UOB 大华银行

United Overseas Bank Limited
HEAD OFFICE
80 Raffles Place UOB Plaza
Singapore 048624
Tel (65) 6533 9898 Fax (65) 6534 2334
uobgroup.com
Co. Reg. No. 193500026Z

24 June 2016

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, 4051 Basel
Switzerland

Dear Sirs

Consultative Document: Reducing Variation in Credit Risk-Weighted Assets - Constraints on the Use of Internal Model Approaches

United Overseas Bank Limited (UOB) appreciates the opportunity to provide comments to the consultative document on reducing variability in credit risk-weighted assets. In summary, the proposed changes aim to reduce the complexity of the regulatory framework and improve comparability between banks; and to address excessive variability in the capital requirements for credit risk.

While UOB is supportive of the intent and objective, we want to caution that over-simplification and standardization to achieve transparency and comparability in the market would erode the risk sensitivity in capital computations, which is what Basel II/III accords set out to achieve. The comments are premised upon achieving the said objectives, taking into consideration the various Basel proposals which are currently put up for consideration, and also ensuring the fundamental principle of risk based capital adequacy requirement is not compromised.

We are also supportive of ensuring adequate capital maintained within the banking system. However, careful consideration must be given to avoid excessive capitalisation within the banking system, as there are wider implications to the economy, with unintended consequences to trade and investment flows.

Listed below are our broad observations and comments.

1. ***Considerations in constraining the use of internal risk-based approach***

We concur with the importance of having simple, consistent and comparable calibration standards applied across banks and jurisdictions. However, this should not be done at the expense of eroding the risk sensitivity of the capital framework.

In an effort to improve comparability across banks and jurisdictions, the Basel Committee on Banking Supervision (Basel Committee) has proposed some changes, which includes prohibiting the use of internal ratings-based (IRB) approach for (i) low default asset classes (i.e. banks, financial institutions

銀大
行華

and large corporates) and (ii) specialized lending. Banks are still allowed to use the IRB approach for other asset classes such as small-and-medium sized corporates.

By doing so, there could be a reversal of risk-weights between certain bank counterparties (measured under revised standardised approach (SA)) and corporate borrowers (measured under IRB approach). The lack of ratings is also assumed to be "undesirable" and allocated to the higher risk buckets under the revised SA. In Asia, there are many credit-worthy corporates and banks that do not seek credit ratings, but under the revised SA, would be allocated with higher risk weights.

When regulatory capital allocation is delinked from the risk-based approach, this could drive the wrong behaviour as banks may be incentivized to increase higher-risk borrowings in search for higher returns. This is a behavior we do not want to promote nor encourage. We propose that the objective of addressing excessive variability be met via appropriate model-parameter floors and harmonizing of modeling approaches, instead of prohibiting use of the IRB approach.

2. *Impact of higher capital requirements on the economy*

The Basel Committee has acknowledged in earlier consultation documents that the objective of the proposed changes is not to increase the overall capital requirements. Instead, capital requirements should commensurate with underlying risks. However, the proposed changes to the treatment of corporate unconditionally cancellable commitments (UCC) indicate otherwise.

The proposed credit conversion factor (CCF) of 50%-75% for corporate UCC is unduly punitive given that such facilities are legally cancellable at the bank's discretion when the borrower's credit condition deteriorates. Imposing such a measure also goes against the grain of risk management and capital allocation principles.

Increased capital requirements are not without costs, and have to be borne by either the banks or the end-users – either of which would have ramifications to the economy. If banks are unable to fully recover cost of increased capital, they may be forced to reduce UCC extended to their corporate customers. As such off-balance sheet financing is a major and important source of liquidity to corporates in the region, trade and investment flows would be reduced significant resulting in undesired consequences on the economy.

3. *Implementation timeline and harmonization across different jurisdictions*

It is now clear that the proposals will have far-reaching and significant impact on banks and the economy. For instance, the banks' existing risk management processes will require major overhaul and re-engineering. Banks also would need to re-calibrate their risk, capital allocation, pricing and business decisions to adjust to the new regulatory norm. Sufficient time is required for banks for proper

UOB 大华银行

implementation, as well as the Basel Committee to allow for careful consideration on the impact the proposed changes may have on the wider regional and global economy.

We urge the Basel Committee to give careful thought to the implementation timeline, in order to ensure sufficient allowance for calibrated implementation and proper harmonization across different jurisdictions. The latter is particularly important to ensure level playing field, and to achieve the original intent of the proposed measures, i.e. improved comparability across banks and jurisdictions.

Conclusion

We also enclose our detailed comments in the Appendix, which we trust will be useful for the Basel Committee's further analytical work. Please do not hesitate to contact the undersigned should you require any further information.

