

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

Zurich, 24 June 2016

Re: Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches

Dear Sir/Madam,

UBS would like to thank the Basel Committee on Banking Supervision ("BCBS") for the opportunity to comment on the consultative document "Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches".

We are supportive of the work of the BCBS aimed at improving and reinforcing the regulatory capital framework. We are aware that the risk-based capital adequacy approach and in particular the model-based risk-weighted assets concept have suffered from public criticism, with concerns relating to a lack of comparability and the complexity of the underlying concepts. We have, however, serious concerns with the proposals outlined in the aforementioned consultation as in combination with the BCBS proposal on the revisions to the Standardised Approach for credit risk, these rules will have significant implications on risk sensitivity, financial stability and regulatory capital requirements across the industry.

In this regard, please find below our comments on some of the most important aspects in the consultative document. Our response should be considered complementary to the IIF and GFMA/ISDA/IACPM/JFMC response letters¹, which UBS also contributed to and supports. We are in particular in strong support of the alternate approaches set out in these response letters, which would allow retaining a certain degree of risk sensitivity.

Loss in risk sensitivity

A radical overhaul of the risk sensitive capital adequacy framework for credit risk as proposed in the consultative document, in combination with the BCBS proposal on the revisions to the Standardised Approach for credit risk, would undo more than 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. Internal models have been introduced by the regulators and the industry to promote accurate reflection of true risks, to ensure that the banks' incentives from internal risk management and from regulatory capital requirements align, and to reduce systemic risk as banks will act in a less correlated way. The recent financial crisis did not reveal a shortcoming of this

¹ IIF response letter dated June 3rd. GFMA/ISDA/IACPM/JFMC response letter dated June 21st.

approach. The crisis highlighted the perils of a simple capital framework, such as Basel I, whereas internal models performed well in terms of predictive performance of defaults through the crisis.² Internal models are the foundation of an effective risk sensitive capital adequacy approach. Considerations of how to balance simplicity and complexity should be centred on the question of how to capture true risks in a cost-effective and well-understood way.

With respect to the consultative paper, we understand that regulators are concerned with excessive RWA variance. Unwarranted RWA variance undermines confidence in internal models and the regulatory capital framework. However, in our view there are other measures to be taken that would allow the regulators to address this concern. The fact that 75% of the RWA variance can be explained by legitimate factors of national discretion and differences in banks' business models needs to be considered. For the remaining 25%, the IIF RWA Task Force report from November 2014 has identified a number of factors that can be addressed in order to reduce RWA variance. RWA variance can be addressed through harmonization of banks' modelling practices without sacrificing the necessary risk-sensitivity of the regulatory capital framework as the current BCBS proposals do.

We also understand the regulators concern that it is difficult to reliably use models for exposure classes where there haven't been many loan defaults or losses. By definition these exposures are low default and therefore typically low in risk. Requiring the banks to use the Standardised Approaches for this type of exposures is not an appropriate measure, as they do not reflect the low default nature but overstate risk on the better credits (please refer to the work by the IIF in conjunction with Global Credit Data³, which demonstrates that the RWAs for the same exposure under the Standardised Approach are significantly higher for highly rated exposures). To overcome the low data challenge we are supportive of a greater use of pooled data across institutions, backed by specific guidelines.

In the broader context, it is of utmost importance that the final approach for the credit risk framework strikes the right balance between risk sensitivity, simplicity and comparability. A lack of risk sensitivity would impose adverse incentives, endanger financial stability and lead to increased economic costs. A distortion of the link between risk and capital will impact incentive systems, regulatory strategies, product pricing, performance management and portfolio construction.

Reiterating our concerns which we outlined in the response letter to the BCBS consultation on the revised Standardised Approach for credit risk, we therefore find that the risk weights are not calibrated in a manner that appropriately reflects the underlying risks of the exposures. In particular where the IRB constraints consultation proposes to restrict the use of the internal model approaches, we would urge the BCBS to re-consider the design and calibration of the risk-weightings of the Standardised Approach in order to achieve a more risk sensitive outcome. We therefore strongly support the IIF's constructive alternate solutions for the Banks, Financial Institutions, Corporate and Specialized Lending asset classes.

For the final calibration of the risk weights, we also 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.

Impact on capital requirements

Contrary to the GHOS mandate which stipulated not to significantly increase capital on average, the capital impact of the revised requirements for the calculation of credit risk-weighted assets as outlined in the above mentioned consultation and the revised Standardised Approach consultation will be significant. The initial results of two industry

² Moody's, 2014, Proposed Bank Rating Methodology; Moody's, 2015, Rating Methodology.

³ Global Credit Data assessment, March 2016, please refer to the joint industry response by the IIF, GFMA, ISDA and IACPM to the second consultative document on revisions to the Standardised Approach for credit risk.

shadow QIS exercises by the CFO Network and IIF/GARP clearly show that for international banks the currently proposed design and calibration of the credit risk framework would result in a very significant capital increase. Considering the cumulative impact, risk weighted assets could as much as double for certain transactions and exposures across the industry⁴.

