



Technical Director
Financial Accounting Standards Board
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25 April 2011

Invitation to Comment, *Selected Issues about Hedge Accounting*

Dear Sir/Madam:

UBS welcomes the opportunity to comment on the FASB Invitation to Comment on *Selected Issues about Hedge Accounting*, which is intended to complement the feedback requested by the IASB on its Exposure Draft ED/2010/13, *Hedge accounting* (the "ED"). UBS is fully supportive of any attempts by the boards to achieve convergence in their financial instruments standards and to improve and simplify their approaches to hedge accounting.

As mentioned in our comment letter to the IASB, which we attach to this letter for your reference (Appendix II), we agree that the current hedge accounting model under IAS 39, *Financial Instruments: Recognition and Measurement*, is overly complex and restrictive and does not consistently reflect the financial effects of many common risk management activities. This view is similarly applicable to the current, as well as proposed, US GAAP hedge accounting requirements under ASC Topic 815, *Derivatives and Hedging*.

We believe there are several areas, where the ED makes positive steps toward a more simplified and principles based framework for hedge accounting which, if embraced by the FASB, could also be beneficial for the hedge accounting model under US GAAP. In particular:

- elimination of the quantitative threshold for the retrospective hedge effectiveness test
- acceptance of risk components of non-financial items as eligible hedged items
- simplification of the ability to designate groups and net positions as eligible hedged items.

We are also cautiously optimistic in respect of the IASB's objective to align the accounting with the results of an entity's risk management strategies. However, we are concerned that, without further clarification, the ED's ambiguity may lead to overly prescriptive interpretations as to the level at which such strategies may be defined. We note that financial institutions employ sophisticated macro strategies which may encompass numerous, and in some instances overlapping, granular approaches. In the spirit of the risk management objective, we would favor acknowledgement and ratification of an entity's ability to designate strategies in the manner in which they are managed.

Moreover, we believe that many of the restrictions in IAS 39 and the ED are inconsistent with its stated objective. Notably, we find the prohibitions against designating a LIBOR component of sub-LIBOR instruments,

hedging a bottom layer of a portfolio of pre-payable financial instruments, and hedging the credit component to be overly rules-oriented, lacking in empathy for the manner in which entities actually manage economic exposures and without conceptual merit.

Additionally, the “no bias” and “minimizing hedge ineffectiveness” criteria appear to be in conflict with the fact that actual risk management practice typically involves controlling exposures within tolerances; not necessarily absolute elimination of all risk. We are concerned that, given these effectiveness criteria, combined with the re-balancing requirements, the ED will result in even greater complexity and dissonance between reported and economic results. We strongly believe that these criteria should be replaced with a more robust and risk-linked principle, such as the “reasonably effective” benchmark proposed in the FASB’s ED amendments to ASC 815.

Finally, we disagree with the conclusion by both boards that voluntary de-designation should be prohibited. Risk management strategy is inherently dynamic and, in order for the accounting to be faithfully representative, it must allow the same flexibility for an entity to de-designate a hedge relationship as it does for designation. We are not aware of any practice abuses in this respect and do not understand the boards’ concerns.

Overall, we commend the direction taken by the IASB and are convinced that the issues noted above are not beyond resolution. We are hopeful that the boards might consider joint pursuit of the risk management objective approach in the ED. We would also encourage the FASB to consider expanding the scope of ASC 815 to hedging of macro / open portfolios, given their importance to the risk management functions of financial institutions.

Please find below (Appendix I) our detailed responses to the questions set forth in the discussion paper. If you have any questions, please do not hesitate to contact John Gallagher at 203-719-4212 or Doug Pittera at 203-719-4616.

Regards,

UBS AG

John Gallagher
Managing Director
Group Accounting Policy

Doug Pittera
Executive Director
Group Accounting Policy

Appendix I

Question 1: When an entity uses financial instruments to manage risk exposures in economic hedges but those instruments are not designated in hedging relationships for accounting purposes, do you believe that the proposed guidance would provide useful information about all of the effects of an entity's risk management objectives?

The ED does not appear to address economic hedging relationships and other elements of an entity's risk management strategy that are not designated as accounting hedges. Considered together with the additional scoping limitations (see discussion in Question 2, below) of the ED, we believe the proposed disclosures will reflect an incomplete picture of an entity's risk management and will therefore be of limited value to users.

We further question the relevance of some of the detailed disclosure requirements. In particular, we do not believe that disclosure of the notional values of derivative instruments provides utility to users, as they do not necessarily provide an indication of the sensitivity of the instruments to changes in underlying prices, rates, indices, etc. Furthermore, when an entity enters into an offsetting contract as a means of closing out a risk position (e.g., as opposed to terminating an open position), the presentation of notionals would imply a doubling of the risk position when, in fact, the risk has been extinguished.

We also question the auditability of some of the required disclosures which imply forward looking statements (e.g., para. 46). We believe it would be inappropriate for companies to disclose such forecasts, or for auditors to opine on them.

We believe that risk disclosures of financial instruments are better addressed under IFRS 7, *Financial Instruments: Disclosures*, and suggest that the IASB review the existing requirements therein (which are already extensive) so as to avoid duplication.

Question 2: Do you believe that the proposed guidance and illustrative examples included in the IASB's Exposure Draft are sufficient to understand what is meant by risk management, how to apply that notion to determine accounting at a transaction level, and how to determine the appropriate level of documentation required? Why or why not?

We generally agree with the IASB objective to represent in the financial statements the effect of an entity's risk management activities and strongly agree that this will, in principle, result in more useful information. However, we are concerned as to how the notion of the "link to risk management" will be applied in practice, especially in the context of the many constraints over the eligibility of hedged items and hedging instruments within the ED.

We do not think that the proposed guidance and illustrative examples included in the ED are sufficient to understand what is meant by "risk management" and are therefore concerned that having not fully defined "risk management" the IASB leaves open the possibility that the accounting interpretation of risk management may not converge with established economic principles of risk management. We suggest that the board should clarify that the concept of "risk management" involves many facets, including the identification, assessment, and prioritization of risks (defined in ISO 31000 as the effect of uncertainty on objectives, whether positive or negative) that are associated with an entity's operations, followed by coordinated and economical application of resources to monitor, and control the probability and/or impact of unfortunate events or to increase the realization of opportunities within specified tolerances.

We note that such a definition is consistent with many of the actual risk strategies commonplace amongst financial institutions, but which are de facto prohibited under the rules newly included in the ED, or brought forward from the existing requirements under IAS 39, e.g.,:

- Replicated interest rate exposure of financial instruments without a predefined maturity cannot be designated as hedged items according to the models which take into account their behavioral or risk characteristics (IAS 39 BC.188);
- Replicated benchmark interest rate exposures of non financial items are not currently eligible for hedge accounting;
- Libor risk cannot be designated as the hedged risk for instruments that have sub-Libor cash flows (ED/2010/13 B.24);
- Hedging of future net interest margin resulting from client deposits ("earnings at risk hedge") is not permitted;
- Multi-currency hedging into a currency other than the functional currency of the entity is not allowed since it does not reduce the cash flow risk but merely exchanges the variability in cash flow risk of one foreign currency to another;
- Bottom layers of a group of hedged items can only be designated as hedged items in limited circumstances (i.e. when they do not contain prepayment options other than those whose fair value is not affected by the hedged risk) (ED/2010/13 36.d).

