1810-100
Comment Letter No. 1480

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Proposed ASU Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities, File Reference No. 1810-100

Dear Mr. Golden:

UBS AG appreciates the opportunity to comment on the FASB's Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the proposed Update). UBS is a global financial institution that files its group consolidated financial statements in accordance with International Financial Reporting Standards as issued by the IASB. We also have several significant subsidiaries that file stand alone financial reports in accordance with US GAAP. As such, we are supportive of the efforts of the FASB and the IASB (collectively, "the Boards") to simplify and improve the reporting for financial instruments.

UBS notes that financial instruments are the subject of a joint project between the Boards. As we believe convergence over the accounting for financial instruments is integral to well-functioning global capital markets, we are supportive of the project's objective to improve comparability between the two sets of accounting standards. However, the Boards have issued vastly different proposals and are proceeding independently in their deliberations. We caution the Boards that that neither has a monopoly on the best steps forward, and that it will only be through disciplined collaboration that a truly robust and improved model can be achieved. Our comments below address issues of convergence and divergence as they relate to each aspect of the proposed Update.

Summary

UBS views the proposed Update and the IASB proposals on financial instrument accounting as offering some specific improvements to financial reporting. We also believe that the various proposals have their weaknesses. Along those lines, we will address our general comments on the proposed Update in terms of the phases into which the IASB has divided their financial instruments project.

Classification and measurement of financial assets

We believe that the proposed model, in which assets held for the purpose of collecting contractual cash flows are recognized at fair value on the balance sheet with changes offset against OCI, is confusing and misdirected. Requiring an entity's financial position to be measured based on the market value of assets for which the holder does not intend to realize recovery through sale is misrepresentative of the entity's financial strategies and inconsistent with the manner in which risk is managed. Amortized cost best reflects the economic returns earned by an entity for financial instruments that are managed on a contractual yield basis because it reflects actual and expected cash receipts rather than fair value changes that will not be realized. Given that accounting is intended to fairly reflect the underlying economic transaction, we fully support the inclusion of an amortized cost measurement category in the proposed model. As such, we do not believe that the proposed model will result in decision-relevant information for users. Further, dislocation of the balance sheet and income statement causes additional and unnecessary complexity.

We believe that with regard to this aspect of financial instrument accounting, the IASB's proposal to measure financial assets held for the purpose of the collection of contractual cash flows at amortized cost on both the balance sheet and in the income statements is the appropriate model for financial assets. This consistent recognition and presentation facilitates user understanding and does not require translation between statements.

Classification and measurement of financial liabilities
We do not agree that fair value is the appropriate default measurement attribute for non-derivative financial liabilities (especially vanilla debt contracts) as it is inconsistent with management's general funding and liquidity objectives. Although the ASU permits certain exceptions to the measurement approach, in the case of most large financial institutions, the asset-based eligibility criteria would preclude amortized cost for financial liabilities.

Regarding the general measurement of financial assets and financial liabilities, we do not believe that mixing attributes between the balance sheet and income statement (full fair value on the balance sheet, but a mix of amortized cost and fair value in the income statement) benefits users. We believe that concepts should be uniform through the financial statements in order to unify the information. Additionally, the creation of entirely new measurement attributes (i.e. remeasurement of core deposits) increases the complexity of, rather than simplifies, the accounting for financial instruments.

In the case of fair value changes related to own credit on liabilities for which the fair value option has been elected, however, UBS does not believe that the own credit changes are reflective of the fair value of the instrument from the issuer's perspective and do not believe it should be reported in profit or loss unless realized through retirement.

We support the model proposed by the IASB in which fair value measurement is optional under certain restrictive conditions (generally most applicable to structured instruments) and in which changes in own credit are recognized in OCI only for liabilities for which the fair value option has been elected. The IASB's proposal addresses a significant issue raised by users that the recognition in net income of own credit changes for non-trading liabilities is misleading.

Hedge accounting
UBS generally supports the Board's efforts to simplify the accounting for hedging activities. We agree that a qualitative benchmark for establishing hedge accounting eligibility is an improvement over current practice. However, we remain concerned that the "long-haul" method of recognizing ineffectiveness for fair value hedges is overly complex and misrepresentative of actual hedging relationships. We note that some of the shortcomings of the long-haul method could be mitigated through the adoption of a "portions" approach, similar to IFRS.

Further, we do not understand the Board's position on voluntary de-designation, as we're not aware of any potential abuses that can be constructed from the existing guidance. We are very concerned that prohibition of de-designation would effectively disallow all dynamic hedging strategies, which are a common and sound element of sophisticated institutions' risk management methods.