Taking into consideration the fact that capital requirements for banks went up ca. 7 to 10 times compared to the pre-crisis levels for most banks⁵ and the unsatisfactory economic recovery in recent years, we believe the proposal will have a significant detrimental economic impact by further increasing the capital requirements substantially, before Basel III is implemented consistently across the different jurisdictions and the implications have been measured comprehensively. Also, Andrew Bailey and Sir John Cunliffe stated in February 2016 that "our banks are now 10 times more resilient than before the crisis" and strongly defended the current capital requirements. Presenting the revised TBTF framework in Switzerland, Mark Branson said that the maximum has been done to resolve the TBTF issue and that any further tightening of regulatory requirements would have a diminishing marginal benefit in terms of stability.

A number of studies by regulatory bodies and academics⁶ show that the additional capital requirements which would come on top of Basel III and the just recently introduced TLAC requirements we would move beyond the inflection point where higher costs for the economy are not justified by potential gains in terms of financial stability. As an example, the paper by the Bank of England published in December of last year comes to the conclusion that net economic benefits are largest at RWA based capital requirements of 10-14% at current RWA calculation methods.

A significant increase in the regulatory capital requirements would negatively impact the provision of credit to the economy at a time when re-establishing growth is a key policy objective in many jurisdictions. In an environment where banks suffer low profitability, generate limited dividends and are trading below book value, additional capital requirements will force the banks to adjust their business models. The industry would see a further deleveraging process, which would affect in particular the economies of jurisdictions where banks are the principal source of credit. A recent study by Bernardi, Perraudin and Yang⁷ assesses the effects of the proposals for the Standardised Approach for credit risk and the output floor on the Swiss loan market and concludes that the proposed rule changes would substantially boost capital overall, affecting most severely capital for Corporate and Specialised Lending exposures, and would rise bank spreads by between 63 and 103 basis points. Taking into account the other regulatory proposals, the cumulative effect would be even larger.

We are also concerned that the consultative document mentions again the output floor(s), which are intended to come on top of the revisions of the capital framework incl. for credit risk (revised Standardised Approach, IRB constraints, parameter floors), market risk (desk-level approval of internal models), operational risk (removal of the model approach) and IRRBB (revised approach). Considering all these revisions and the re-calibrated leverage ratio, which should act as the primary backstop measure, we question the use of aggregated output floors, which would create complex construct of multiple 'backstop' measures.

Constrained timeline and limited impact assessment

Acknowledging the BCBS's objective to finalize the revision of the capital framework by year-end and appreciating the objective to finally achieve regulatory certainty, we note that

⁴ As outlined by The European Banking Group.

⁵ According to Mark Carney, capital requirements for banks went up at least seven times the pre-crisis standards for most banks, and for globally systemic banks even ten times. Speech given by Mark Carney, at the 2014 Monetary Authority of Singapore Lecture on 17 November 2014.

⁶ Including the following studies: Bank of England, 2015, Measuring the macroeconomic costs and benefits of higher UK bank capital requirements; IMF, 2016, Benefits and Costs of Bank Capital; BCBS, 2016, Literature review on integration of regulatory capital and liquidity instruments.

⁷ Bernardi, Perraudin & Yang (2016), Update on Capital Floors, the Revised SA and the Cost of Loans in Switzerland.

the BCBS is operating under an excessively tight timeline for this comprehensive revision of the capital framework.

Given the significant capital implications of the revised approaches, there is a need to consider carefully the cumulative impact of all the regulatory proposals through a comprehensive analysis. Neither the international regulators, the national regulators nor the industry have had sufficient time and opportunity to assess the coherence and cumulative impact of the proposals in the respective markets and jurisdictions, also due to BCBS's piecemeal approach to consulting on separate but strongly interrelated parts of the capital framework.

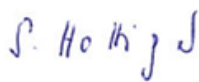
We appreciate that a more comprehensive QIS analysis is underway and consider it essential that the BCBS is carefully assessing the implications, also considering regional differences. It will also be necessary for the industry to be provided with an opportunity to review and comment on the entire set of proposals once the QIS results are available.

We urge the BCBS to take into account the industry feedback and consider the alternative proposals outlined in the IIF paper in order to address the shortcomings and unintended consequences of the current proposals as outlined in the consultative documents. We believe that these considerations will go a very long way to achieving the ultimate goal of removing the unintended variability in RWA, whilst retaining an appropriate level of risk sensitivity, and being aligned with the GHOS mandate not to increase capital requirements significantly across the industry.

We would be happy to discuss with you, in further detail, any questions you may have. Please do not hesitate to contact us.

Yours sincerely,

UBS AG



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