Similarly, we do not think that the ED is sufficiently clear as to how to apply the "link to risk management" notion to risk management strategies of financial institutions that are generally defined at a macro or portfolio level rather than micro transaction-by-transaction level (which does not necessarily mean that financial institutions only wish to apply portfolio hedge accounting).

Financial institutions apply a variety of risk management practices to hedge multiple risks at the same time so that the risk management decisions as to whether to transact hedges for particular hedged items are not taken in isolation (e.g. stabilizing the Tier 1 ratio while protecting the shareholder's equity from losses due to foreign currency fluctuations). Often such risk management practices have overlapping goals. For example, Foreign Currency Translation adjustments within OCI ("FCT") are managed on a group level in order to achieve the aforementioned goals, but at the same time FCT is managed on an entity level to avoid booking of FCT impacts to P&L upon disposal.

Hence we do not believe that risk management strategy should necessarily be considered on a transaction by transaction basis or at the lowest common denominator. The standards should be clear that the objective of hedge accounting is to best represent the entity's risk management activities at an appropriate level. In our comment we suggested to include the following language as a supplement to para. 1 of the ED:

"Risk management strategies may exist at various levels within an organization and are inextricably linked to an economic view that may or may not coincide with the accounting view. Further, a given instrument or portfolio of instruments may be impacted by multiple, and in some cases, independent risk management strategies. Conversely, a given risk management strategy may affect multiple instruments or portfolios. A risk management strategy which is not designed to control an economic exposure to which the entity is exposed shall not be eligible as a designated risk management strategy for purposes of this statement."

We believe that the risk management controls present (and required by regulation) in financial institutions are sufficiently robust to provide objective evidence as to the appropriateness of an entity's designated strategies. We note that, under Basel III, the risk models of financial institutions are subject to a high level of

documentation and testing. Basel III acknowledges the viability of different internal risk management models depending on the size and complexity of the entity's operations and passes on the responsibility for proving the effectiveness of the internal models in achieving the targets and the existence of proper governance processes to financial institutions, with review by auditors. We believe that such a framework could be reliably incorporated into an institution's designations of its risk management strategies for hedge accounting purposes.

Question 3: Do you foresee an entity changing how it determines, documents, and oversees its risk management objectives as a result of this proposed guidance? If yes, what changes do you foresee? Do you foresee any significant difficulties that an entity would likely encounter in establishing the controls related to complying with the proposed guidance?

As described in our response to Question 2, we believe that hedge accounting guidance should be harmonized with risk management practice. To the extent that inconsistencies between risk management practice and hedge accounting guidance can be eliminated through more principles-based guidance, we would expect that it would be unnecessary for entities to change the manner in which they oversee risk management. The risk controls currently required by most sophisticated regulatory bodies should be adequate for purposes of substantiating compliance

Question 4: Do you foresee any significant auditing issues arising from the proposed articulation of risk management and its link to hedge accounting? For example, is the information required to be disclosed regarding an entity's risk management strategies measurable and objective? Could the inclusion of an entity's risk management objectives create an expectation gap that the auditor is implicitly opining on the adequacy of an entity's risk management objectives?

As mentioned in our response to Question 2, we believe that the notion of "risk management" is not sufficiently articulated in the ED. Moreover, the qualifying criteria for hedge accounting are narrowly focused on hedge ratios and volumes and do not adequately address the overall risk management objective, which may be governed by other metrics; e.g., risk sensitivity. Further, it is not clear whether hedge accounting is precluded in those instances where hedge designation does not perfectly follow the risk management strategy (e.g. proxy hedging). These factors create ambiguity that, if codified, will likely result in application uncertainty and auditing difficulties.

However, we believe that if IASB were to align the hedge effectiveness criteria to incorporate the concept of "reasonableness" (see our comment in Question 14) in the context of the entity's risk management strategies, and eliminate the prescriptive carve-outs for certain common risk management models (e.g., sub-libor, use of behavioral models), the risk management framework present in financial institutions (and required by regulation) could build a robust basis for objective, measurable and auditable information.

Question 5: Should cash instruments be eligible to be designated as hedging instruments? Why or why not? If yes, is there sufficient rigor to prevent an entity from circumventing the classification and measurement guidance in other relevant accounting guidance (for example, IFRS 9, Financial Instruments, and IAS 21, The Effects of Changes in Foreign Exchange Rates)? Are there any operational concerns about designating cash instruments (such as items within a portfolio of receivables) as hedging instruments?

We agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible as hedging instruments. We welcome the principles-based approach to the determination of the eligibility of hedging instruments.

Because only cash instruments measured at fair value through profit or loss are eligible for hedges of other than FX risk, we do not see any possibilities of abuse. We do not anticipate frequent utilization of hedge accounting for cash instruments designated as hedging items (other than for FX risk).

Question 6: Do you believe that the proposed guidance is sufficient to understand what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item (for example, equity instruments measured at fair value through profit or loss, standalone derivatives, hybrid instruments, and components of instruments measured at fair value through profit or loss that are not permitted to be bifurcated)? If not, what additional guidance should be provided?

We think that the guidance included in the ED with regards to components that are eligible for designation as a hedged item is sufficiently clear. However, we disagree with the rules-based exclusion of certain risk components within the standard, such as those relating to credit risk, prepayment risk and inflation.

We also disagree with the disallowance of designating a hedge of the LIBOR component of a sub-LIBOR hedged item, as this contradicts the overarching principle of representing the effects of risk management practice in the financial statements. It is quite common among financial institutions to use benchmark rates (e.g. LIBOR/swap rates) as a basis for pricing financial instruments. The spread to the benchmark rate (either positive or negative) is generally not relevant in a bank's interest rate risk management strategies.

Question 7: Do you believe that the proposed criteria are appropriate when designating a component of an item as a hedged item? If not, what criteria do you suggest? Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to determine when the criteria of separately identifiable and reliably measurable have been met? If not, please describe what additional guidance should be provided.

Please refer to our answer to Question 6.

Question 8: Do you believe that "separately identifiable" should be limited to risk components that are contractually specified? Why or why not?

We support the principle-based application of the requirements that are to be fulfilled when risk components are designated as hedged items. Given the numerous common conventions for identification of financial and other risks, we believe that it is unnecessary to require that such exposures be contractually specified. Further, in our comments to IASB we suggested that the IASB should eliminate the references to credit risk, prepayment risk and inflation as risks which do not meet the definition of separately identifiable and reliably measurable. These are all risk elements which can be and are managed discretely within financial institutions. As an example, the credit risk component of a bond is not contractually specified, however in practice it is granularly risk managed through CDS', guarantees and other instruments.