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Finally, we note that the Board has not addressed the important economic practice of hedging net positions. As such, the proposed model is severely deficient in achieving the objectives of simplification and usefulness.

We note that the IASB is currently developing its own hedge accounting proposals and will likely retain the ability to hedge a portion of a financial instrument and the ability to achieve macro hedge accounting. We encourage the Board to liaise with the IASB in pursuing the joint development of a fully converged and improved hedge accounting model, taking into account the work of both Boards.

Impairment

The proposed Update makes limited changes to the current incurred loss model for impairment. The most significant change is the elimination of the "probable" loss threshold for recognizing an impairment loss and the easing of specific guidance around the calculation of those incurred losses. The proposed Update does not permit the consideration of future trends or events in calculating impairment.

This is in contrast to the work of the IASB, which is moving to an expected loss model and has decided to recognize the initial expected losses for a portfolio over the life of the portfolio. While the IASB's deliberations are ongoing, it is clear that the Boards are starting from very different bases and that there will be further divergence in the future if the Boards continue on their current paths. We implore the Boards to work together to develop a single converged impairment model.

Our comments in response to the specific questions in the proposed Update can be found in the appendix to this letter.

As a supplemental matter, UBS notes that IFRS and US GAAP remain un-converged in the important area of initial recognition for financial instruments that are held at fair value with fair value changes recognized through net income. The difference arises due to the disparate recognition guidance for initial profit and loss on instruments classified as Level 3 in the fair value hierarchy (so-called "Day 1 profit or loss"). We encourage the Boards to converge guidance in this area to further improve the comparability between US GAAP and IFRS for users.

Once again, we appreciate the opportunity to participate in the FASB's due process. Independent standard setters and robust due process are the cornerstones of high quality accounting standards. If you would like to discuss any comments that we have made, please do not hesitate to contact Ralph Odermatt at +41 44 236 8410 or John Gallagher at +1 203 719 4212.

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Appendix

Question 1: Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments do you believe should be excluded or which financial instruments should be included that are proposed to be excluded? Why?

UBS has addressed specific concerns about the scope of the proposed Update in our responses below.

Question 2: The proposed guidance would require loan commitments, other than loan commitments related to a revolving line of credit issued under a credit card arrangement, to be measured at fair value. Do you agree that loan commitments related to a revolving line of credit issued under a credit card arrangement should be excluded from the scope of this proposed Update? If not, why?

UBS supports the classification and measurement of loan commitments at fair value if the entity has a past practice of selling the asset resulting from its loan commitments shortly after origination or if it is a derivative. If those commitments are made within a business model whose strategy is to hold the resulting loan for the collection of cash flows, then we believe that those commitments should follow current accounting and be recognized upon funding, with the impairment analysis for those commitments following the same impairment model used for funded loans held for the collection of cash flows. This simplifies the accounting in this area and improves the information for users while adhering to the business model driven classification and measurement. Additionally, further convergence would simplify the accounting for users that analyze financial information under both IFRS and US GAAP.

Question 3: The proposed guidance would require deposit-type and investment contracts of insurance and other entities to be measured at fair value. Do you agree that deposit-type and investment contracts should be included in the scope? If not, why?

We do not object to the proposed scope as we believe the treatment is consistent with the treatment under IFRS and appropriate for these types of instruments.

Question 8: Do you agree with the initial measurement principles for financial instruments? If not, why?

UBS supports the initial measurement of all financial instruments at fair value as this reflects the economics of the instrument on the day the entity executes the transaction. In the case of instruments that will not be carried at fair value through profit or loss on an ongoing basis, we believe direct transaction fees and costs should be included in the initial measurement in line with the IASB proposal.

Question 11: Do you agree that transaction fees and costs should be (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income and (2) deferred and amortized as an adjustment of the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income? If not, why?

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We agree that transaction fees and costs should be deferred and reflected in yield for financial instruments not measured at fair value through profit or loss. This is reflective of the way in which those costs or fees are recovered and would align US GAAP and IFRS.

Question 13: The Board believes that both fair value information and amortized cost information should be provided for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows. Most Board members believe that this information should be provided in the totals on the face of the financial statements with changes in fair value recognized in reported stockholders' equity as a net increase (decrease) in net assets. Some Board members believe fair value should be presented parenthetically in the statement of financial position. The basis for conclusions and the alternative views describe the reasons for those views. Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?

