of the trading book and other initiatives to adjust the calibration of the Basel III framework are enhancing capital adequacy framework.

Q4: Which of the potential ideas outlined in Section 5 offer the greatest potential benefit in terms of improving the balance between the simplicity, comparability and risk sensitivity of the capital adequacy framework?

A. Explicitly recognizing simplicity as an additional objective.

As noted above, the primary objective should be risk sensitivity in order for the accord to allow for the appropriate measurement of risk. The objective is to measure, manage, and monitor risks appropriately. One of the most important lessons from the financial crisis is that it is critical to continue to measure, manage, and monitor risks in the financial system, and to continuously and rigorously validate, backtest and update these practices on the basis of new or expected developments. Risk measurement per se is not simple and realities in the modern global financial system are complex.

Given that this real world complexity is unavoidable, simplicity should not be a primary objective. Settling for simple measures will not achieve the objective to measure the true risks appropriately. Simplicity should not be an argument for unduly simplifying the regulatory framework. Risk sensitivity is important to ensure that regulatory metrics align with economics of transactions, internal risk models and internal equity/capital allocation process. More simple measures could have too high opportunity costs, most notably when they lead to sacrificing the capital framework's risk sensitivity. As outlined above, in particular the leverage ratio and the standardized approach fail to recognize significant risk profiles differences as they are based on very crude assumptions.

Simplicity is a desirable feature of any regulatory framework as no regulatory framework should entail unnecessary complexity. We strongly support simplicity in the meaning of cost effectiveness and ease of operational implementation. This type of simplicity would facilitate the implementation of the global standards in the different jurisdictions and would help to ensure a global level playing field. In order to increase the understanding and ultimately credibility in risk measurement and RWA calculation, simplicity is the wrong approach. Instead higher transparency could increase the acceptance of more complex risk measurement methods. Below, we propose different types of disclosures that aim at increasing the acceptance.

B. Enhancing disclosure

While we agree that certain disclosures aid comparability, transparency and potentially the acceptance of risk measurement, it is very important that additional disclosures add value to the reader, do not give the wrong signals and are balanced with confidentiality concerns as well as cost/benefit considerations. While enhanced disclosures have the advantages that they don't sacrifice on the objective of the capital framework's risk sensitivity and could be helpful to create more credibility in the RWA calculation, the potential benefits of such disclosure for end users must be worked out carefully in collaboration with the various stakeholders in order to avoid complexity and costs for the banks.

It is important to clearly distinguish between disclosures that are of value to the regulator and others that are of value to the investor community. Additional disclosures not necessarily increase credibility, in particular when disclosures are not harmonized, duplicative and complex to understand. Banks are facing significant increases in demands and requirements for disclosure; oftentimes these initiatives are not coordinated or aligned. The proposal which seeks to bring to light more detailed information about the inputs and outputs of the capital adequacy calculation could be valuable if it is aligned and consistent.

We endorse the work of the Enhanced Disclosure Task Force (EDTF) and the recommendations issued by the EDTF in its report 'Enhancing the Risk Disclosures of Banks'. The EDTF combined together preparers as well as users and accounting firms, resulting in disclosure recommendations that reflect a broad perspective. Our Annual Report for 2012 contained disclosures cited publicly as leading or good practice and we will be including further enhanced disclosures in the context of these recommendations in our Annual Report in 2013.

As outlined in the previous section, UBS strongly endorses the idea of regularly applying models to standardized hypothetical portfolios, as proposed in Paragraph 53 of the Discussion Paper. These exercises allow both the regulators and the banks to compare model outputs and to identify outlying results. Armed with that information, banks can more closely review their models which appear to be out of line with their peers, and regulators can target their inquiries accordingly, particularly in respect of material models. Yet, we are not supportive of disclosures of the results of standardized calculations even if only in addition to the results of internal models. Such disclosures will only serve to highlight how standardized models are less finely calibrated, therefore yielding different outcomes, and will not convey any information about the quality of a firm's internal model. Standardized RWAs are simple to calculate but will not increase transparency of the true risks across the different banks. Also, the standardized approaches differ between jurisdictions and are not comparable. Since they standardized models are easier to understand in case of parallel disclosures of the standardized and internal model results there is the risk that the various stakeholders, including analysts and journalists will focus on the standardized approach and the importance of internal models approach will erode. As noted above, this would be dangerous and imply serious consequences for the industry and financial stability. Banks will be disincentivized to build best-in-class models and risk taking could increase. The credibility of the risk-based approach will deteriorate.

C. Using additional metrics

UBS agrees that a broader set of metrics against which banks can be compared could prove valuable for supervisors and investors. Standardized definitions and disclosure templates are useful as they allow for higher comparability. In case where metrics are already available or can easily be calculated based on the current disclosures we would support disclosing such metrics based on a more standardized template. However, we do not agree with additional regulatory requirements based on these additional metrics in terms of thresholds or capital requirements.