Question 9:

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Question 10: Do you believe that the proposed guidance is sufficient to understand what constraints apply to determining a layer component from a defined, but open, population? (For example, do you believe that the sale of the last 10,000 widgets sold during a specified period could be designated a layer component in a cash flow hedge?) If not, what additional guidance should be provided?

We believe that the sale of the last 10,000 widgets does not qualify for designation as a layer component due to the fact that when such a sale occurs it is not possible to identify whether it is part of the hedged layer and the entity could not therefore comply with the outlined accounting requirements for effective hedge relationships. In our view the guidance is sufficiently clear. However, we note that we do not employ similar strategies in our risk management activities.

Question 11: Do you foresee any operational concerns applying other guidance in IFRS (for example, guidance on impairment, income recognition, or derecognition) to those aggregated positions being hedged? For example, do you foresee any operational concerns arising when an impairment of individual items within a group being hedged occurs? If yes, what concerns do you foresee and how would you alleviate them?

Currently we do not foresee any additional operational concerns applying the above mentioned guidance to groups of hedged items pertaining solely to the fact that the affected group of items is subject to hedge accounting.

In our comment letter to IASB we raised some concerns that the ED does not provide sufficient guidance on the accounting treatment of the derivatives that are designated as a hedged item in a hedge of an aggregated exposure and urged IASB to establish more clarity by providing illustrative examples.

Question 12: Do you believe that the proposed guidance on aggregated exposures will provide more transparent and consistent information about an entity's use of derivatives? Why or why not?

Provided there is sufficient clarity with regards to the application of hedge accounting to aggregated exposures (please refer to our response to the previous question) we do believe that the proposed scope extension allowing designation of derivatives as hedged items will result in more useful information as it would allow more transparent and faithful reflection of some of the existing economic risk management practices that are currently not eligible for hedge accounting in the financial statements.

In our comments to the IASB we also suggested considering further existing risk management practices – e.g. use of a basis swap to convert a foreign currency cash flow exposure into an exposure in a more preferred currency (e.g. a currency subject to a natural offset arising from exposures from other balance sheet positions and/or highly probable forecast transactions or firm commitments) that in our view should be permissible.

Question 13: Do you believe that an entity should be permitted to apply hedge accounting to a group of cash instruments or portions thereof that offset and qualify as a group under the proposed guidance and satisfy the proposed hedge effectiveness criteria? Why or why not?

We agree that net positions should be eligible for hedge accounting. We believe that further deliberations on open portfolio hedging should result in development of more robust application parameters around the core concepts established in the ED, including net position hedging.

In our comment to IASB we highlighted the instances where net position hedging is the only meaningful way of reflecting the risk management activities in the financial statements. This is the case for hedging of net investments. As an international financial institution, UBS operates through various foreign operations, including holding structures. As a result, some of the UBS foreign operations that share the same functional currency have positive net assets (i.e. their assets less investment in subsidiaries exceed their liabilities) and some have negative net assets (i.e. their liabilities exceed their assets less investments in subsidiaries). Upon a change of the exchange rate between the functional currency of these foreign operations and the reporting currency of the group, offsetting negative and positive net assets result in foreign currency translation amounts that are diametrically opposed. Therefore, we asked IASB to clarify that a group of net investments can constitute net positions.

Question 14: Do you foresee any significant operational concerns, including auditing issues, in determining how to assess whether a hedge achieves other-than-accidental offset? If yes, what concerns do you foresee and how would you alleviate them?

We do not foresee any significant operational concerns in proving that the hedge relationship achieves other-than-accidental offset. As mentioned in our response to Question 2, we strongly believe that the boards should further pursue the hedge accounting objective outlined in the ED and remove the remaining constraints that disallow the application of hedge accounting to some commonly employed risk management strategies of financial institutions. Provided hedge accounting follows the risk management activities, there should be no difficulty in proving the existence of an economic relationship between the hedged item and the hedging instrument, so that the hedge relationship achieves other-than-accidental offset.

We are concerned that the "unbiased result" and "minimizing hedge ineffectiveness" criteria are overly restrictive and conceptually inconsistent with the statement that the hedge relationship need not be perfect in order to qualify for hedge accounting in para. B29 of the ED. If it is indeed the intent that no bias exist on each assessment date, and that ineffectiveness must be minimized, then we believe that this is a higher hurdle than achieving the 80-125% required by IAS39. Therefore, we suggest establishing the concept of "reasonableness" instead of "unbiased result" and "minimizing hedge ineffectiveness" as the governing criterion for assessing hedge effectiveness. This concept is sufficiently robust to preclude abuse, yet flexible enough to allow for the use of an entity's own risk management metrics in establishing boundaries. For instance, an entity's risk management controls may incorporate stress limits (PVBP, duration, VaR, deltas, etc.) by which the success of the entity's strategies are measured. Where such parameters are objective and relevant to management's actual approach to controlling risk, hedging outcomes that fall within management's defined limits should be considered "reasonably effective".

Question 15: Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to analyze hedge effectiveness (for example, how to measure the change in the

value of the hedged item attributable to the related hedged risk for nonfinancial items)? If not, what additional guidance is needed?

We believe that the IASB has made significant progress toward eliminating unnecessary complexity in the assessment of effectiveness; notably, we support the elimination of quantitative bright lines and continuous retrospective testing. However, as described in our responses to Questions 1 and 14, we have significant concerns with regard to the specific effectiveness criteria. As these are inter-related with the methods for assessment of effectiveness (i.e., per para. BC86¹), our general concerns are equally applicable in this context. This notwithstanding, we believe the ED's guidance for methods of assessment (BC86-90) is appropriate on the whole. However, we would support the inclusion of illustrative guidance in order to mitigate the possibility of inconsistencies in practice.

Question 16: Do you foresee any significant operational concerns or constraints in determining whether (a) a change to a hedging relationship represents a rebalancing versus a discontinuation of the hedging relationship or (b) an entity's risk management objective has changed? If yes, what concerns or constraints do you foresee and how would you alleviate them?

As mentioned in our response to Question 2, we do not think that the ED is sufficiently clear on how to apply the "link to risk management" notion to risk management strategies of financial institutions that are generally defined at a macro or portfolio level rather than micro transaction-by-transaction level (which does not necessarily mean that financial institutions only wish to apply portfolio hedge accounting). Therefore, it might be difficult to document how the decisions about changes in the risk management strategy taken on the macro level would impact each particular hedge relationship, be it a micro hedge or a portfolio hedge.

We also envisage situations whereby it will be desirable to terminate hedges without any change in the overall risk management situation, as more optimal hedge designations become available elsewhere within the portfolio, or to take advantage of natural offset where additional on balance sheet risk positions are transacted. This is not an uncommon situation, as risk management strategies are inherently dynamic.