Yours faithfully
UNITED OVERSEAS BANK LIMITED

Leong Hong Yew
Managing Director
Entity Reporting and Control

Frankie Phua
Managing Director
Country and Credit Risk Management

cc. Monetary Authority of Singapore
(Attention: Ms Annabel Tan / Mr Tay Jun Yuan)

大華銀行

UOB 大华银行

Appendix

Consultative Document: Reducing Variation in Credit Risk-Weighted Assets – Constraints on the Use of Internal Model Approaches

Summary of proposed changes	**Comments from United Overseas Bank Limited**
Design of capital floors based on standardised approaches Considering whether to have an aggregate output floor which could be calibrated in the range of 60% to 90%. An alternative could be to apply output floors at a more granular level, where appropriate.	The key objective of capital floor is to act as a backstop to constrain outliers and guard against model risk. Capital floor may not be necessary on the following reasons: (i) The Basel Committee's proposed model-parameter floors to the IRB approach and harmonization of modeling approach can serve as an alternative to reduce variation in credit RWA across banks and jurisdictions. (ii) The leverage ratio would also act as a backstop to risk-based capital. If capital floor based on revised SA is to be introduced, it should be calibrated to a sufficiently low level that it meets its objective of acting as a backstop. It should not override IRB approach for the majority of credit portfolio, so that banks are not disincentivised from continuing to invest and enhance their risk management processes, systems and models.
Exposures to banks, other financial institutions and corporates Remove IRB approach and apply SA ▪ Banks and other FI ▪ Corporates where consolidated group total assets > €50bn Where calculation of total assets is based on (a) average past 3 years or (b) measured at origination and updated every 3 years	Instead of removing low default portfolios from IRB approach, we urge the Basel Committee to consider model-parameter floor and harmonization of modeling approach as a solution to address excessive variability in RWA. We also urge the Basel Committee to conduct further detailed study on the potential implications arising from moving certain asset classes to SA, particularly when banks have made significant investments in building the necessary internal rating models/systems for these portfolios. Application of SA for certain portfolios could result in reversal of risk weights between certain high grade banks/FIs/large corporates under SA and middle/small corporates under IRB approach. The risk weight buckets under SA are much less risk sensitive compared to IRB

大華銀行

UOB 大华银行

Summary of proposed changes	Comments from United Overseas Bank Limited
	approach. For example, the revised SA has only 4 risk weight buckets for bank exposures with the best risk weight at 20%, which would still be higher than the risk weight of some corporate exposures under IRB approach. The granularity and calibration of the risk weight buckets under revised SA would need to be enhanced for it to be suitable alternative to IRB approach. While some of the large corporates with consolidated group total assets exceeding €50b threshold have external ratings, many of their subsidiaries do not. It is also common for many Asian corporates (including banks and financial institutions) not to have an external rating. It is therefore not appropriate to assign the higher risk weights merely on a lack of external ratings. This goes against the grain of risk capital allocation principals, and may reduce banks' incentives to model credit risk for these portfolios.
Specialised Lending Remove IRB approach that use banks' estimates of model parameters, leaving only the SA or Supervisory Slotting approach	This is based on the Basel Committee's assumption that banks are unlikely to have sufficient data to produce reliable estimates of PD for specialized lending. This may not necessarily be true in all jurisdictions. For banks that have made significant investments in building the necessary internal rating models/systems for these portfolios, the Basel Committee should consider allowing them to continue to use PD model for specialized lending, subject to independent supervisory review of their regulators that the performance of the PD model is acceptable. The Supervisory Slotting approach with only 4 supervisory rating grades is not as risk sensitive as PD model. The granularity and calibration of the supervisory rating grades under Supervisory Slotting approach would need to be enhanced for it to be suitable alternative to PD model.
Counterparty credit risk and CVA Proposed revisions to the CVA risk framework	The Basel Committee believes that CVA risk will be significantly reduced through the use of central clearing and margining for non-centrally cleared transactions. However, central clearing and margining are generally not applicable to

銀大
行華

<table>
<tr><th>Summary of proposed changes</th><th>Comments from United Overseas Bank Limited</th></tr>
<tr><td></td><td>corporate borrowers.

Corporate borrowers enter into derivative transactions to hedge their business risk and such transactions are usually held to maturity. It is therefore too conservative to impose a capital charge on corporate borrowers for CVA risk that is based on market risk fluctuations meant for the trading portfolio.

Imposing CVA risk capital charge on corporate borrowers unnecessarily increases the cost of hedging business risks. Latest QIS results show that CVA risk capital will increase significantly under the revised framework.

