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By E-Mail

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Attn: Comments/Legal ESS

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications RIN 3064-AC96

Dear Mr. Feldman:

UBS Bank USA (the "Bank") welcomes the opportunity to comment on the Basel IA notice of proposed rulemaking ("NPR") published in the December 26, 2006 Federal Register by the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Federal Reserve System and the Office of Thrift Supervision (collectively the "Agencies").[1] The Bank is an FDIC-insured, state-chartered institution with a single office. As of December 31, 2006, the Bank had assets of approximately $22 billion, capital of $2.3 billion and a tier-one risk-based capital ratio of 19.48%. The Bank is an indirect, wholly owned subsidiary of UBS AG, a Swiss banking corporation conducting a global financial services business directly and through operating subsidiaries throughout the world. UBS AG is registered as a financial holding company with the Federal Reserve Board, and is subject to the Bank Holding Company Act of 1956, as amended, through Section 8(a) of the International Banking Act.

Overview

We appreciate the efforts of the Agencies to ensure that the risk-based capital guidelines continue to adhere to and promote the articulated principles of "(1) [p]romot[ing] safe and sound banking practices and a prudent level of regulatory capital; (2) maintain[ing] a balance between risk sensitivity and operational feasibility; (3) avoid[ing] undue regulatory burden; (4) creat[ing] appropriate incentives for banking

[1] See 71 Fed. Reg. 77446 (Dec. 26, 2006).

organizations; and (5) mitigat[ing] material distortions in the risk-based capital requirements for large and small banking organizations."[2] In particular, we welcome the Agencies' proposal to increase the number of risk-weighting categories in an effort to better reflect the relative credit risk associated with various credit exposures, and to recognize the value of a broader range of collateral in minimizing the credit risk faced by lenders.

In one area, however, we believe that the NPR fails sufficiently to take account of the limited credit risk faced by banks when they make certain secured loans. Specifically, although the NPR would provide for significant reductions of risk weighting for loans that are collateralized by investment grade debt securities, the NPR fails to provide any risk reduction for the broader category of non-purpose loans[3] that are fully secured by the pledge of publicly-traded debt and equity securities (referred to below as "securities-based loans" or "SBLs").

We respectfully request that the Agencies include in their final rulemaking a risk weighting scheme that would assign a risk weight to a non-purpose loan based on the loan-to-value ("LTV") ratio in a manner similar to the proposed assignment of risk weightings to residential mortgage loans, provided that the following conditions are met: (1) the SBL is initially secured, and remains secured, by a pledge of debt or equity[4] securities for which there is a ready market;[5] (2) the collateral pledged to the SBL is marked-to-market on a daily basis; and (3) the bank has a process in place to address fluctuations in the value of the collateral, by requiring the borrower to provide additional collateral, to pay down the loan or to allow the bank to sell a portion of the collateral in the event the LTV exceeds certain levels. If these conditions are met, we suggest that the SBL be assigned a risk weighting based on the LTV as follows:

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[2] Id. at 77449.

[3] A "non-purpose" loan is a loan where the proceeds are not used to purchase or carry securities.

[4] We would include as equity securities for this purpose shares of qualified investment companies under the Investment Company Act of 1940, exchange-traded stocks, funds, and American Depository Receipts.

[5] Under regulations of the Securities Exchange Commission ("SEC"), a "ready market" includes "a recognized established securities market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom." 17 CFR § 240.15(c)(3)-1(c)(11)(i). Further, a ready market is deemed to exist "where securities have been accepted as collateral for a loan by a bank . . . and where the broker or dealer demonstrates to its Examining Authority that such securities adequately secure such loans[.]" Id. § 240.15(c)(3)-1(c)(11)(ii).

LTV	Risk Weight
Less than or equal to 60%	20%
Greater than 60% but less than or equal to 80%	35%
Greater than 80% but less than or equal to 85%	50%
Greater than 85% but less than or equal to 90%	75%
Greater than 90%	100%

Discussion

When done in a program with appropriate controls, SBL lending is among the safest and most secure lending that can be done by an insured depository institution, whether measured by default rates, or loss given default ("LGD"). For example, the Bank's credit-based losses on its portfolio of securities-based loans have been well below the industry's experience with losses on residential mortgage loans.[6] Several attributes of SBL lending lead to this excellent record.

