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Mrs Danièle Nouy
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
4002 Basel

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"The New Basel Capital Accord", Consultative Document (April 2003)

Dear Mrs Nouy,

UBS has followed the development of the New Accord closely and takes a great interest in the current debate. Indeed, as a major international player and the largest domestic bank in Switzerland our interests do not diverge from the goals of the revised regulation, namely to promote the safety and soundness of the financial system, to enhance competitive equality, to improve the risk sensitivity of the regulatory framework and to address risk in a comprehensive manner.

We have provided you with our comments on the earlier consultative papers in our letters of 30 March 2000 and 28 May 2001. On 7 February 2003 we summarised our position which was formulated after the conclusion of the most recent quantitative impact study (QIS3). We appreciate that during the development phase of the New Accord changes have been made to ensure that the overall calibration of the capital requirements under Pillar I meets the regulators' expectations and that the capital calculation for some portfolios has been adjusted to answer some concerns expressed by the industry and other interested parties. Essentially, however, the proposed New Accord has remained unchanged over time and many suggestions and recommendations which we believe are crucial for the success of Basel II have not been taken into account.

Whilst we endorse the three pillar approach and the idea of offering a menu of methods to banks under Pillar I, we continue to believe that the stability of the financial system does not hinge on capital alone. We should mention two other elements which are of equal importance. First, risks entered into by a financial institution should be assessed against its ability to generate profits. As we already observed critically in 2000, it is an omission in the proposed framework that there is no reference to the fact that a diversified and more stable earnings base provides a strong buffer against "unexpected" losses. The importance of a balanced approach between risk taking and revenue potential should at least be explicitly acknowledged under Pillar II. Second, the first symptom of a potential problem is insufficient liquidity of a financial institution, which can have many causes, even unfounded market rumours. It is therefore important that there be clear policies that govern a bank's access to liquidity in case of unforeseen events.

We wish to add that systemic stability is unlikely to be significantly enhanced by the introduction of Basel II. In fact, practices at the major internationally active banks have inspired the Basel Committee rather than the other way round and best practice at these institutions may already lie ahead of the risk measurement approaches proposed under the New Accord.

It will remain a weakness of the New Accord that it is likely not to be uniformly introduced and applied throughout at least the major industrialised countries. More of a concern for us is, however, the fact that there are still no established common regulatory capital standards amongst all systemically relevant financial institutions. We recommend the Basel Committee to strengthen its discussions with other regulatory bodies to try and achieve harmonisation of the supervisory approach.

Pillar One

To compress both credit and operational risk methodologies into the same timetable is challenging given the lack of consensus on what can be considered "best practice", especially for operational risk. We feel that the basic approaches which the Committee took to these two risk categories are inconsistent in that an "internal model based approach" will be permissible for operational risks only. Since a reliable distribution is no more difficult to obtain for credit loss than for operational loss, this approach seems illogical and raises doubts as to the consistency of the framework.

Our observations from the results of the QIS3 are that, whilst the stated goal of maintaining the same level of capital in the system may have been achieved, there are large discrepancies between the data of individual banks.

Credit Risk

If the differences in risk capital between banks were mostly a reflection of different risk profiles, the result would be desirable. Since the variance of the results is so large, we doubt, however, that this is the only factor. If significantly different capital requirements are due to interpretations of loss histories (default definition, bank practices etc.) and choices of parameters (assessment of borrowers, granularity of ratings, estimations of PD, LGD and EAD, inclusion of a conservative bias etc.) the comparability between banks will be no better than under the current Accord. Banks which have a more conservative approach than others will be punished under Basel II because their higher estimations of expected loss will translate directly into increased capital requirements (or into a lower "BIS ratio"). In many cases it will be impossible for regulators to assess the level of conservatism since loss data are notoriously scarce in many sectors of a bank's portfolio, especially the large(r) corporate and correspondent bank segments. We have elaborated on this issue in our letter of 7 February 2003 and strongly recommend that the Basel Committee undertake detailed studies in this regard prior to the finalisation of the Accord.