Corporate borrowers, particularly small-and-medium-sized corporates, should be exempted from CVA risk capital charge. Imposing CVA risk capital charge on such corporate borrowers has the perverse effect of discouraging them from hedging their business risks due to higher cost.</td></tr>
<tr><td>Parameter floors

F-IRB
<table>
<tr><th></th><th>PD Floor</th></tr>
<tr><td>Corporates (assets ≤ €50bn)</td><td>5 bps</td></tr>
</table>

A-IRB
<table>
<tr><th></th><th>LGD Floor</th><th>PD Floor</th><th>EAD Floor</th></tr>
<tr><td>Corporates (revenue ≤ €200m):</td><td></td><td rowspan="9">5 bps</td><td rowspan="16">∑ on-BS outstanding + 50% of off-BS</td></tr>
<tr><td>Unsecured</td><td>25%</td></tr>
<tr><td>Secured by financial collateral</td><td>0%</td></tr>
<tr><td>Secured by receivables</td><td>15%</td></tr>
<tr><td>Secured by CRE/RRE</td><td>15%</td></tr>
<tr><td>Secured by other physical collateral</td><td>20%</td></tr>
<tr><td>Retail:</td><td></td></tr>
<tr><td>Mortgages</td><td>10%</td></tr>
<tr><td>QRRE transactors</td><td>50%</td></tr>
<tr><td>QRRE revolvers</td><td>50%</td><td>10bps</td></tr>
<tr><td>Other Retail</td><td></td><td rowspan="6">5bps</td></tr>
<tr><td>Unsecured</td><td>30%</td></tr>
<tr><td>Secured by financial collateral</td><td>0%</td></tr>
<tr><td>Secured by receivables</td><td>15%</td></tr>
<tr><td>Secured by CRE/RRE</td><td>15%</td></tr>
<tr><td>Secured by other physical</td><td>20%</td></tr>
</table></td><td>The proposed parameter floors are too conservative and are not reflective of actual loss experiences, and do not consider the quality of bank specific portfolios. For example, the proposed 20% floor on exposures secured by other physical collateral is two time the actual downturn loss experiences in certain prime quality portfolios.

Overly conservative floors will render many IRB models risk insensitive. We urge the Basel Committee to re-calibrate the parameter floors.</td></tr>
</table>

UOB 大华银行

Summary of proposed changes	Comments from United Overseas Bank Limited
collateral ** LGD Floor for partially secured exposure = Weighted average of unsecured LGD floor for unsecured portion and secured LGD floor for secured portion	
LGD under A-IRB a) Unsecured exposures ➔ To estimate for non-defaulted assets (i) long-run average LGD (ii) add-on for downturn impact (which will subject to floor) b) Fully and partially secured exposures (exclude residential mortgages) ➔ To estimate downturn LGD, which will subject to floor where floor is weighted average of secured and unsecured LGD floors $Floor = LGD_{U\,floor} \cdot \frac{E_U}{E} + LGD_{S\,floor} \cdot \frac{E_S}{E}$ c) A-IRB exposures where Collateral is not modelled: to apply formula for fully and partially secured exposures under F-IRB.	The proposed formula for computing the floor for secured exposures has a limitation as it does not recognize the risk mitigation benefit of over-collateralization.
Requirements for PD modelling ▪ <u>Rating systems</u>: assignments to rating categories to remain stable over time and throughout business cycles. Migration between categories should generally be due to idiosyncratic or industry-specific changes ▪ <u>Data</u>: observed historical average 1-year default rate; include mix of good and bad years; minimum weighting from downturn years of 1 in 10. ▪ <u>Granularity</u>: Minimum PD estimated for each rating grade ▪ Take into account seasoning as risk factor for retail exposures	The requirement that "assignments to rating categories to remain stable over time and throughout business cycles" seems to imply that banks' rating systems have to be built based on Through-the-Cycle (TTC) approach. This may not feasible for all portfolios, in particular, the retail models which are based on behavioral factors and will vary across the cycle.

<table>
<tr><th>Summary of proposed changes</th><th>Comments from United Overseas Bank Limited</th></tr>
<tr><td>
Credit Conversion Factor (CCF)

a) F-IRB and A-IRB exposures to apply CCF per Standardised approach

<table>
<tr><th></th><th>FIRB</th><th>AIRB</th><th>Revised SA</th></tr>
<tr><td>Other commitments
- original maturity > 1 year</td><td>75%</td><td rowspan="3">Internal estimates</td><td rowspan="2">[50-75%]</td></tr>
<tr><td>- original maturity ≤ 1 year</td><td>75%</td></tr>
<tr><td>- unconditionally cancellable</td><td>0%</td><td>[50-75%] Non retail
[10-20%] Retail</td></tr>
</table>
</td><td>
The proposed CCF of 50% to 75% for corporate Unconditionally Cancellable Commitments (UCC) is too punitive given that these are legally cancellable at bank's discretion, when the borrower's credit condition deteriorated. We also observe that the proposed CCF of 50% to 75% is very conservative compared to the bank's internal advanced IRB estimates.

The increased capital requirements arising from this proposal will have serious impact to business and the general economy. As banks are unable to pass the full cost of increased capital requirements to the borrowers, the extension of UCC will be reduced accordingly. Most of the corporate UCCs are trade-related; a reduction of such off-balance sheet financing available to corporates will have severe implications to trade and investment flows, and eventually unintended consequences on the wider economy.

We urge the Basel Committee to re-calibrate the CCF for corporate UCC at an appropriate level. It should not be higher than the proposed CCF of 10% to 20% for retail UCC given that corporate UCC are subject to closer monitoring, compared to retail UCC.
</td></tr>
</table>