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Working Draft of Statement of Financial Accounting Standard No. 15X, Fair Value Measurements

Proposed FASB Staff Position No. 133-a, Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133

Dear Ms. Bielstein and Mr. Smith:

UBS supports the Board's efforts to develop a fair value measurement framework and address fair value measurement issues. As such, we welcome the opportunity to comment on the proposed FASB Staff Position No. 133-a, *Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133* (the "Proposed FSP"). We have also included comments on the Working Draft of Statement of Financial Accounting Standard No. 15X, *Fair Value Measurements* (the "Working Draft"), which we hope the Board finds useful in finalizing that standard.

Fair Value Measurement Working Draft

Clarification of Hierarchy

We are concerned that constituents may inconsistently interpret Level 3 of the fair value hierarchy. Requiring a Level 3 input to be "observable over the full term of the instrument" could be read to imply that normal interpolation between observable market points is not a Level 3 estimate. As such, the fair value estimate of some instruments initially categorized as a Level 3 estimate could subsequently be considered a Level 4 estimate. Consider as an example interest rates (which the proposal lists as an example of a Level 3 estimate). The fair value of a 3-month USD LIBOR swap would be a Level 3 estimate at inception because the 3-month USD LIBOR swap rate is observable. However, as proposed, the fair value estimate for the same swap, measured a day later, may be viewed as a Level 4 estimate by some constituents because there exists no observable 89-day USD LIBOR swap rate. Currently, USD LIBOR swap rates and certain other rates are interpolated using observable pricing points. We believe interpolation within inputs directly related to the asset or liability being priced are permissible in a Level 3 estimate and believe that interpolation between data points from a different, yet correlated, instrument is a Level 4 estimate. We recommend the Board amend the definition of Level 3, or provide application guidance, to clarify this point.

Effective Date

The Working Draft currently requires its disclosure provisions be applied earlier than its other provisions (i.e., a year before implementing the fair value hierarchy, eliminating block discounts, etc.). In requiring an earlier effective date for the Working Draft's disclosure provisions, the Board noted the importance of the information and reasoned that the "disclosure requirements of this Statement clarify and codify the fair value information reported under existing accounting pronouncements."[1] While true for some of the Working Draft's disclosure provisions, it cannot be said that current accounting pronouncements require disclosure of where within the fair value hierarchy the estimates of fair value fall (paragraph 35(c)) or of unrealized gains and losses relating to assets and liabilities remeasured at fair value using a Level 5 estimate (paragraph 36(b)).

The fair value hierarchy described in the Working Draft does not exist in current accounting pronouncements. Footnote 3 to EITF Issue No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities* ("EITF 02-3"), comes close, but what is considered an unobservable input under the guidance in EITF 02-3 will not necessarily equal a Level 5 input as contemplated in the Working Draft. There are other differences as well. Plus, EITF 02-3 only applies to derivatives (a subset of the assets and liabilities within the scope of the Working Draft).

As a result, entities will need to consider the full breadth of the new fair value measurement guidance in order to prepare the disclosures required by paragraphs 35(c) and 36(b). We do not believe that this assessment can be performed within the timeframe provided by the Working

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[1] Paragraph C116 of the Basis for Conclusions

Draft's effective date. Additionally, capturing the data required by paragraphs 35(c) and 36(b) could require extensive systems changes. As such, we request that the effective date for the proposed disclosures coincide with the effective date for the remainder of the Working Draft.

Proposed FSP 133-a

Unrealized Gain (Loss)

We do not support the requirement in paragraph 4(b) of the Proposed FSP to recognize a deferred credit or debit, separate from the related derivative instrument, when the minimum reliability threshold for income or loss recognition is not met. We believe that recognition of the deferred unrealized gain or loss as a separate item on the balance sheet is inappropriate because the resulting deferred amount is neither an asset nor a liability, as defined by Concepts Statement No. 6, *Elements of Financial Statements*. Any unrealized gain resulting from applying the Proposed FSP is not a liability because no obligation exists to sacrifice assets in the future. Similarly, any unrealized loss is not an asset because no future economic benefit is associated with it.

Additionally, we would like to highlight that the Proposed FSP contradicts one of the stated objectives in the standard that it is attempting to interpret. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("Statement 133") includes as one of its four key objectives that "only items that are assets or liabilities should be reported as such in financial statements."[2] In the Board's deliberations of Statement 133, they noted that losses or gains resulting from measuring derivatives at fair value "are not separate assets or liabilities because they have none of the essential characteristics of assets or liabilities."[3]

Given that deferral of gains and losses is not acceptable practice in Statement 133 (unless as a result of an effective hedging relationship), we believe there are two alternatives for recognizing the difference between a Level 5 fair value estimate and the transaction price at inception of a derivative instrument that do not contradict Statement 133: (1) eliminate the minimum reliability threshold and recognize all unrealized gains and losses resulting from initial fair value measurements in earnings, or (2) recognize that the transaction price is better evidence of fair value when the estimate of fair value includes significant Level 5 inputs. The first approach would hold true to the Fair Value Measurement Working Draft while the second approach would require an amendment to the Working Draft such that the transaction price replaces Level 5 (similar to the approach taken by footnote 3 to EITF 02-3). We would support either approach, but favor eliminating the minimum reliability threshold, with appropriate disclosures.