Another concern is the uncertainty regarding the volatility of capital requirements once the New Accord is implemented. If the loss histories of banks and the initial calibration of the risk weight functions are based on data which cover a period where the economic environment was not uniform across the globe, but in many cases still relatively benevolent, and if individual institutions have rating systems that react noticeably to swings in the economic cycle, capital requirements and their volatility may increase significantly in the future, especially when major economies stagnate or even fall into a depression. Banks could then face a liquidity crunch, if their risk measures lead to a reduced capital ratio causing a lack of confidence of retail and wholesale depositors, and even solvency problems, which may require the issue of new equity when this will be most difficult. In order to counter such effects, institutions may have to severely curtail lending with an impact on their profitability and – more importantly – on the economy as a whole. As we stated previously, we feel that it is of paramount importance to have the view of the regulators as to the band within which PDs and other parameters should fluctuate in response to economic conditions (not necessarily for other applications of an expected loss concept within a bank's day-to-day business management).

The complexity of the framework has been criticised throughout the development of the New Accord. The desire to lay down rules that are prescriptive and aim to cover all possible aspects is likely to be counterproductive. First, this approach is backward looking (addressing the deficiencies of Basel I that led to its erosion). Since markets will always develop ahead of changes to the regulatory framework, it appears to us preferable to adopt a principle based approach covering more than an overly prescriptive rulebook that simply invites exploitation of "loopholes". Second, the volume of guidelines with respect to risk mitigation and asset securitisation is out of proportion to the overall rules under Pillar I. The basic risk drivers are counterparty risk assessment and transaction structures (i.e. PD and LGD) and it is in these areas that it is difficult to establish a "firm grid" as we have explained in the first paragraph of this section. In addition, we observe an inconsistency in the regulatory approach, because the capital treatment of the other risk categories (market and operational risks) are much more based on principles.

As to asset securitisation, the New Accord does not sufficiently recognise that banks should be encouraged to use state-of-the-art portfolio management techniques, an observation that we shall also make in the context of Pillar II. As far as Pillar I is concerned, we strongly support the industry-wide viewpoint that the philosophy of a "capital neutral treatment" (same capital for same credit risk, irrespective of whether it is securitised or not) should be the first principle guiding the treatment of these important transactions in the regulatory framework.

Operational Risk

With respect to the basic and standardised approaches, the Committee relies on arbitrary risk measurement proxies, like gross income. Given that AMA methods are based on very different risk measurement drivers, it is difficult to imagine how the Committee intends to produce appropriate incentives over time for firms to move into the most sophisticated part of the spectrum of approaches.

Under AMA, the Committee still relies too much on the assumption that market risk measurement techniques are philosophically the right methodological foundation to assess operational risk. Reference is made to loss distribution parameters, like a 1-year holding period and a 99.9% confidence interval that must be met whatever approach the bank uses, and to notions like expected / unexpected losses and correlation.

As a reliable operational risk loss distribution is much more difficult to obtain than in market risk (operational risk losses are unique events in that they carry specific and unique time and environment dimensions), subjective risk assessment becomes relatively so important as to remove from loss distribution approaches any significant role in operational risk management. Loss distribution parameters should not be given the status of methodological cornerstones.

UBS believes that tangible progress in operational risk management stems more from qualitative (organisational) aspects than from pure modelling of internal event data. The analysis of external events, possible scenarios and key risk indicators is useful for assessing a control framework but may not be crucial to the modelling of event data that is used to determine capital requirements. This distinction is not sufficiently reflected in the present proposal.

Pillar II

We remain critical of the principles that (i) require banks to operate above the minimum regulatory capital requirement and (ii) formalise regulatory early intervention in the event that capital is deemed insufficient. Pillar I has been designed to cover risks with a high level of confidence (the requirements for the estimation of the parameters and the calibration of PD to the risk weight function already include many buffers for uncertainties, e.g. stress testing for IRB and scenario analysis for AMA, and hence cover a large variety of "unexpected" events). Moreover, total regulatory capital is still the result of a simple sum across risk categories.

For a bank with sound internal practices and standards, the capital calculated under Pillar I should constitute the regulatory capital requirement, with no further buffer, and the circumstances where an additional charge might be imposed should be clearly defined. Other than in these limited circumstances, regulators should generally not determine the level of capital that a bank should hold in excess of the regulatory minimum, as this is a strategic decision and the responsibility of the bank’s management.

Amongst the new elements which raise concern, we highlight three.