Furthermore, we do not believe that it is helpful to mandatorily add most of the proposed measures to banks' existing disclosure obligations. Market participants can easily create many of the proposed metrics with publicly available data more frequently, and in a more timely fashion, than banks can provide in their disclosures. In this case banks might just be required to duplicate information that is not used as the consumers of such information continue to use their own data and calculations. Also, the disclosures should allow for better comparability but not send the wrong signals. Many of the proposed measures seem to have a limited value from a risk perspective as they are mainly business or market-driven.

Market-based indicators can over- and underestimate the fundamental risks as they are driven by market volatility and often pro-cyclical.

In terms of risk-related metrics, we would be happy to discuss in more detail the potential to disclose more standardized disclosures on quantitative assessment of total risk under pillar 2. This kind of information can help to show the extent to which a reduction in RWA is being accompanied by a corresponding reduction in economic risk. However, we are concerned that no meaningful standardization is possible as the approaches are usually not comparable between the banks. Also, quantitative assessments of total risk only add value if their drivers can be easily understood and compared which can only be achieved if enforced and heavily standardized. Enhanced disclosures on internal stress tests including assumptions and impacts on P&L as well as capital could be considered as an alternative in this context. More granular information on stress test results could be used to strengthen the credibility of the advanced RWA models. In our view, pillar 2 calculations have not received sufficient attention in comparison to Basel's pillar 1 and pillar 3. Other metrics proposed in the Discussion Paper, such as the ratio of non-performing assets to total assets or asset growth, are indicators of risk and can add certain value to the investor community.

In any case standardized metrics should be aligned where possible with definitions used in other reporting initiatives already in place; and such standardized metrics should replace similar metrics that are being reported to regulators or disclosed to the public.

D. Ensuring the effectiveness of the leverage ratio

As noted under the general principles we are in support of the current Basel III approach, where the leverage ratio is not the constraint in normal times, but a backstop that should only become binding in stressed times. In Switzerland the regulator has already implemented a model where the incentives of the capital ratio and the leverage ratio approaches are aligned. In our view a leverage ratio which limits the capacity for excessive leverage is reasonable.

However, UBS is concerned about any proposal that would result in a leverage ratio becoming a binding constraint rather than a backstop. The proposals outlined in the Discussion Paper would increase the stringency of the leverage ratio through the use of buffers or the increase of the requirements for G-SIBs, and potentially lead to a more binding leverage ratio. These proposals could undermine the benefits of the risk-based approach. As outlined by the IIF, the leverage ratio is deficient in every dimension: it is not risk sensitive, it sets the wrong incentives, it is not simple, and it does not result in comparable results due to the inconsistencies in the way the denominator captures exposure. A binding leverage ratio would mask the real complexity of the real world.

E. Utilizing added floors and benchmarks to mitigate the consequences of complexity

UBS is not supportive of strict floors as they undermine a coherent, risk-based framework. Floors would restrict the risk sensitivity of the capital framework which is important for ensuring that capital is proportionally to risk and to maintain incentives for banks to continue to improve their risk measurement and management systems. Many floors, benchmarks, and other safeguards against model risk already exist in the capital framework. Also the regulator has the possibility for add-ons/ floors in case he thinks the internal models are insufficient. This allows the regulator to introduce specific floors in justified circumstances. Additional safeguards to the capital framework have already been introduced with the leverage ratio and Pillar 2 requirements. Floors do not improve comparability of outcomes.

On the contrary, such constraints could mask true variations in risk, and would not necessarily assign the correct risk weight or capital level to variations in risk that are due in whole or in part to model risk. In particular, it would be difficult to establish floors that are calibrated in a way that they represent the underlying risks.

Any floor or benchmark relying on the use of standardized approaches without considering sound risk analysis or management would only mask weaknesses and create perverse incentives. Whilst this applies to standardized approaches used for all risk types, it is most critical for market risk. A lack of timely updates associated with market, product and macro-economic developments in market risk capital approaches can negatively affect financial stability. In addition, imposing floors to internal models would reduce the incentives for banks to develop and maintain sophisticated risk measurement and management models. Banks will be incentivized to calibrate towards the floor, leading to model concentration risks. Risk measures influence business decisions, and can in this case lead to the wrong incentives: for instance it will make it more challenging for risk functions to communicate to the business functions the need to mitigate risk if risk mitigation is not adequately reflected in regulatory capital requirements.

Certain Probability of Default (PD) or Loss Given Default (LGD) floors are maybe useful. In particular as certain banks have difficulties to estimate LGDs or PDs accurately due to only few historic data points. Such floors would need to be calibrated very carefully in order not to create distortions that are too deleterious. It is important to consider that different banks are following different strategies which can result for instance in different LGDs or other parameters (as an example: different banks with different recovery strategies can have different estimations of LGDs). The floors would need to be set accordingly to take this into account. Similarly, the proposal to introduce benchmarks could make sense but would strongly depend on the types of benchmarks. Concrete suggestions would need to be evaluated. The major problem with benchmarks is that they set strong incentives on banks to align their business practices and therefore result in an increase of systemic risks.