Therefore we suggest allowing voluntary de-designation in order to alleviate these concerns.

Question 17: Do you foresee any significant operational concerns or constraints relating to the potential need to rebalance the hedging relationship to continue to qualify for hedge accounting? If yes, what concerns or constraints do you foresee and how would you alleviate them?

We are concerned that, as written, the ED can be interpreted as requiring institutions to systematically adjust their hedging instruments in order to achieve 100% effectiveness at all times. In practice, this is not the way risk management is defined. Generally, the risk manager does not systematically rebalance his books as long as the position remains within the pre-defined sensitivity limits (often completed with stop loss limits). As a consequence, the hedge relationship will in fact only be re-balanced as and when the risk management limits are breached or about to be breached. We believe that the requirement to rebalance cannot be a requirement resulting from the application of accounting standards and should rather follow the risk management strategy applied.

¹ , "the method used to assess the effectiveness of the hedging relationship needs to be suitable to demonstrate that the objective of the hedge effectiveness assessment has been achieved"

We agree, however, that changes in hedge relationships must not necessarily lead to de- and re-designation processes and therefore support the possibility of rebalancing the hedge relationship. Unfortunately rebalancing is solely addressed in the ED in the context of changing the hedge ratio. We note that there might be further instances where rebalancing should be applicable, e.g. if a different hedging instrument is designated to achieve better effectiveness or an additional hedging instrument is designated to compensate for changes in the market structure. Therefore we would welcome some further examples where rebalancing would be allowed under hedge relationships driven by economic risk management strategies.

Question 18: Do you believe that capitalizing the time value of an option as a basis adjustment of nonfinancial items (in other words, marking the asset or liability away from market) will improve the information that is provided in an entity's statement of financial position? Why or why not?

We agree with the conclusions on the accounting for the time value of options that are reflected in the ED. However, we note that this topic has no particular relevance for hedging strategies currently employed by UBS.

Question 19: Do you believe that the proposed presentation of the gains and losses in other comprehensive income will provide users of financial statements with more useful information? Why or why not?

We do not recognize the merits of recording the gain or loss on the hedging instrument and the hedged item in a fair value hedge in other comprehensive income (OCI). Because the ineffective portion of the gain or loss is transferred to profit or loss, the amount that is deferred in OCI relating to fair value hedge relationships will be zero at all times. Thus, the booking entries to OCI would introduce additional complexity without providing any additional information as compared to the disclosures currently required under IFRS 7.

We agree that in order to facilitate the understanding of the hedging activities by the users of the financial statements, the respective disclosures on hedge accounting should be bundled in one place, preferably in the notes to the financial statements.

Question 20: Do you believe that the proposed presentation of a separate line item in the statement of financial position would increase the transparency and the usefulness of the information about an entity's hedging activities? Why or why not?

We support the presentation of the gain or loss on the hedged item attributable to the hedged risk as a separate line item in the statement of financial position, which aligns it to the presentation of portfolio hedges of interest rate risk. However, we are concerned that for entities applying multiple hedge accounting models of different type of risks, the number of separate line items may be substantial, so that such presentation would create more confusion than it would contribute to a fair and coherent presentation of the entity's risk management activities. Therefore, we propose that one single line item is recognized on the face of the statement of financial position (an asset or a liability as appropriate) with accompanying detailed information to be provided in the notes to the financial statements.

Question 21: Do you believe that there is sufficient guidance to specifically link the hedging adjustments to the hedged assets and liabilities that compose a hedged net position with respect to presenting a separate line item in the statement of financial position?

As mentioned in our response to the previous question, we suggest limiting the number of single lines on the face of the statement of financial position to one with further detailed information to be provided in the notes. We believe that entities should be allowed to apply judgment when determining the level of disclosures and the usefulness of these disclosures to the users of financial statements. Therefore, whenever the information about the adjustments to the assets and liabilities that form part of the net position hedge is relevant, we expect entities to disclose this link in the notes to the financial statements.

Question 22: Do you foresee any significant auditing issues arising from the inclusion of risk management disclosures in the notes to the financial statements? If yes, what issues do you foresee and how would you alleviate them? Do you believe that it is appropriate to include risk management disclosures in the notes to the financial statements rather than in other information in documents containing financial statements? Why or why not?

While we can see the value in some of the disclosures proposed in the ED, we are concerned that the information required to be disclosed is too extensive and may require disclosure of some sensitive information about the forecasted transactions.

As mentioned under Question 2, we consider that the linkage between an entity's risk management objective and its hedge accounting strategies needs to be better articulated in the ED. This issue is also relevant to the proposed disclosures, which we believe require entities to explain their risk management strategy and the consequences of hedge accounting, without showing the extent to which they are aligned (or indeed, the extent to which they are different). It seems that the disclosures have been written assuming a 1:1 mapping between risk management strategy and hedge relationships which, as noted, is not typically the case.

See also our response to Question 1, above.

Question 23: Do you believe that the changes proposed by the IASB provide a superior starting point for any changes to U.S. GAAP as it relates to derivatives and hedging activities? Why or why not? Should the FASB be making targeted changes to U.S. GAAP or moving toward converging its overall standards on derivatives and hedging activities with the IASB's standards?

See cover letter.

Appendix II



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9 March 2011

Exposure Draft ED/2010/13, *Hedge Accounting*

Dear Sir David:

UBS welcomes the opportunity to comment on the IASB exposure draft ED/2010/13, *Hedge Accounting*. UBS fully supports the board's comprehensive review of IFRS hedge accounting principles. We agree that the current hedge accounting model under IAS 39, Financial Instruments: Recognition and Measurement, is overly complex and restrictive and does not consistently reflect the financial effects of many common risk management activities. However, until the board has further advanced its deliberations over open portfolios, we do not have sufficient contextual information to fully validate the proposal in respect of the risk management strategies that have utmost importance to banks and other financial institutions - open portfolio or macro hedging – which are widely applied especially in the context of interest rate and foreign exchange risk management.

Although we believe that the foundational concepts of the ED are basically sound, we feel that they must be iteratively cross-checked and refined with the critical elements of the open portfolio phase of the board's hedge accounting project. The formulation of hedging principles for open portfolios will consequentially necessitate the development of more robust application parameters around the core concepts established in the ED. Therefore, in the interest of achieving the highest quality standard, we believe it is vital that the two projects must be combined. As such, we suggest that the board extend its timetable to allow sufficient time to complete

a substantial composite. We strongly encourage the board to then re-expose a final hedge accounting standard in its entirety.

