

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

Zurich, 11 March 2016

Re: Revisions to the Standardised Approach for credit risk - second consultative document

Dear Sir/Madam,

UBS would like to thank the Basel Committee on Banking Supervision ("BCBS") for the opportunity to comment on the second consultative document "Revisions to the Standardised Approach for credit risk".

UBS welcomes the iterative process being undertaken by the BCBS to define the Standardised Approach (SA) for credit risk. We appreciate that in particular the feedback with regards to the removal of the references to external ratings and the proposed use of single risk drivers was taken on board. It is of utmost importance that the final approach strikes the right balance between risk sensitivity, simplicity and comparability as a lack of risk sensitivity would impose adverse incentives, endanger financial stability and lead to increased economic costs.

In this regard, please find below our comments on some of the most important aspects set out in the second consultative document. Our response should be considered complementary to the Joint Associations' response¹ which UBS also contributed to and supports.

Overall considerations

- Despite the regulatory intention not to increase overall capital requirements, we find that the rules as proposed by the consultative document would in fact increase capital requirements to the detriment of critical bank lending activities. In particular, we find that SA RWAs for exposures to unrated corporates and exposures to counterparties with investment grade ratings can be materially higher than under the advanced approach. Consequently, and as outlined by the study by Bernardi, Perraudin and Yang (April 2016), a precise view of the future calibration of the floor proposal is required in order to fully assess the economic implications of the consultative document. We urge the BCBS to assess the economic implications of the proposal in the context of the floor proposal and the other revisions to the capital requirement framework, including market risk requirements, operational risk requirements, leverage ratio recalibration, IRRBB and TLAC. We are concerned that the cumulative capital requirements will not only exceed prudent levels, they will also have a significantly adverse impact on core lending activities and the boost needed to ultimately jumpstart the floundering economic recovery.

¹ Joint Association response by IIF, GFMA, ISDA and IACPM.

- We find that the risk weights are not calibrated in a manner that appropriately reflects the underlying risks of the exposures. For the final calibration of the risk weights, we encourage the BCBS to take into account not only the results of the on-going QIS exercise, but also the data provided by the industry, and the insights gained from the testing and review of IRB models by regulators. As this proposal would result in significantly higher risk weights for many asset portfolios a bank holds, it is critical that the industry participants be afforded a more concrete understanding of the BCBS analysis, statistical evidence and reasoning underpinning the proposed levels of risk weights. Such transparency would ultimately allow for a more factual debate and facilitate a greater engagement with the industry.
- We are convinced that the standardised approach can be only complementary to the IRB models. 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 to work towards achieving. In particular, the requirement for use test compliance ensures that firms are required to use models and their output for each of external regulatory capital reporting, internal risk and capital management. The regulatory framework should motivate banks to properly manage their risks by encouraging appropriate hedging mechanisms and other risk management techniques. In this regard, the standardised approach needs to be sufficiently risk sensitive so as to avoid providing massive disincentives to prudent risk management.
- Several proposals as currently set out in the consultative document will further hamper a level playing field in terms of the application of risk weights across jurisdictions. In particular, the proposal includes a bias towards jurisdictions where the use of external ratings is allowed. Risk weightings and the attending levels of RWA should be the same for a given level of underlying credit risk notwithstanding the potential legal differences between jurisdictions that may exist in terms of the use of external ratings. Also, there shouldn't be jurisdictional differences in the treatment of unrated exposures.

Methodological and technical considerations for the different exposure classes

Exposures to banks and corporates:

- With regards to the exposures to banks, the onus is on the banks to perform due diligence in the External Credit Risk Assessment Approach (ECRA), and in the grading assignment in the Standardised Credit Risk Assessment Approach (SCRA). Since this type of analysis is more aligned with the work a Credit Risk department will perform in its process, it makes sense to allow for the alignment of these processes. Where available, banks should be allowed to use their existing AIRB processes to compare the external to internal ratings and apply appropriate adjustments. Additionally, these AIRB processes also could form the basis for the allocation of bank exposures to grades A through C.
- The bucketing approaches for ECRA and SCRA should be harmonized. Currently ECRA offers a more granular bucketing approach, which may put banks in jurisdictions where external ratings are not allowed at a disadvantage.
- With regards to the standardised approach for corporates our concern is that the proposal is misaligned with, and less granular and risk sensitive than, the proposal for banks. In our view the approach for corporates could be enhanced as follows:
 - Usage of external ratings in jurisdictions that allow the use of external ratings for regulatory purposes.
 - Establishment of Grades A to D (to mimic the four buckets for External Ratings) for unrated exposures or in jurisdictions that do not allow the use of external ratings for regulatory purposes.
- The proposal to apply 100% risk weighting for unrated exposures is particularly punitive for the Low Default unrated corporate counterparties, such as managed funds and pension funds. To improve the risk sensitivity of the proposal, a grading system for corporates should be considered.

