Mr. Lawrence Smith  
Financial Accounting Standards Board  
Director-Technical Application and Implementation Activities  
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October 10, 2005

UBS welcomes the opportunity to comment on the Exposure Draft of proposed Statement of Accounting Standards - Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140 (File Reference No. 1210-001)

Dear Mr. Smith

UBS welcomes the opportunity to comment on the Exposure Draft of proposed Statement of Accounting Standards - Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140 (the "Proposed Statement"). UBS utilizes International Financial Reporting Standards (IFRS) as its primary reporting basis and reconciles its IFRS reported results to US GAAP. As such, we apply the fair value option and elect to measure certain financial instruments at fair value, as provided by IAS 39. The use of the fair value option in IAS 39 has enabled UBS to reduce artificial volatility in the income statement and has provided significant relief from the very complex rules related to hedge accounting and the separation of embedded derivatives. Further, use of the fair value option allows us to account for financial instruments in line with how they are managed.

We are thus keenly interested in the Board’s efforts to develop a fair value option for all financial instruments and believe that the Proposed Statement is a step in the right direction. However, we urge the Board to continue its efforts in developing a full fair value option in a timely manner.

We support the Board’s decision to permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. However, we have concerns regarding application of the election and the...
proposed transition requirements. UBS is separately commenting on the revised exposure
draft of proposed amendments to FASB Statement No. 140 relating to the Accounting for
Transfers of Financial Assets.

Proposed Amendments to Paragraph 16

Paragraph 16 of the Proposed Statement permits fair value measurement for any hybrid
financial instrument that contains an embedded derivative that otherwise would require
bifurcation. The proposal reduces the complexity of applying FASB Statement No. 133,
Accounting Derivative Instruments and Hedging Activities (Statement 133). However, by
requiring that the embedded derivative would otherwise be bifurcated, the very complex
“clearly and closely related” criteria of Statement 133 will continue to apply. We do not
see the merit in continuing to analyze whether the clearly and closely related criterion is
applicable in order to apply the proposed fair value election, as this unnecessarily retains
some of the complexity of SFAS 133. We note that one of the Board’s objectives in
providing for the election to measure hybrid financial instruments at fair value is to simplify
the accounting for such instruments and, to some extent, provide an alternative that
results in the greatest degree of convergence with IFRS. We believe that the election to
measure hybrid financial instruments at fair value could be simplified by further converging
with IFRS. In providing for a similar, although more broad-reaching, fair value option, the
IASB did not see a need to ensure the embedded derivative would otherwise require
bifurcation in order to elect the fair value option. Rather, IAS 39 (paragraph 11A) allows for
fair value measurement of any hybrid instrument unless: "(a) the embedded derivative(s)
does not significantly modify the cash flows that otherwise would be required by the
contract; or (b) it is clear with little or no analysis when a similar hybrid instrument is first
considered that separation of the embedded derivative(s) is prohibited, such as a
prepayment option embedded in a loan that permits the holder to prepay the loan for
approximately its amortized cost.” We believe the election to measure hybrid financial
instruments at fair value could be drastically simplified by eliminating the requirement to
determine whether the embedded derivative would require bifurcation and adding
criteria similar to paragraph 11A of IAS 39.

Additionally, income statement volatility may continue to occur with such a restriction as
companies may find it uneconomical to hedge host contracts that have embedded
derivatives whose economic characteristics and risks are clearly and closely related to the
host contract (e.g., where a debt contract includes a call feature, the cost of hedging
with a callable swap is substantially greater than with a vanilla swap). We do not believe
that companies will embed non-substantive derivatives in host contracts to achieve fair
value measurement for a host contract. Additionally, applying the clearly and closely
related criterion to beneficial interests will be difficult due to the complexity of the cash
flow allocations and interdependency of the assets and other arrangements within a SPE, especially for the purchaser of beneficial interests who has limited information.

We believe that the Board should retain the practicability exception previously provided in paragraph 16 of Statement 133. We understand the Board believes that, by deciding to expand the fair value option to all hybrid financial instruments that contain an embedded derivative that otherwise would require bifurcation, there is no longer a need for the practicability exception previously provided in paragraph 16 of Statement 133. We believe that the practicability exception, if unchanged, would actually be used more than it is currently applied today. We believe the elimination of Statement 133 Implementation Issue D1, coupled with the proposed amendments to paragraph 14 of Statement 133, create a need for a practicality exception and therefore request the Board leave that portion of paragraph 16 to Statement 133 unchanged. The IASB shared our concerns when developing the fair value option in IAS 39 and included a practicability exception in paragraph 12 of IAS 39 similar to the existing language in paragraph 16 of Statement 133.