We agree with the board's objective to represent in the financial statements the effect of an entity's risk management activities and strongly agree that this will, in principle, result in more useful information. However, we note that the field of risk management, especially as applied in financial institutions (and as recognized by their prudential regulators), embodies a broad range of economic applications, the objectives of which may stretch beyond the accounting notion of offsetting an exposure. The objective of a chosen risk management strategy is to achieve a target level of exposure to certain risks rather than completely eliminating those risks. Financial institutions seek to have exposures to a range of risks that are commensurate with their capital position as well as their economic forecasts of the foreseeable future. When executing a chosen risk management strategy, a continuous reassessment of economic indicators is made to ensure the risk positions remain in line with the defined risk targets. This could mean that sometimes an increased exposure to certain risks is sought because a shift in the forecast risk-reward profile has occurred. We are concerned that the board has, in the past, prescriptively precluded financial institutions from applying hedge accounting to core risk strategies that are used in practice to manage and control economic exposures. In particular, we highlight the following common risk management strategies which current (and proposed) hedge accounting guidance does not permit:

- Designation of a LIBOR risk component of financial instruments which may have a negative spread to LIBOR (the sub-LIBOR issue);
- Designation of non-financial items and items without a predefined maturity (e.g. core deposits) according to the models which take into account their behavioral or risk characteristics;
- Hedges of a "bottom layer" for groups of financial instruments with prepayment options.

We believe that the board's re-stated hedge accounting objective can only be achieved if risk management, as an economic principle, is faithfully and consistently adhered to throughout the standard; from the scoping of eligible hedged and hedging instruments to the measures used in defining effectiveness. We are hopeful that, as the board continues its deliberations on open portfolios, many of the previous deviations between accounting and economic practice can now be rationalized under the new objective.

On the whole, the ED makes many positive steps toward a more simplified and principles based framework for hedge accounting. We applaud such positive developments as the simplification of the hedge effectiveness assessment and the elimination of the bright line 80-125 test, the ability to designate risk components of non-financial instruments, and the streamlining of the criteria for hedges of a group of items.

However, certain concepts will be operationally impracticable without more clarity. Notably, we believe there must be greater inter-relationship between the articulation of risk management strategies and the prescription for assessing their effectiveness (as well as the knock-on consequences of re-balancing and de-designation).

Moreover, we fully disagree with the prohibition of voluntary de-designation of a hedging relationship. Risk management strategies (of financial institutions esp.) are inherently dynamic and are influenced by risk-specific as well as strategic business factors. We do not believe that voluntary de-designation creates the risk of earnings management as companies cannot predict the future behavior of risk.

Given the inherent complexities associated with this accounting topic, it would be in the best interests of the entire community of users and preparers to ensure that any new guidelines have been thoroughly vetted for their operational efficacy. Toward such end, we would gladly endorse and support the board in any efforts necessary to field-test the revised standard.

Finally, we would also encourage the board to integrate all principles within the body of the standard rather than in the implementation guidance (e.g., the macro cash-flow hedging concepts incorporated in the current interpretative guidance in form of examples from IAS 39 IG.F.5 and IAS 39 IG.F.6).

Our comments to the specific questions raised in the request for views are included in the Appendix. Please feel free to contact us if you would like to discuss any of our comments.

Kind regards,

UBS AG

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Appendix A

Question 1: Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

Definition and Scope of Risk Management Strategies:

We generally agree with the proposed broad objective to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks. We are concerned, however, that having not fully defined "risk management" in the ED, the board leaves open the possibility that the accounting interpretation of risk management may not converge with established economic principles of risk management. We believe the board must clarify that the concept of "risk management" involves the identification, assessment, and prioritization of risks (defined in ISO 31000 as the effect of uncertainty on objectives, whether positive or negative) that are associated with an entity's operations, followed by coordinated and economical application of resources to monitor, and control the probability and/or impact of unfortunate events or to increase the realization of opportunities within specified tolerances.

We note that such a definition is consistent with many of the actual risk strategies commonplace amongst financial institutions, but which are de facto prohibited under the rules newly included in the ED, or brought forward from the existing requirements under IAS 39, e.g.,:

- Replicated interest rate exposure of financial instruments without a predefined maturity cannot be designated as hedged items according to the models which take into account their behavioral or risk characteristics² (IAS 39 BC.188);
- Replicated benchmark interest rate exposures of non financial items are not currently eligible for hedge accounting;
- Libor risk cannot be designated as the hedged risk for instruments that have sub-Libor cash flows (ED/2010/13 B.24);
- Hedging of future net interest margin resulting from client deposits ("earnings at risk hedge") is not permitted;
- Multi-currency hedging into a currency other than the functional currency of the entity is not allowed (please refer to the examples in our responses to Question 3) since it does not reduce the cash flow risk but merely exchanges the variability in cash flow risk of one foreign currency to another;
- Bottom layers of a group of hedged items can only be designated as hedged items in limited circumstances (i.e. when they do not contain prepayment options other than those whose fair value is not affected by the hedged risk) (ED/2010/13 36.d).

We are hopeful that the board's deliberations on macro / open portfolio hedging will address the inconsistencies of past accounting guidance for these examples relative to the core objective of the ED, and that future decisions will be rationalized with that objective.

Today, IAS 39 resolves some of these issues through the allowance of artificially designated hedged items i.e. items that may not be directly related to the risk management strategies themselves, only to fulfill accounting requirements (e.g., AG.118). We believe that this approach has resulted in rules-based guidance that necessarily promotes overly complex accounting practices and has not served to enhance the utility of the resulting financial statements in faithfully representing the results of entities' risk management strategies.

Therefore, we emphasize our concern that the standard must be throughout faithful to its principle. Scoping limitations on risk management strategies themselves will defeat the purpose of the hedge accounting objective. The result will be the perpetuation of artificial volatility in earnings of financial institutions or a hedge accounting designation that follows hedge accounting requirements rather than the effective risk management practices.

Identification of Risk Management Strategy:

We support the board's principles approach which inherently implies flexibility in the identification of an entity's risk management controls. However, we believe that this notion should be clearly articulated within the standard, in order to prevent the audit practice from reverting to overly myopic, one-size-fits-all rules. In particular, we feel that the ED has been written on the basis that risk management is considered at a very micro level. This is evident in the requirement for hedge relationships to be terminated when the risk management

² It is a fundamental risk strategy of financial institutions to move interest rate risk at an internal transfer price into a centralized risk management unit within the organization and to use interbank money market / swap rates to determine the internal transfer price. Furthermore, banks with retail portfolios commonly manage interest rate risk on the basis of models, where certain balance sheet positions are internally reflected at effective (behavioral) maturities instead of contractual maturities. One example of an internal model is the replication of core deposits for the purpose to manage earning's volatility or the interest rate risk of products with administered rates by transferring non-market rates into market rates. Not allowing designation of replicated transactions means disregarding this crucial risk management method. Many international organizations and regulators acknowledge these models and the treatment of positions where the effective maturity differs from the contractual maturity.

strategy changes, and precluding termination of hedges when risk management strategy has remained the same (we discuss the impact of this further in our responses to Questions 6 and 7).