- The risk weights are significantly higher than those under the IRB model approach. In particular, as the work by the IIF in conjunction with Global Credit Data demonstrates, the RWAs for the same exposure under the standardised approach are significantly higher for highly rated exposures and somewhat lower for lower rated exposures, when compared to the RWAs under the IRB approach. We would therefore urge the BCBS to consider the calibration of the risk-weightings in order for the standardised approach to achieve a more risk sensitive outcome. In terms of harmonization between the IRB and standardised approach, it is preferable that the risk weights under those two approaches are similar. It seems that the proposed risk weights rely predominantly on the PD and do not sufficiently emphasize the non-financial collateral mitigants, typically allowed in the LGD. This is linked to the discussion on specialised lending exposures below.

Specialised lending exposures to corporates:

- Due to the bespoke nature of these loans, the proposed flat and comparably high risk weights are not appropriate for this business type as they do not appropriately reflect the underlying risk levels. The high risk weights do not seem to recognise the value of the different types of underlying collateral and the risk management practices applied for this type of lending. First, these loans are typically over-collateralized and secured by counterparty assets. The level of collateralization is the key risk mitigant and differentiator in these types of portfolios and should therefore be considered appropriately. This is an issue in particular for the leveraged finance business, commodity trade finance and aircraft finance. In particular, in the case of commodity trade finance the transactions are fully collateralized and generally of a short-term duration. Second, credit risk management practices, i.e. monitoring of payments, are very strict for these types of loans, which should be reflected appropriately in defining the risk weight levels.

Retail portfolio:

- Considering the risk mitigating actions and portfolio collateralization included in certain retail transactions, such as credit card receivables, payroll payments, rents, etc., or those collateralized by durable goods (e.g. vehicles) that meet specific requirements, as well as the advanced event monitoring techniques in place (also driven by IFRS 9), the risk weights seem to be far too punitive, particularly where the IRB risk weights are significantly lower. Risk sensitivity could be increased by taking these factors into account as well as by reflecting the maturity of the exposures.
- The BCBS should clarify the treatment of cases where individuals interact with a bank through a trust or SPV structure, and the exposures would not strictly be to individual persons. In instances, where all other retail criteria are met, it would be appropriate to treat such an exposure stemming from private banking or wealth management as a retail instead of a corporate exposure.

Real estate exposure class:

- The proposed risk weight tables for residential and commercial real estate exposures should be recalibrated and made more granular, specifically allowing for lower risk weights for LTV ratios of less than 60%. This would recognize a more refined calculation of risk weighting of the loan's full exposure into different LTV buckets and would enhance risk sensitivity. We would support the introduction of more granular risk weights as well as a "fractional approach" (i.e. tranching of the loan's full exposure into different LTV buckets) when determining the overall risk weight of an exposure in order to avoid cliff effects around the LTV buckets and to avoid inappropriate incentives, which are outlined below.
- The LTV bucketing approach as currently set out will result in inappropriate incentives. The risk weighting steps between LTV buckets create cliff effects that are likely to result in loans becoming grouped around borderline LTV values with no recognition of the value of lower LTVs within the existing LTV buckets. The following example of a residential mortgage loan can illustrate this: The incremental cost of being just above a 60% LTV (e.g. 62%) is so high that a bank is better off giving the counterparty excess over 60% as an uncollateralized loan (or to ignore the existence of additional collateral), as the uncollateralized exposure would then only be subject to a 100% risk weight instead of the marginal risk weight of 185% in the example of a 62% LTV.

From a risk perspective, however, the contrary is true, i.e. the bank is better off having collateral instead of having an uncollateralized risk. This is equally relevant for higher LTVs (i.e. for any LTV above 80%). The marginal RWA rates are higher than 100% (125%/145%) once LTVs are above 80% and therefore higher than uncollateralized loans that would attract a 100% risk weight. Incremental costs of above 100% should be avoided in order to avoid the aforementioned effects. The "fractional approach" mentioned above does not have this disadvantage.