First, we notice a reference to strategic and reputation risks in the New Accord, which is new. We believe that linking these risk categories to the capital framework is undesirable. Strategic risks are inherent in any business environment and (indirect) interference of national regulators in a bank's strategy could be very problematical from an economic and potentially even a legal perspective. Since the proposals do not include the earnings capacity of an institution as an important feature for the overall assessment of the soundness of a firm, a potential focus on strategic risks (which may impact earnings power in future years) would also be inconsistent. Finally, if the risk profile of a bank changes following a strategic change of direction, this will immediately show an impact on the capital charges under Pillar I (in all three areas of credit, operational and market risks). As to the reputation risks, we wish to caution against any attempt to test a bank's determination to safeguard its reputation in a formulaic sense. Whilst the importance of policies and procedures is undisputed, the essence lies in the culture of a bank and how individuals value the reputation of their firm. Responsibility for the protection of the good reputation of a bank can neither be delegated to authorities within the firm nor addressed simply by manuals which supervisors may peruse and assess. Formally to subject these risks to capital rules would create an unwarranted interference by supervisors in business management.

Second, we question the emphasis on stress testing. We interpret this as a requirement for banks to perform scenario analyses, i.e. to estimate the change to the capital requirements caused by increased PD or LGD parameters (e.g. in a severe down-cycle). We refer to the comments about (i) the choice of parameters, where empirical evidence is scarce, and (ii) capital volatility, which we mentioned earlier in this letter. Furthermore, "what, if" scenarios are highly judgmental and fail to assess other elements, which have to be considered, namely (i) the level of profits and retained earnings in such a situation and (ii) policy actions which may lead to reduced credit volumes or increased demands for security.

Third, we wish to emphasise the importance of active portfolio management for ensuring financial stability. The New Accord should therefore encourage the proper use of the growing possibilities of managing credit portfolio risks – inter alia, by way of asset securitisation – and not discourage firms by setting inappropriately high hurdles.

Pillar III

We believe that, fundamentally, disclosure is important and that markets honour transparency. UBS has acted on this belief for several years and is among the leaders in the field. Whilst it is in banks' interests to promote more extensive external reporting, we wish to address a few issues that we have with the proposals under Pillar III.

Differences between the definitions underlying the credit risk rules and those characterising accounting standards increase market opacity and implementation / running costs at banks. Thus, if the definition of default and the valuation of impaired assets, which drive the major parameters under Pillar I (PD, LGD), are different for accounting and regulatory purposes, banks will have to report two sets of information regarding their portfolio and impaired assets. It is clear that this rather dilutes than increases transparency. We reiterate our request that accounting and regulatory standards be fully harmonised.

The level of prescriptiveness adopted within Pillar I for credit risk influences the detailed disclosure required under Pillar III. Unfortunately, the false sense of uniformity across the industry suggested by the detailed construct of the Pillar I framework carries over into Pillar III and the market, promoting dangerous comparisons amongst firms. Although many readers of external risk disclosure are expected to be educated on this important subject, there remains a risk that information – especially if structured in a rigid and prescribed way – is misinterpreted with potentially damaging consequences. First this relates directly to the level of conservatism adopted by a firm when defining the parameters and to the sensitivity of its rating systems to swings in the economic conditions (see our remarks in the section Pillar I). Second expected loss in itself is a poor measure for portfolio risks for it ignores "lumpiness" of exposures and risk diversification on the one hand and the related profit stream on the other.

A credit risk approach under Pillar I based on principles rather then rules would benefit both the accounting and transparency points made above.

Implementation

Based on the statements made by the Basel Committee, we do not believe that the last consultation round will produce major changes in the approach and the complexity of the framework. The spirit of Basel II is to some degree one that is based on the market risk developments during the past decade, which led to the introduction of the 1996 amendment to "Basel I". Whilst we support the general direction and evolution of the regulatory framework it has to be accepted that credit and operational risks cannot be put on a par with market risk when it comes to risk quantification. We remain convinced, therefore, that many aspects of the New Accord have to be interpreted in a pragmatic way and that judgement must be applied to many issues which cannot easily be quantified with precision. The costs of implementing Basel II for a bank that already uses risk quantification methods should therefore not be excessive. We appreciate that the "all or nothing" notion has been de-emphasised over time and urge supervisors to be pragmatic so that advances are made and costs incurred only where they provide material benefit for both bank management and supervisors.

The other fundamental issue is that internationally active banks must have certainty as to which rules apply to their integrated cross-border business. We strongly suggest a clear and early stipulation of the principle of lead home country supervisor – whereby rules set out by the recognised home regulator should be the basis for the assessment of a bank group by host regulators – accompanied by increased harmonisation and efficiency in the supervisory process of global firms. Assessment of overall capital adequacy should be the exclusive task of the lead home regulator.