Even where financial institutions are able to apply micro hedge accounting relationships, risk management is considered at a higher, macro or portfolio level. By this we do not mean that financial institutions only wish to apply portfolio hedge accounting, but rather that risk management decisions as to whether to transact hedges for particular hedged items are not taken in isolation.

We ask the board to consider that in financial institutions a variety of risk management practices are applied to hedge multiple risks at the same time (e.g. stabilizing the Tier 1 ratio while protecting the shareholder's equity from losses due to foreign currency fluctuations). Often such risk management practices have overlapping goals. For example, Foreign Currency Translation adjustments within OCI ("FCT") are managed on a group level in order to achieve the aforementioned goals, but at the same time FCT is managed on an entity level to avoid booking of FCT impacts to P&L upon disposal.

Hence we do not believe that risk management strategy should necessarily be considered on a hedge by hedge basis. The ED should be clear that the objective of hedge accounting is to best represent the entity's risk management activities at an appropriate level. For instance, the following language might be included as a supplement to para. 1:

Risk management strategies may exist at various levels within an organization and are inextricably linked to an economic view that may or may not coincide with the accounting view. Further, a given instrument or portfolio of instruments may be impacted by multiple, and in some cases, independent risk management strategies. Conversely, a given risk management strategy may affect multiple instruments or portfolios. A risk management strategy which is not designed to control an economic exposure to which the entity is exposed shall not be eligible as a designated risk management strategy for purposes of this statement."

We believe that the risk management controls present (and required by regulation) in financial institutions are sufficiently robust to provide objective evidence as to the appropriateness of an entity's designated strategies. We note that, under Basel III, the risk models of financial institutions are subject to a high level of documentation and testing. Basel III acknowledges the viability of different internal risk management models depending on the size and complexity of the entity's operations and passes on the responsibility for proving the effectiveness of the internal models in achieving the targets and the existence of proper governance processes to financial institutions, with review by auditors. We believe that such a framework could be reliably incorporated into an institution's designations of its risk management strategies for hedge accounting purposes.

Finally, we do not agree that hedge accounting should be limited to exposures that could affect profit and loss. For example, it is not uncommon for financial institutions to hedge the FX risk of equity investments designated at fair value through OCI, much in the same manner as they would hedge the FX risk of a net investment in a consolidated foreign entity. We do not understand the conceptual basis for prohibiting the former, while allowing the latter.

Question 2: Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

We agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible as hedging instruments. We welcome the principles-based approach to the determination of the eligibility of hedging instruments.

Question 3: Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

We agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item. We strongly welcome this scope extension which brings hedge accounting closer to actual risk management practices. Nevertheless we feel that additional guidance on the accounting treatment of derivatives that are part of the aggregated exposure that is designated as a hedged item is required. Currently, only derivatives that are designated and effective as hedging instruments are exempt from the accounting treatment at fair value through P&L. We do not believe that the ability to include a derivative as part of the hedged item will result in accrual accounting for the derivative; however we think that implementation guidance on the mechanics of applying paragraph 15 and B9 would be helpful.

Under the existing rules of IAS 39, a basis swap that involves currencies other than the functional currency of the entity that holds the instrument is not eligible for cash flow hedge accounting since the basis swap does not reduce the cash flow risk but merely exchanges the variability in cash flow risk of one foreign currency to another one. However, use of a basis swap to convert a foreign currency cash flow exposure into a more preferred one (e.g. to match the exposure from other balance sheet positions) is a common risk management practice and should be allowed (refer also to our comment in question 1 above regarding eligibility).

In addition, we note that a natural extension of the board's decision to permit the designation of a derivative as a hedged item would be to also permit the designation of forecasted cash flows related to the highly probable future issuance of a derivative as a hedged item. However, it is unclear from the present language of the ED whether this was indeed the board's intention.

We believe that more clarity could be conveyed if the principles of designation as a hedged item of a combination of derivative and non-derivative instruments were demonstrated using examples, e.g.:

- Example 1: a fixed rate foreign currency debt in combination with a receive fixed pay floating interest rate swap is designated as a hedged item in a cash flow hedge of foreign currency risk, where the hedging instrument is a basis cross-currency swap converting variable cash flows in the foreign currency into variable cash flows in the local currency;
- Example 2: a fixed rate foreign currency debt in combination with a receive fixed pay floating interest rate swap is hedged with a basis cross-currency swap converting variable cash flows in the foreign currency into variable cash flows in another foreign currency which is not the functional currency of the entity, but naturally offsets other cash flows in the same foreign currency;
- Example 3: highly probable forecasted variable rate foreign currency cash inflows in combination with highly probable forecasted basis cross-currency swaps converting variable cash flows in the foreign currency into variable cash flows in the local currency are designated as a hedged item in a cash flow hedge of interest rate risk, where the hedging instrument is a receive fixed pay variable interest rate swap in the local currency.

Question 4: Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

We agree with the proposal to allow the designation of a risk component as a hedged item if it is separately identifiable and reliably measurable.

However, we disagree with the rules-based exclusion of certain risk components within the standard. We believe that it is not appropriate for the board to incorporate opinions within the standard as to whether risks are "reliably measurable", such as those relating to credit risk, prepayment risk and inflation. We believe that such statements will inevitably lead to a more rules-based application of the standard, which runs counter to the board's expressed objective of issuing a more principles-based standard. We note that financial markets continue to evolve and innovate at a very rapid pace and are constantly developing new indices and instruments, such that what may be considered difficult to measure today may become a standardized metric tomorrow. We note that there appears to be no such prescriptive guidance precluding non financial institutions from identifying the key risks in order to manage their businesses, therefore the ED now seems to be unfairly biased towards non financial institutions in this area. Accordingly, we suggest that the board should eliminate the references to credit risk, prepayment risk and inflation as risks which do not meet the definition of separately identifiable and reliably measurable.

As noted in our comment to question 1, the disallowance of designating a hedge of the LIBOR component of a sub-LIBOR hedged item contradicts the overarching principle of representing the effects of risk management practice in the financial statements. It is quite common among financial institutions to use benchmark rates (e.g. LIBOR/swap rates) as a basis for pricing financial instruments. The spread to the benchmark rate (either positive or negative) is generally not relevant in a bank's interest rate risk management strategies.

As an example, a bank's bond trading desk may hold two fixed rate bonds: Bond 1 is issued by a AAA government entity and Bond 2 is issued by an investment grade corporate. The rate on Bond 1 may be below LIBOR (i.e. sub-LIBOR, or negative spread) due to the favorable credit of the issuer and the liquidity of the market in which the instrument trades. The rate on Bond 2 will likely reflect a premium over LIBOR due to its lower credit standing and liquidity. The bank's central treasury unit's strategy is to convert all fixed rate risk exposure to LIBOR floating (the bond desk manages credit exposure under a separate strategy, independent of the central treasury) in order to close out a funding gap with its floating rate liabilities. It will generally use a LIBOR-based interest rate swap to hedge the LIBOR component of the overall interest rate. The central treasurer will not differentiate the interest rate risk of the borrower whose debt is issued at a positive spread to LIBOR from the borrower whose debt is issued at a negative spread to par; i.e., it would use the same swap regardless, as the LIBOR rate is the benchmark index for the market(s) in which the bonds trade.

