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Secretariat of the Basel Committee on Banking Supervision

Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
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By email: baselcommittee@bis.org

Zurich, 18 January 2014

Re: Second consultative document "Fundamental review of the trading book: A revised market risk framework"

Dear Sir/Madam,

UBS shares the desire of the Basel Committee on Banking Supervision to seek strengthened capital standards and a more resilient banking sector, and we would like to thank the BCBS for the opportunity to comment on the second Consultative Document "Fundamental review of the trading book: A revised market risk framework"; herein we set out our response.

Our view of the appropriate framework to determine regulatory capital adequacy is based on the following assessment:-

1) Regardless of the framework used to measure their regulatory capital requirement, banks will be motivated to minimize their exposure as measured by the chosen prescription, so as to improve their apparent performance. It is therefore incumbent on regulators to align that capital framework, to the greatest extent possible, with the actual risks being run by the bank. Otherwise, the distortions in risk measurement (and subsequently in risk management) engendered by the regulatory capital prescription will not motivate banks to hedge their exposures properly, nor to manage their exposures optimally, to the detriment of the banks' clients, stakeholders and ultimately to the real economy.

2) Regardless of how simple or sophisticated the framework used, a detailed, uniform prescription as to how banks should measure their risks is extremely dangerous and should be avoided. This danger arises because of the motivation for banks to minimize

their capital requirements. If these requirements are highly prescriptive, detailed and applied uniformly, banks will be motivated to manage their risks and to position their books in a more-aligned way. This tendency to align positioning increases systemic risk, even if the prescription used to measure and manage the risk may have been better than the one that the bank would have adopted of its own volition. Paradoxical as it may seem, bank supervisors should motivate banks to adopt a diversity of risk management practices, not uniform standards (however high those standards may purport to be) in order to minimize systemic risk.

3) It follows from points 1) and 2) that supervisors should put more emphasis on Basel Pillar II, relying much more heavily on banks' own internal risk and capital adequacy assessments, and relatively less emphasis on ensuring uniform, prescribed treatments for capital underpinning under Pillar I. Emphasis on Pillar II motivates banks to align their own risk measurement and risk management practices (but not to align their practices with one-another), leading to optimal hedging and risk management using the best available knowledge of each bank's portfolio. At the same time systemic risk is minimized as banks persue diverse risk management procedures. We propose additional requirements for banks to perform granular P&L Explain and granular Back-testing of their models, as proposed in the Fundamental Review in respect of Pillar I models, as a means of giving comfort to supervisors as to the appropriateness of banks' own modeling choices.

4) We recognize that, whilst regulators should encourage diversity amongst risk management practices, nevertheless they could benefit from a deeper understanding of the comparability of different banks' aggregation methodologies. We therefore suggest that banks be asked to apply their methods to a suite of standard dummy portfolios supplied by supervisors. We acknowledge that this method is not foolproof; if the dummy portfolio contains positions which are not amongst the population that a particular bank trades regularly, then the bank may well not have appropriate valuation and risk aggregation models to handle those positions. Nevertheless, we believe that the transparency into banks' modeling which this method would allow would be of value to supervisors and allow them to scrutinize in more detail the methods of banks which appeared to be material outliers.

We would be happy to discuss with you in further detail, and answer any questions you may have.

Yours sincerely,

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