LTV Ratios. In order to account for risks arising out of market fluctuations, bank SBL programs typically require over-collateralization of the underlying credits. The more sophisticated the program, the more tailored the LTV requirements may be for various types and concentrations of collateral. For example, the Bank has several levels of its SBL collateralization requirements that take into account a variety of factors such as collateral quality, collateral concentration and collateral volatility. In order to recognize the substantially reduced risk (both risk of default and LGD) created by low LTV ratios while maintaining the simplicity of implementation for the Basel IA group, we respectfully suggest that the Agencies establish the new SBL lending risk-weighting categories described above, which we believe are conservative when compared to the risk weights assigned to other lending activities.[7]

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[6] The average quarterly charge-off rate for bank residential mortgage loans in the last six (6) years was over 16 basis points. See "Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks," Federal Reserve Statistical Release, http://www.federalreserve.gov/releases/chargeoff/chgallsa.htm (visited 3/22/07).

[7] Indeed, a more sophisticated approach to risk weighting of SBL loans would recognize the significant differences among different types of collateral, such U.S. treasuries, investment grade debt, non-

Under the approach we suggest, SBL loans will qualify for reduced risk weighting based upon the extent to which they are over-collateralized. For simplicity of application and consistency across asset classes, we are suggesting that the Agencies assign risk weights that are similar to the risk weights for the other major form of collateralized lending separately addressed by the NPR -- mortgage lending.[8] This will avoid the substantial imbalance between the risk weighting for mortgage lending and for SBL lending in the NPR. For example, under the NPR a first lien mortgage with an LTV of 50% would be assigned a risk weight of 20%. In contrast, under the NPR, if the collateral consisted instead of a diversified pool of equity and non-investment grade debt securities that is marked to market on a daily basis, the risk weight would be 100%, no better than a completely unsecured loan.[9] Moreover, the NPR assigns first lien mortgages a risk weight of 50% at LTV's as high as 85%. While this is certainly appropriate given the loss history with respect to mortgage loans, similar risk sensitivity should be applied in the SBL context. For that reason, we are proposing to use the same LTV-based risk weighting for SBL loans which meet the criteria discussed above that the NPR assigns to first lien mortgages.[10]

Collateral Valuation. Another essential element of SBL lending is appropriate collateral valuation. While debt and equities may be subject to greater price volatility than, for example, residential real estate, there are substantial mitigating factors which make properly structured SBL lending compare favorably to residential mortgage lending from a risk perspective. First, if qualifying SBL collateral is limited to debt and equity securities traded on a public market, valuation will be market-driven, verifiable, and constantly current, as opposed to real estate appraisals which are less transparent and infrequently, if ever, updated following the initial loan underwriting. For example, the Bank uses sophisticated measures to track and control the value of collateral

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investment grade debt and equities. Although the approach proposed above sacrifices a level of refinement that could easily be justified, it has the merit of providing a simple, easily applicable standard that gives at least partial recognition of the low risk posed by properly managed SBL programs.

[8] For first lien mortgages, the NPR assigns a risk weight based on the LTV. See Proposed 12 C.F.R. pt. 325, Appendix E, § II.C.9(b) and Table G1, 71 Fed. Reg. at 77505-06 (Dec. 26, 2006). If the LTV is less than or equal to 60%, the risk weight assigned is 20%. For LTVs from 60% to 80%, the risk weight is 35%; for LTVs from 80% to 85%, the risk weight is 50%; for LTVs from 85% to 90%, the risk weight is 75%; for LTVs from 90% to 95%, the risk weight is 100%; and for LTVs greater than 95%, the risk weight is 150%. See id.