F. Reconsidering the linkage between internal and regulatory models

UBS believes that the linkage between internal and regulatory models is crucial as risk-based capital requirements influence business decisions. A delinkage which would be the result of using a binding leverage ratio or standardized approach could create wrong incentives. As the regulatory model fails to take into account the true risks, banks would be incentivized to increase their risk profiles. Also, it would make it more challenging for risk functions to communicate to the business functions the need to mitigate true risks if the regulatory models to not adequately reflect these risks and there is not capital requirement effect. This is why we consider the use test requirement as an important principle that aligns internal and regulatory models. Where there are differences between internal model results for risk based capital purposes versus those for risk management, these should be justified by business reasons.

G. Limiting national discretion and improving supervisory consistency

As outlined by the IIF, the recent BCBS analyses of the RWAs in the trading and banking books, supervisory choices at the national level account for a non negligible part of the differences in RWAs. This is a major concern for UBS and we support the Basel Committee’s work on reviewing current uses of national discretion to assess the need for, and extent of, their use and support its idea to build a database of discretions and their use to aid comparison.

UBS also supports the recommendations with regard to harmonizing supervisory practice and national implementation requirements as outlined in the Basel Committee summaries of the trading book and banking book reviews conducted as part of the RCAP.

One way to achieve this would be if the international and national regulators work together more efficiently in order to standardize implementation approaches across jurisdictions and in particularly on model assessment and approval. Areas such as imposed capital add-ons for model risk or conservatism, and their application in Pillar 1 or 2, required (length of) data series, etc. are examples where harmonization of supervisory practices could be considered.

H. Improving the accessibility of Basel Committee documents

UBS would strongly welcome an initiative to improve the accessibility of Basel Committee documents. In particular we would endorse a single rulebook which consolidates all the Basel standards into a single, accessible, structured set of documents and which is always kept up-to-date. We also welcome the Basel Committee's initiative to improve the website allowing for a better navigation. In addition, we would encourage that there is a central database where the industry can access documents of the local Basel III implementations.

I. Addressing factors driving complexity in a more fundamental manner

UBS strongly objects to the proposed fundamentally different approaches of the Basel Committee's longer-term thinking which include a complete re-examining of the main pillars of the current capital adequacy framework. Before calling Basel III into question, the focus of the Committee should be on the consistent implementation of Basel III. All the three proposed ideas are very radical in nature and would lead to a fundamental discussion of the entire regulatory framework, and this before the current framework is installed entirely and has taken effect.

We are concerned about the implications of these proposals. The current standard of regulatory requirements of Basel III has been achieved only after several years of improvements. Since Basel I many lessons have been learnt, and the framework has been significantly improved. The new framework would show deficiencies in the beginning as well and it would take years until the new framework would be on a similar level as today's Basel III framework.

All of the three proposals would mean that the enhancements along the different Basel accords would be lost. In particular, the concept of the tangible leverage ratio did not produce the intended results under Basel I, and will not work now. This approach would also exclude off-balance sheet exposures which would in turn incentivize banks to turn to transactions which are not balance sheet relevant. It would reduce the risk sensitivity of the capital framework. Similarly, the combination of leverage ratio and standardized approach is deficient as this idea would reduce risk sensitivity and be based on very crude assumptions. As outlined above, the leverage ratio per se is not a simple concept, so that the main objective of these ideas would not be achieved either. Rather, combining these two crude and rigid approaches would be a gigantic step backwards as both would not reflect actual risks.

We likewise object the proposal of a pre-commitment approach as it is based on simple assumptions that are not realistic. As such, constant volatility and correlation assumptions are insufficient parameters to predict a crisis. This concept is a backward-looking framework which hinges on very strong simplified assumptions. One way to test the value of these three ideas would be to apply them to a variety of hypothetical crises and assess how they would have identified them ex ante.

We are also strongly concerned with the implications of the other proposed measures to reduce future banking risk and complexity, such as placing supervisory controls on the pace of development of highly complex and innovative financial instruments, restricting activities that are not designed to promote traditional customer-oriented banking business, and improving bank resolvability and reducing global and domestic interconnectedness. These proposals should not be part of a capital adequacy framework. The idea of placing supervisory controls on the development of complex and innovative instruments or the idea of activities that are not designed to promote traditional customer-oriented banking business would be part of product and not prudent regulation. Banking products innovation is usually driven by the need of end-users. Markets and economies are evolving and as a natural consequence customers' financial needs alter. The industry has strongly supported efforts to improve bank recovery and resolvability. There are already various measures in place or being in the process to be finalized.

Q5: Are there other ideas and approaches that the Committee should consider?

As outlined in section 3 we encourage regulators to increase international collaboration in order to reduce national discretion. International regulators should among each other agree on a set of standards against which internal models are validated and approved. This would also allow the national regulators to have a better understanding of the mechanics and increase comparability. However, it is important to keep sufficient flexibility for banks to manage the risks most effectively. Supervisors should work together more effectively in order to drive consistent standards and for greater efforts to be invested in cross-sectional reviews of the types now being conducted. Stress analysis provides a critical means to help improve robustness.

We acknowledge that to improve comparability it may be necessary to limit some discretion in the way that internal models are deployed, for example by standardizing time series or confidence intervals. However, this should not result in a trade off of risk sensitivity. We would be happy to discuss potential additional ideas in more detail.