Credit Risk in Beneficial Interests

Paragraph 14B of the Proposed Statement states that “credit risk in a beneficial interest resulting from financial instruments or other assets and liabilities (including derivative contracts) that are held by the issuing entity, shall not be considered an embedded derivative under this Statement”. It is not clear whether this statement, clarifying that there is no need to bifurcate credit risk in most qualifying SPEs, is equally applicable to non-qualifying SPEs. We are concerned that the use of the term “beneficial interest”, which has been re-defined in the proposed amendment to FAS 140, may be construed to pertain solely to qualifying SPEs. We see no compelling reason why the same point would not be true for non-qualifying SPEs. For instance, the credit risk in a CDO issued by a non-qualifying SPE is typically directly attributable to the assets and liabilities held by the SPE. We do not see the merit in requiring an investor to bifurcate the credit risk component in such an instrument merely because the structure does not utilize a qualifying SPE.

Transition

The Board proposes a prospective transition for all instruments obtained or issued after the Proposed Statement’s effective date and specifically prohibits application of the Proposed Statement to instruments that the entity holds at the effective date. We do not agree with the proposed transition. We believe that the election to measure hybrid financial instruments at fair value should be applied on a prospective basis for new instruments and for any existing instrument, on a contract-by-contract basis, as a retrospective adjustment. Alternatively, we would support application of the election to measure hybrid financial instruments at fair value to any existing instrument with a cumulative effect adjustment recorded to reflect the existing hybrid financial instruments at fair value.
We understand the Board’s reasoning, as described in paragraph A30 of the Proposed Statement, for limiting transition to prospective application. We also understand that the Board had reservations for allowing a cumulative effect type approach on a contract-by-contract basis, because of the risk associated with such a transition in permitting an entity to choose only those contracts in a gain position or, more likely, only those contracts in a loss position. We believe this risk can be mitigated through transparent disclosure. The IASB’s approach to transition of the fair value option in IAS 39 was to permit an entity to designate a previously recognized financial asset or financial liability for the fair value option, on a contract-by-contract basis. The IASB solved the risk of cherry-picking gains or losses by adding a disclosure requirement (to IAS 32) to provide information about the fair value of the financial assets or financial liabilities designated into each category and the classification and carrying amount in the previous category. Specifically, Paragraph 105 of IAS 39, as amended, states:

When this Standard is first applied, an entity is permitted to designate a previously recognised financial asset or financial liability as a financial asset or financial liability at fair value through profit or loss... despite the requirement in paragraph 9 to make such designation upon initial recognition... For any financial instrument designated as at fair value through profit or loss... the entity shall (a) restate the financial asset or financial liability using the new designation in the comparative financial statements; and (b) disclose the fair value of the financial assets or financial liabilities designated into each category and the classification and carrying amount in the previous financial statements.

We encourage the Board to converge the transition provisions of the Proposed Statement with IFRS, as there are many foreign-based US registrants that recently began applying the fair value option in IAS 39 to their existing financial assets and liabilities.

We have included responses to the specific questions asked in Appendix A of this letter.

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

John Gallagher  
Managing Director  
Accounting Policies and Support

Samuel Lynn  
Executive Director  
Accounting Policies and Support
Appendix A

Fair Value Election

Issue 1: Do you support the Board’s decision to permit fair value remeasurement for hybrid financial instruments that contain an embedded derivative that otherwise would require bifurcation?

Yes. However, we have concerns regarding application of the election and regarding transition as described in the body of this letter.

Evaluation to Determine If Embedded Derivatives Exist

Issue 2: Should this proposed Statement provide implementation guidance on how to evaluate whether an instrument contains an embedded derivative that would require bifurcation? If so, what type of guidance do you believe the Board should consider?

No. We do not believe additional guidance is required if the final standard will require an embedded derivative be evaluated to determine whether it should be bifurcated in order to apply the fair value election. Additional guidance would merely add to the complexity of the rules governing embedded derivatives.

Interaction with Statement 140

Issue 3: This proposed Statement requires evaluation of instruments for identification of embedded derivatives and permits but does not require fair value measurement for instruments that contain embedded derivatives that otherwise would require bifurcation. Are the requirements for evaluating and accounting for interests issued by qualifying SPEs clear and understandable? Is the guidance for evaluating how the existence of embedded derivatives would affect whether an entity is a qualifying SPE clear and understandable? If not, what additional clarifying guidance should the Board consider?

As described in the body of this letter, we seek clarification of paragraph 14B in the Proposed Statement - specifically regarding its application to interests in non-qualifying SPEs.

Effective Date

Issue 4: This proposed Statement would be applicable to all instruments obtained or issued after the earlier of fiscal years beginning after December 15, 2005, or fiscal years that begin during the fiscal quarter in which the Statement is issued, if applicable. Do you believe that the effective date provides sufficient time for implementation by calendar-year reporting enterprises?

If transition will be prospective, we believe the effective date provides sufficient time for implementation. However, we do not agree with the proposed transition. As noted in the
body of this letter, we believe that the election to measure hybrid financial instruments at fair value should be applied on a prospective basis for new instruments and for existing instruments with a cumulative effect adjustment recorded to reflect the existing hybrid financial instruments at fair value.