It appears from the ED's basis for conclusions that the board was concerned over counter-intuitive outcomes in which the rate on a bond may turn negative due to the size of the negative spread relative to LIBOR. We note that this would be a highly unusual circumstance; however, it would nonetheless still be consistent with the economic driver... the LIBOR element of the rate. Further, we find no basis for asymmetric treatment to the bond with the positive spread over LIBOR; effectively, the board is proscribing the use of hedge accounting for a widely used risk management practice based on the credit quality of an instrument's issuer. We do not believe the board's concerns over outlier scenarios in which a negative spread is created are a compelling conceptual argument for precluding a hedge of the LIBOR component. We strongly believe that the hedge accounting designation should follow the risk management, so that the LIBOR component can be designated, rather than adopting specific rule-based restrictions.

Question 5: (a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why? (b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?

We agree that a layer of the nominal amount of an item or a group of items should be eligible for designation as a hedged item. This would reduce the recognition of artificial hedge ineffectiveness in those cases where, from a risk management perspective, there is none.

One of the key requirements for financial institutions is to have a suitable hedge accounting solution for the hedge of interest rate risk for layers of portfolios of assets prepayable at other than fair value. The guidance in the ED would exclude hedging layers of such portfolios because of the prepayment terms, even if the portfolio was closed. This exclusion is inconsistent with market practice, where it is common for entities to "under-hedge" in anticipation of prepayments within a portfolio.

However, we are pleased to note that this issue is being considered as part of the board's deliberations on portfolio hedging, and based on the tentative decisions so far we support the direction the board has taken on this issue. For that reason, we would be keen to ensure that the portfolio hedging guidance is not ultimately exclusive to open portfolios.

Consequently, we support the ability to designate a layer of a closed group as part of a fair value hedge where the hedged group is prepayable at fair value. However, from our perspective this guidance is really a stepping stone for the ability to hedge layers within portfolios where prepayment is impacted by the hedged risk as part of open portfolio hedging.

Question 6: Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

We welcome the board's decision to focus on the qualitative characteristics of hedge effectiveness and to abandon the bright line 80 – 125% effectiveness corridor. We believe the existing guidance on this concept had little relevance in the context of real risk management practice and created numerous unnecessary operational complexities, e.g. in a Fair Value Hedge relationship where a fixed rate debt is hedged with an interest rate swap that exactly matches in critical terms but where the effectiveness test could fail because of the P&L volatility of the floating leg. Further, we agree that effectiveness should be assessed on a prospective-only basis. We generally agree to the requirement that hedge effectiveness should remain as a qualifying criterion for hedge accounting; however we believe the tolerance thresholds should be rationalized to the risk management objective.

We also agree that the notion of "other than accidental offsetting" provides satisfactory evidence of the existence of an economic relationship between the hedged item and the hedging instrument. However, we are concerned that the "bias" and "minimal ineffectiveness" criteria are overly restrictive and conceptually inconsistent with the statement in para. B.29 that the hedge relationship need not be perfect in order to qualify for hedge accounting. If it is indeed the board's intent that no bias exist on each assessment date, and that ineffectiveness must be minimized, then we believe that this is a higher hurdle than achieving the 80-125% required by IAS39 and we would not support this approach.

We agree that a hedge relationship would provide a biased result if it reflects a deliberate mismatch with the risk management strategy. We believe it was the board's intent to allow for reasonable flexibility within the risk tolerances of a specific risk management strategy. Tolerance could be defined, for instance, in relation to the magnitude of any ineffectiveness and also the source of ineffectiveness defined by the risk management strategy. For example, we understand that the time value of a hedged item and the full fair value movements of the hedging derivatives must be considered for the purpose of reporting ineffectiveness. However, for risk management purposes entities may not consider all causes of fair value movements to be relevant. We would not expect fair value movements from changes in the credit risk of derivative counterparties or the unwind of the financing element from non-zero fair value derivatives to be a cause of concern within the effectiveness assessment. We would assume if judgment were permitted to be applied to determine whether the effectiveness assessment was met, then the impact of these sources of ineffectiveness could either be ignored or excluded. We believe that the use of the words 'no bias' are inconsistent with the ability to apply judgment and should therefore be amended.

We suggest that the board consider substituting the concept of "reasonableness" for "bias" and "minimal ineffectiveness" as the governing criterion for assessing hedge effectiveness. This concept is sufficiently robust to preclude abuse, yet flexible enough to allow for the use of an entity's own risk management metrics in establishing boundaries. For instance, an entity's risk management controls may incorporate stress limits (PVBP, duration, VaR, deltas, etc.) by which the success of the entity's strategies are measured. Where such parameters are objective and relevant to management's actual approach to controlling risk, hedging outcomes that fall within management's defined limits should be considered "reasonably effective".

Question 7: (a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why? (b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?

We disagree with the concept of 'mandatory rebalancing' as it is not aligned to risk management. Rebalancing is a matter of fact based on the risk management strategy applied and cannot be a requirement resulting from the application of accounting standards.

As written, the ED can be interpreted as requiring institutions to systematically adjust their hedging instruments in order to achieve 100% effectiveness at all times. In practice, this is not the way risk management is defined. Generally, the risk manager does not systematically rebalance his books as long as the position remains within the defined sensitivity limits (often completed with stop losses limits). As a consequence, the hedge relationship will in fact only be re-balanced as and when the risk management limits are breached or about to be breached. We believe it was the board's objective to allow for fluctuation of the relationship between the hedging instrument and the hedged risk within the parameters of the associated risk management strategy; i.e., a reasonable tolerance. Therefore, we suggest that this criterion be re-stated in the context of the risk management strategy (see further our comment in Question 6 regarding hedge effectiveness criteria).

We agree, however, that changes in hedge relationships must not necessarily lead to de- and re-designation processes. De- and redesignations are mainly an issue of the consideration of take-on RVs in cash flow hedge accounting where existing hedging instruments have a take-on RV but the hypothetical derivative constructed to

represent the hedged position does not. The board may rather want to address this specific issue and allow voluntary de- and re-designations (see question 8).

Question 8: (a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why? (b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

We understand and agree to the necessity of de-designating the hedge relationship if it no longer meets the qualifying criteria or the risk management objective. However, we disagree with the board's prohibition of discretionary discontinuation of the hedge relationship.

Risk management strategies (of financial institutions esp.) are inherently dynamic and are influenced by risk-specific as well as strategic business factors. We envisage situations whereby it will be desirable to terminate hedges without any change in the overall risk management situation, as more appropriate hedge designations become available elsewhere within the portfolio, or to take advantage of natural offset where additional on balance sheet risk positions are transacted. Given that hedge accounting is not mandatory where risk management activities are undertaken with financial instruments, it seems strange to us that there is a requirement within the ED to continue with hedge accounting if it was no longer desirable for an entity. Similar to our comments on the two preceding questions, we do not believe this requirement is consistent with the board's overall objective for hedge accounting.