Transaction Costs

If the Board maintains the requirement in paragraph 4(b) of the Proposed FSP to defer unrealized gains or losses resulting from Level 5 fair value estimates, we request clarification regarding the

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[2] Paragraph 3(c) of Statement 133

[3] Paragraph 229 of the Basis of Conclusions to Statement 133

recognition of transaction costs related to the assets or liabilities whose initial gain is deferred. The Working Draft specifies that the fair value estimate (exit price in the reference market) for the asset or liability shall not be adjusted for transaction costs. However, given that the Proposed FSP takes a revenue recognition view to addressing the reliability of initial Level 5 fair value estimates, and does not allow for income statement recognition of the initial gain or loss when the minimum reliability threshold is not met, we believe that incremental direct transaction costs related to derivative assets or liabilities should be deferred when the initial unrealized gain for that asset or liability is deferred. Incremental direct costs would include, for instance, brokerage or arrangement fees incurred to complete a derivative transaction.

We believe it could be inferred that the evidence provided by incremental direct costs incurred, relating to the execution of a specific derivative transaction, forms an observable reference point. This point is effectively a minimum boundary on the valuation of a transaction after considering other liquidity and/or model reserves. Entities generally behave in a rationale manner so as to achieve economic profit. In the banking industry, for instance, complex transactions of the type which might fall within Level 5, are vetted by various risk functions to ensure they are appropriate and consistent with the entity's revenue generating objectives. Intuitively, therefore, entities will not enter into transactions which do not at least compensate them for the related direct incremental costs they incur. Thus, we believe it is counter-intuitive to suspend a portion of a derivative instrument's fair value while recognizing incremental direct costs related to that instrument. As such, we encourage the Board to consider these points in providing additional guidance regarding the treatment of incremental direct transaction costs related to derivative assets or liabilities when the initial unrealized gain for those assets or liabilities is deferred.

Disclosure

We fail to understand the need for the disclosure required by paragraph 6(a) given that the fair value measurements that generate the unrealized gains and losses at inception meet the minimum reliability threshold for earnings recognition. We also question the usefulness of such a disclosure given that it covers only a limited subset of instruments that are measured at fair value through earnings (derivative instruments).

Additionally, the disclosures proposed in paragraph 6(a) will require that we divorce the initial unrealized gain or loss of a transaction in a given day from that day's market movements that occurred from inception to market close. As both amounts are recognized in current period earnings, we fail to see the benefit of such a disclosure to users of our financial statements. Further, as we currently do not capture this information (because the information is not relevant in managing our business), capturing and reporting this information will require costly systems and process changes.

We support the Board's objective for requiring disclosures that enable financial statement users to assess the financial effects of derivative transactions. However, we do not believe that the proposed disclosure in paragraph 6(a) meets the Board's objective. We note the Board's Derivatives Disclosure Project on its current agenda and understand that the project is expected to reconsider existing disclosure requirements under Statement 133 and related guidance. We question why the Board is adding additional derivative disclosure requirements through paragraphs 6(a) and 6(b) of the Proposed FSP, prior to completing its more comprehensive project to enhance and codify derivative disclosures. We encourage the Board to refrain from requiring any disclosures in the Proposed FSP and support the Board's efforts to develop a more comprehensive disclosure framework for derivative instruments through its current Derivatives Disclosures Project.

Transition

In requiring limited retrospective application of the Proposed FSP, the Board concluded that initial application would result in a change in the method used to estimate the fair value of a derivative instrument at its initial recognition and that the effect of the change in method is separable from the change in estimate. We would agree with this assertion had the Proposed FSP only been addressing the initial recognition of a derivative instrument using the fair value guidance in existence prior to the Working Draft (footnote 3 to EITF 02-3). However, since the Proposed FSP interprets the Working Draft (the new fair value measurement guidance), application of the Proposed FSP is not separable from application of the Working Draft. As the Working Draft requires prospective application, we believe the Proposed FSP interpreting the Working Draft should also be applied prospectively.

If retrospective application is required for the Proposed FSP, we question how to apply the new fair value hierarchy to past transactions and events. Determining where evidence falls within the fair value hierarchy is a point-in-time assessment. It is unrealistic to assume that entities can ascertain what corroborative market data existed in a prior period in order to determine the appropriate treatment historically under the Working Draft's fair value hierarchy. Entities may not have made these assessments, or at least the same assessments, when applying the guidance in EITF 02-3. As such, we believe that the Proposed FSP, when considered in combination with the Working Draft, results in a change in accounting estimate effected by a change in accounting principle and should therefore be recognized on a prospective basis.

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We hope you find our comments useful. Should you wish to discuss any comments that we have made or speak to us on this topic, please do not hesitate to contact John Gallagher at 203-719-4212 or Sam Lynn at 203-719-7774

Regards,

UBS AG

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