- The proposed LTV calculation does not give full recognition to available risk mitigants. The computation of the LTV should allow for so-called indirect amortizations, which is relevant in jurisdictions that link savings or pension plans to the mortgage due to tax considerations. For countries with full recourse to private wealth, the additional liquid assets that the client holds at the bank (e.g. in the form of a ratio of liquid assets to mortgage exposure) should also be considered either in the LTV computation or in the risk weights determination. Not allowing for such mitigants would only have a punitive effect on a lender's income situation in the respective countries. Also, the calculation of the LTV should be based on the current debt outstanding as well as the current value of the property. The current proposal generates an incentive to change lenders or to close new contracts as the mortgage amortizes or the market value improves. To avoid such inefficiencies and ultimately higher lending costs for the economy, we propose to revisit the calculation principles.
- The new proposal further introduces a distinction between the self-occupied mortgages (where 'repayments are not materially dependent on cash flows generated by the property') with risk weights of 25%-55% and mortgages for rented-out properties (where 'repayments are materially dependent on cash flows generated by the property') with risk weights of 70%-120%. In our view, further clarity around when there is material dependence on cash flows generated by the property is required. If further refinement in this respect is expected at a national supervision level (similarly to the underwriting practices), we are concerned that application across jurisdictions will remain inconsistent and hence contribute to further variability in risk weighted assets. In our view, a general threshold with respect to e.g., the ratio of rental cash flows to total cash flows could be more helpful as opposed to a reference to "standard debt service coverage".

Risk weight add-on for exposures with currency mismatch:

- In our view, an add-on for exposures with currency mismatch is not appropriate as
 - this risk is already incorporated to some extent as part of the external rating and due diligence requirements (double counting),
 - the proposal does not reflect the proportion to what extent the underlying revenues are generated in the same currency as the loan,
 - the proposal is not sufficiently risk-sensitive since there is no differentiation in terms of the actual currency risk, which among other factors depends on the maturity of the exposure and the volatility of the exchange rate pairs,
 - the proposal will unnecessarily increase financing costs for internationally operating companies,
 - the proposal's effects will differ at different points in the economic cycle, and
 - the proposal is defined unclearly (e.g. is there a flat 50 pp add on or a risk weight add-on of 50%).

Off-balance sheet exposures:

- The proposed CCF treatment for general commitments (50%-75%) is considered unduly punitive compared to historical default experiences and external studies. This punitive treatment will most likely lead to one of the following outcomes for financial institutions: increase in the spread charged to clients for the unutilised part of the facility and/or reduction of the general commitments (limits) for new facilities or those under renegotiation – both leading to an actual reduction in the availability of credit with negative effects on economic growth.
- As the new treatment for unconditionally cancellable commitments (UCC) has been narrowed in scope to only cover retail exposures, all other non-retail commitments that are currently categorised as UCC would be treated as general commitments.

This will have a material impact on the small and medium corporate segments, where counterparties are granted such unconditionally cancellable commitments for short-term financing and working capital requirement purposes. Historically, those credit facilities were given preferential treatments from both EAD and RWA point of views with the use of low CCFs to convert their off-balance sheet exposures into credit exposure. With these facilities' EAD calculation being subject to the much higher CCFs for general commitments, this will create an inconsistency from a risk measurement perspective by failing to recognise the important mitigating effect of revocability in the determination of expected losses and capital requirements. Last but not least, there is also strong internal evidence that revocable facilities exhibit lower CCFs than irrevocable ones over time and across portfolios hence the need to maintain this segmentation in EAD measurement.

Defaulted exposures:

- In our view the proposed risk weighting for the unsecured, un-provisioned part of the exposure at a flat 150% (100% for residential real estate exposures) is too punitive and should be aligned with the treatment of exposures in the IRB approach. For defaulted exposures only LGD is still subject to volatility (PD and EAD are no longer uncertain), and only this potential volatility of LGD has to be reflected in the determination of the regulatory capital requirements. Similar to the IRB approach, the standardised approach's risk weight applied to defaulted exposures should be calibrated to reflect the potential variability of losses for these exposures, over and above the amounts already provisioned in order to avoid double counting.

Credit Risk Mitigation Framework:

- The main concern with the revised proposal is that it maintains the restriction on utilizing the advanced exposure measurement approaches in combination with a standardised counterparty risk weighting approach. Although we understand the need for overall RWA simplification and the fact that such a step reduces overall complexity of the framework and improves comparability across banks, we strongly feel that this does not adequately represent the risk profile or indeed the risk appetite of the banks.
- Indeed, banks may wish to engage in traded product activity predominantly with well rated, large international institutions. These banks, justifiably, may not feel the need to invest in IRB approaches as the effort is not justified. However, they will have sophisticated exposure measurement capabilities due to the nature of their portfolios. The original and revised proposal penalizes such institutions, which does not seem to be justified.
- With regards to allowable Credit Derivative Protection, as it applies to the US, we believe that a 40% haircut for CDS's without restructuring provisions is unnecessarily punitive. In the US, Chapter 11 provides a legal mechanism to ensure that the CDS protection is 100% effective. This is discussed in detail in the comprehensive response of the International Association of Credit Portfolio Managers (IACPM) to the initial proposal on the revisions to the Standardised Approach for credit risk (d307), dated 27 March 2015.

We would be happy to discuss with you, in further detail, any questions you may have. Please do not hesitate to contact Basil Ackermann (basil.ackermann@ubs.com; +41-44-239 37 07).

Yours sincerely,

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