Further, we do not understand the board's concerns that hedge accounting may be manipulated to manage earnings. It is well known that IAS39 permits voluntary discontinuation, and the impact is prospective. We do not believe that the IAS39 guidance in this area has been subject to abuse. It is not possible under the present rules to simply de-designate and create earnings since, upon termination of the hedge, any suspended P&L will have to be amortized to earnings over the remaining life of the hedged item for cash flow hedges and, for fair value hedges, the entity will be exposed to the uncertain market volatility on the hedging derivative; neither of which constitutes earnings management.

Question 9: (a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognized in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why? (b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why? (c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?

We do not recognize the merits of recording in other comprehensive income (OCI) the gain or loss on the hedging instrument and the hedged item in a fair value hedge. Because the ineffective portion of the gain or loss is transferred to profit or loss, the amount that is deferred in OCI relating to fair value hedge relationships

will be zero at all times. Thus, the booking entries to OCI would introduce additional complexity without providing any additional information as compared to the disclosures currently required under IFRS 7.

We agree that in order to facilitate the understanding of the hedging activities by the users of the financial statements, the respective disclosures on hedge accounting should be bundled in one place, preferably in the notes to the financial statements.

We support the presentation of the gain or loss on the hedged item attributable to the hedged risk as a separate line item in the statement of financial position, which aligns it to the presentation of portfolio hedges of interest rate risk and which could also include the fair value changes of designated replication portfolios. However, we are concerned that for entities applying multiple hedge accounting models of different type of risks, the number of separate line items may be substantial, so that such presentation would create more confusion than it would contribute to a fair and coherent presentation of the entity's risk management activities. Therefore, we propose that one single line item is recognized on the face of the statement of financial position (an asset or a liability as appropriate) with accompanying detailed information to be provided in the notes.

For reasons mentioned above, we agree that linked presentation is not appropriate for fair value hedges.

Question 10: (a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why? (b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why? (c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

We agree with the board's conclusions, as represented in the ED.

Question 11: Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

We strongly support the simplification of the requirements of IAS 39.83 for hedging of groups of items. We note that it initially appears helpful that the board has decided to relax the requirement in IAS 39 that the change in the fair value attributable to the hedged risk for each individual item in the group must be 'approximately proportional' to the overall change in the fair value of the group for the hedged risk. However, the requirement in paragraph 36(c) seems to re-introduce the criteria "the items in the overall group from which the layer is identified are exposed to the same hedged risk (so that the measurement of the hedged layer is not dependent on which items from the overall group form part of the hedged layer)".

We also welcome the net position hedging allowing similar treatment for net positions that eventually do or do not result in a nil net position.

We would like to make the board aware of instances where net position hedging is the only meaningful way of reflecting the risk management activities in the financial statements. This is the case for hedging of net investments. As an international financial institution, UBS operates through various foreign operations, including holding structures. As a result, some of the UBS foreign operations have positive net assets (i.e. their assets less investment in subsidiaries exceed their liabilities) and some have negative net assets (i.e. their liabilities exceed their assets less investments in subsidiaries). Upon a change of the exchange rate between the functional currency of these foreign operations and the reporting currency of the group, offsetting negative and positive net assets result in functional currency translation amounts that are diametrically opposed. Therefore, we ask the board to clarify that a group of net investments can constitute net positions.

Question 12: Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (e.g. in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

We understand the purpose of the board's guidance is to alleviate the potential need to "gross-up" P&L for each side of the net hedged position. We agree that this is a generally sensible rule. However, we note that financial institutions may utilize the allowance for designating hedges of net position in the context of managing their net interest margin. Net interest income is a commonly reference metric for evaluating a bank's performance. As such, we presume that entities will not be precluded from presenting the separate line item within the section of the income statement which most faithfully reflects its nature (in our example, contiguous with interest income and interest expense). If this is consistent with the board's view, we would suggest that the guidance reflect this flexibility.

Question 13: (a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why? (b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

While we can see the value in some of the disclosures proposed in the ED, we are concerned that the information required to be disclosed is too extensive.

As mentioned under Question 1, we consider that the linkage between an entity's risk management objective and its hedge accounting strategies needs to be better articulated in the ED. This issue is also relevant to the proposed disclosures, which we believe require entities to explain their risk management strategy and the consequences of hedge accounting, without showing the extent to which they are aligned (or indeed, the extent to which they are different). It seems that the disclosures have been written assuming a 1:1 mapping between risk management strategy and hedge relationships, which as noted is most of the time not the case.

In addition, the guidance in the ED (paragraphs 45-48) is not consistently clear whether the disclosure requirements are only applicable where hedge accounting is applied, or where risk management activities are undertaken.

In particular we do not support the requirement to disclose notional amounts related to the hedging instruments (para 49(b)). We do not believe that this will be useful information, especially where a combination of derivatives are used in a hedge relationship.

Question 14: Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

This guidance is not generally pertinent to financial institutions. Therefore, we have no comment.

Question 15: (a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not? (b) If not, which of the three alternatives considered by the board in paragraphs BC226–BC246 should the board develop further and what changes to that alternative would you recommend and why?

Of the alternatives presented, we are most sympathetic to alternative 3. However, we believe that the standard should permit companies the choice to amortize the consequential fair valuation adjustments upon designations post-inception over the life of the instrument in a systematic fashion. This would reduce much of the potential complexity which would otherwise result from imputing an effective yield.

As an alternative, we would suggest the board consider permitting the designation of 'everything but the LIBOR component' as an eligible risk component for hedge accounting. We believe that such a component will be separately identifiable and measurable (consistent with the approach to measures of own credit within IFRS7 and IFRS9). This would enable entities to compare changes in 'everything but the LIBOR component' to changes in hedging CDSs.

Question 16: Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

We are of the view that key standards impacting upon financial services activities should have a single adoption date, in order to maintain comparability and to cope with the systems 'developments inherent to the implementation of complex new texts. In our answer to the request for views on effective dates and transition methods, we have suggested that January 2015 be the effective date with no restatement of the previous years.

Further, we believe that the classification and measurement and hedge accounting phases of the financial instruments project are inter-dependent. When considering application of the proposed hedge accounting model, entities will need to consider the cost/benefits associated with the new model versus application of the fair value option. It is imperative that entities be allowed to elect the fair value option when they become subject to the new hedge accounting model. As such, preparers should be allowed to adopt classification and measurement and hedge accounting simultaneously. Those entities that have already adopted classification and measurement should be afforded the opportunity to early adopt hedge accounting once finalized. Thus, we would encourage the board to consider an exception with respect to the hedge accounting guidance if it chooses to generally prohibit early adoption.