Conclusion

We thank you for the opportunity to comment on the various consultative documents. We hope that our remarks allow you to assess our bank's position with respect to "Basel II". The success of the New Accord will now depend on its industry-wide implementation and the "use test" over a number of future years. The role of the Accord Implementation Group will be crucial in ensuring that the goals are achieved not only in theory but also in practice.

If you have any questions on the issues raised in this letter and in the annex, or would like to discuss aspects of CP3 further with us, please contact:

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Annex: Specific aspects

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Treatment of Guarantees and Credit Derivatives

Simplified substitution approach

The current treatment of credit derivatives based on a simplified substitution approach, is not sufficiently sophisticated or risk sensitive. We welcome the recent research paper issued by the FED[1], which acknowledges the very conservative nature of the current proposal with respect to measuring the double default condition that would trigger a default on a hedged exposure. We urge the Committee to engage in further discussion of potential use of more risk sensitive models.

Restructuring

We welcome the further development of rules regarding restructuring risk on credit default swaps and the willingness of the Committee to allow capital relief if restructuring is not covered as a default event (footnote 47, page 34 of the consultative Accord). We are however concerned that the subjective nature of a restructuring event, if left to national discretion, will damage the level playing field. National discretion should be minimised in this area.

First to Default and Total Return Swaps

We think that the current treatment of first to default credit default swaps is too conservative. Indeed, where the bank acts as credit protection buyer only the asset with the lowest risk weighted amount gets a capital relief. Furthermore, the current treatment is arguable particularly in relation to the condition which says that the notional amount of this asset has to be less than or equal to the notional amount of the credit derivative. We believe that a bank should choose the asset to be protected and that, moreover, partial hedging should be recognised as it is currently the case for other guarantees and credit derivatives (see paragraph 166).

We consider that protection purchased with a total return swap on tradable securities is a synthetic forward sale. The correct capital treatment in such cases consists in underpinning the credit equivalent amount. Where the asset is not a tradable security the substitution approach should be used.

Maturity adjustment

Paragraph 291 of the consultative Accord states that the one-year floor does not apply for certain short term exposures (listed under paragraph 292). This raises the issue of maturity adjustment for short dated exposures.

With respect to the exposures listed under paragraph 292, we observe the following:

- With respect to bullets 4 and 6, we believe these types of transactions should be completely outside the capital framework. Transactions in major securities markets are mainly DVP settled and with the advent of CLS most FX transactions are also subject to secure settlement. There is thus rarely a risk of loss of the full trade value. If a trade does indeed fail to settle, the loss resulting from price movements will tend to be very small given the short term between trade date and settlement date. We therefore believe that the potential risk is too small to warrant computing and allocating capital to these exposures.

- Bullet point 5 of that list should only consider exposures arising from failed cash settlements.

Back-testing of Close-out VaR models for repo-style transactions

Paragraph 151 of the consultative Accord describes the proposed sampling method for back-testing Close-out VaR models for repo-style transactions. It is essential that supervisors permit flexibility to banks in the use of specific validation techniques. Any sample definition and back-testing method should consider the structure of the firm's repo-style transactions portfolio and its most relevant risk parameters. It should not prescribe a standardised approach.

[1] Treatment of Double-Default and Double-Recovery Effects for Hedged Exposures under Pillar 1 of the Proposed New Basel Capital Accord, June 2003

Furthermore, the back-testing approach presently proposed relies on a daily test portfolio which enforces day to day comparison by removing all intra-day transactions. Experience with Market Risk VaR back-testing has shown that the process of adding back matured trades, deducting new trades and stripping out trade amendments can be extremely onerous. For repo-style transactions back-testing will have to be applied to the 10 largest counterparties, which have, by definition, large portfolios with a high volume of new trades, roll offs and amendments daily.

An alternative method to validate the model, that we offer for consideration, would be to set up a separate database of daily portfolio snapshots in order to compare the expected daily exposure (VaR modeling approach) on day 1 with the actual credit exposure of the same portfolio on day 2.

Furthermore, the Committee should explicitly indicate that the term 'repo-style transactions'[2] can be applied to certain prime brokerage products, provided their close-out periods are comparable to other repo-style transactions (repo, reverse repo and stock borrowing/lending) and the exposures are remarked and re-margined by banks on a daily basis.