[9] Under the NPR an SBL loan with an LTV of 50% would have a risk weight of 20% only if the collateral pledged consisted solely of debt securities rated in one of the two highest investment grades. See Proposed 12 C.F.R. pt. 325, Appendix E, § II.C.9.a and Tables F1 and F2, 71 Fed. Reg. at 77505 (Dec. 26, 2006). An unsecured loan would receive a risk weight of 100%. See id. § II.C.6, 71 Fed. Reg. at 77504 (Dec. 26, 2006).

[10] The NPR assigns risk weights higher than 100% to first lien mortgages with LTVs higher than 95%. However, because our proposal applies only to SBL loans that remain over-collateralized and meet the other conditions discussed above which minimize the risk associated with the loans, under our proposal an SBL loan would never be assigned a risk weight higher than 100%.

pledged to a securities-based loan. As a general rule, such collateral is "marked-to-market" on a daily basis, meaning that the value of the collateral is calculated daily based on the price at which the securities are traded. In some cases, this occurs several times during a day, and in others it occurs overnight.

Second, if SBL collateral is marked-to-market on a daily basis, the risk related to collateral value fluctuation can be managed in a safe and secure manner through the appropriate enforcement of maintenance requirements. Using constantly updated market data concerning SBL collateral value, banks can identify the need for maintenance calls and take steps to ensure that securities-based loans remain within acceptable LTV ratios. Coupled with appropriate maintenance requirements, such processes provide more than adequate ability for SBL lenders to ensure that their security is not impaired by market movements. Accordingly, as noted above, we respectfully suggest that an element of a lower risk-weighting for securities-based loans could be a requirement that the bank mark-to-market its collateral on a daily basis.

Enforcement. By using current collateral values, banks that make securities-based loans have the ability to make maintenance calls at collateral levels significantly above the outstanding loan amount, thereby preventing collateral deterioration to the point that would adversely affect the security and substantially contributing to the overall safety and soundness of an appropriately structured SBL program. Unlike mortgage loans where banks have little recourse in the event of the impairment of collateral values (if they even have appropriate data on such impairment), SBLs provide an on-going enforcement mechanism that helps minimize the LGD of any SBL. Thus, LTV requirements provide substantial leeway for fluctuations in the value of collateral, while maintenance requirements ensure the continuation of over-collateralization with a sufficient buffer to protect the lender in the event of default.

Furthermore, in the event of default, a properly structured SBL program will provide the bank with the ability quickly and efficiently to exercise its rights vis the SBL collateral, frequently through possession of pledged securities by an affiliate, or at a minimum, under a control agreement with a third party broker. Unlike mortgage loans with cumbersome, expensive foreclosure procedures, SBLs provide a more effective mechanism for banks to liquidate their collateral.

Simplicity of Approach. As demonstrated by the discussion above, a tiered approach to risk weighting of SBLs could easily be supported to provide a mechanism for capital allocation that is more closely aligned to risk. Indeed, we believe that several commentors on the Advance Notice of Proposed Rulemaking suggested such approaches, which were not adopted in the NPR. While we will not propose a more sophisticated approach in light of this history, we believe that the information provided above and by other commentors clearly supports the very basic recognition of the materially lower risk of SBL lending compared to simple unsecured credit. Accordingly, by refining an approach that sacrifices some risk sensitivity for greater simplicity and

clarity, we believe our proposal strikes a balance that (1) promotes safe and sound banking practices by associating lower capital requirements with better-managed, highly secured SBL programs, (2) creates better risk sensitivity than lumping a highly secured, low risk product with unsecured credit for purposes of risk weighting, yet remains easy to administer, (3) does not create excessive regulatory burdens, but instead relies on essential elements of any well-managed SBL program, (4) creates appropriate incentives for safe and secure lending by associating more appropriate capital standards with less risky lending and (5) mitigates distortions that would result from effectively lowering the capital cost of SBL programs for Basel II institutions but not Basel IA institutions.

Thank you for considering these comments. If you have any questions, please feel free to contact me at (801) 741-0312.

Respectfully,

George F. Coburn
Chief Operating Officer