Lastly, we consider the multipliers applicable to back-testing exceptions to be excessive and the increase between buckets too steep, specifically for the first range of exceptions.

Securitisation

We welcome the revision and clarifications made in the draft Accord on securitisation but continue to have fundamental concerns. The revised Accord must address these concerns if the Committee is to achieve its stated goals without disrupting the liquidity and risk dispersion roles that securitisation now plays.

If adopted, the current proposal for securitisation will materially impair the ability of banks to distribute risk from their own balance sheets into the capital markets. Our main concern continues to be that the calibration of capital currently distorts the risk for the various roles undertaken, including originator, sponsor and investor, and the securitisation exposure acquired, retained and transferred. Our comments below highlight key concerns that we trust will be addressed in the final Accord.

1. Risk weights for securitisation exposures under the internal ratings based approach must be consistent and appropriate to the risk

The capital weights applied to securitisation positions (whether under the standardised or the IRB approach) for assets such as retail exposures are excessive, especially in comparison to risk weights for like-rated corporate bonds. We continue to advocate that there is no cause to distinguish between ABS positions and like-rated corporate positions. In particular we note:

a) High floor capital charge under the Supervisory Formula Approach (SFA)

The proposals impose a floor capital charge under the SFA of 56 basis points. This compares with an effective floor capital charge for corporate bonds of a few basis points, in the absence of a minimum loss-given-default level. The result is that the proposed floor charge for securitised positions is too high relative to the risk weights for like-rated corporate bonds.

Moreover, the proposed floor will impose regulatory capital even where the current SFA, without floor, readily provides a lower level of regulatory capital.

We recommend that the floor capital charge under the SFA be eliminated or calibrated closer to the underlying risk.

b) Originators should be able to use external ratings on positions, even if below K_{IRB}

The proposals permit investors to make ratings based risk capital calculations for positions rated between BB+ and BB-, but require originators to take a full deduction from capital for all positions below K_{IRB}, regardless of rating. The fact that it is the originator who holds the position does not, however, impact the rating or

[2] As referred to in paragraph 138 (minimum holding periods) and paragraph 141 (zero H condition) of the consultative Accord

inherent risk, but this is what the proposal implies. There is no difference in the risk associated with a particular position simply because it is retained rather than acquired.

2. *Synthetic securitisation is discriminated against cash securitisation with respect to the risk transferred*

a) Substitution approach

The substitution approach gives rise to a significant discrepancy between the regulatory capital cost of hedges and their internal cost, causing distortion of pricing and risk management. By simply substituting the risk weighting of a guarantor or credit protection provider for that of the underlying asset, the proposals ignore the increased protection inherent in the additional layer of credit. The proposals ignore the fact that both the underlying obligor and the protection provider or guarantor must default before a loss is incurred. We noted above that a research paper by the FED acknowledges the conservative character of substitution and proposes a more risk sensitive treatment of double default risk. We trust this research will advance discussion of this topic before the final Accord is issued.

b) Quality of super-senior tranches

Currently, the risk capital for super-senior tranches does not reflect their superior quality. This in turn discriminates against synthetic transactions by making them inefficient when compared to cash structures. We believe that super-senior tranches should attract a zero risk weight in light of their quality.

3. *The proposal for liquidity facilities does not balance the risk and the role of the provider of such facilities*

a) Asset quality tests

Liquidity commitments to Asset-backed Commercial Paper (ABCP) conduits are subject to dynamically adjusting asset quality tests. We think that the proposals do not fully recognise the presence of these tests, which are designed to ensure that the level of an outstanding commitment at any time does not exceed the availability of performing assets. Therefore, we believe that a credit conversion factor of 20% (50% for maturities longer than a year) should be applied under both standardised and IRB approaches.

b) Use of internal ratings

The Rating Based Approch (RBA) would require banks to have liquidity facilities rated in order to avoid the burdensome calculation of K_{IRB} under the SFA approach. The ratings process would be time-consuming and add costs for each transaction while providing little benefit given the relatively low risk of a liquidity facility, infrequency of draw downs and very low losses under these facilities historically.

We recommend that banks be permitted to apply their own internal ratings and models to determine required capital for liquidity and credit enhancement positions supporting ABCP conduit transactions, so long as the rating of a position is at least investment grade.