UBS does not support the default presentation of financial instruments at fair value on the balance sheet. We believe that fair value presentation on the face of the financial statements is misleading in the case of financial instruments that are not managed on a fair value basis or held for trading. We note that fair value disclosures are already required in the footnotes and question the basis for moving this disclosure forward as we have not noted significant user interest. For the small minority of users that utilize fair value information for positions not held for trading or derivatives, it is already available in the footnotes. This measurement methodology does not reflect the business model in which those instruments are managed.

UBS believes that amortized cost provides more decision-useful information than fair value measurement for financial instruments that have basic loan features and are managed on a contractual yield basis. Amortized cost best reflects the economic returns earned by an entity for financial instruments that are managed on a contractual yield basis because it reflects actual and expected cash receipts rather than fair value changes that will not be realized. Given that accounting is intended to fairly reflect the underlying economic transaction, we fully support the inclusion of an amortized cost measurement category in the proposed model.

Along those lines, we support the IASB's decision to move forward with a mixed-attribute measurement model focused on fair value through profit or loss and amortized cost. We encourage the Boards to pursue converged financial instruments accounting based on a mixed-measurement model throughout the face of the financial statements.

Question 14: The proposed guidance would require that interest income or expense, credit impairments and reversals (for financial assets), and realized gains and losses be recognized in net income for financial instruments that meet the criteria for qualifying changes in fair value to be recognized in other comprehensive income. Do you believe that any other fair value changes should be recognized in net income for these financial instruments? If yes, which changes in fair value should be separately recognized in net income? Why?

UBS is supportive of the recognition in net income of the items noted above (interest income, credit impairments, reversals of credit impairment, and realized gains and losses). We do not believe that other fair value changes (such as liquidity and market discounts and premiums) provide enhanced information on financial instruments not held for the realization of fair value changes.

Question 15: Do you believe that the subsequent measurement principles should be the same for financial assets and financial liabilities? If not, why?

UBS does not support the subsequent measurement principle in the proposed Update as we believe that an amortized cost measurement category is necessary and useful to users. That said, with the exception of own credit fair value changes for non-traded liabilities, we support consistent subsequent measurement principles (such as fair value and amortized cost) for financial assets and financial liabilities.

Question 16: The proposed guidance would require an entity to decide whether to measure a financial instrument at fair value with all changes in fair value recognized in net income, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at amortized cost (for certain financial liabilities) at initial recognition. The proposed guidance would prohibit an entity from subsequently changing that decision. Do you agree that reclassifications should be prohibited? If not, in which circumstances do you believe that reclassifications should be permitted or required? Why?

No, we do not agree that reclassification should be prohibited. The key driver for classification is the business model. We believe that reclassification should be required if there is a change in business model. While we do not expect such events to happen often, significant events can occur that cause an entity to change its business model or redeploy capital among its existing business models. We believe that reclassification between measurement classifications should be required to the extent that they are based on those significant events. In the event such a reclassification does occur, it should be accompanied by explanatory disclosures.

Question 17: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?

While we acknowledge that all deposits have an aspect of economic value not captured by amortized cost measurement, we do not believe the proposed measurement methodology is indicative of that economic value and it is not clear to us whether users perceive a benefit from an alternative method of valuing deposits.

Question 18: Do you agree that a financial liability should be permitted to be measured at amortized cost if it meets the criteria for recognizing qualifying changes in fair value in other comprehensive income and if measuring the liability at fair value would create or exacerbate a measurement attribute mismatch? If not, why?

UBS supports the availability of amortized cost measurement for financial assets and financial liabilities, based on the characteristics of the instrument and the business model for the portfolio of instruments into which that instrument falls. Due to the composition of their balance sheets, UBS does not believe that large financial institutions would be able to achieve amortized cost accounting for their financial liabilities. We do not believe that reflecting all financial liabilities at fair value is appropriate when this is not the manner in which those instruments are managed.

Question 21: The Proposed Implementation Guidance section of this proposed Update provides an example to illustrate the application of the subsequent measurement guidance to convertible debt (Example 10). The Board currently has a project on its technical agenda on financial instruments with characteristics of equity. That project will determine the classification for convertible debt from the issuer's perspective and whether convertible debt should continue to be classified as a liability in its entirety or whether the Board should require bifurcation into a liability component and an equity component. However, based on existing U.S. GAAP, the Board believes that convertible debt would not meet the criterion for a debt instrument under paragraph 21(a)(1) to qualify for changes in fair value to be recognized in other comprehensive income because the principal will not be returned to the creditor (investor) at maturity or other settlement. Do you agree with the Board's application of the proposed subsequent measurement guidance to convertible debt? If not, why?

UBS notes that US GAAP is replete with specific rules on the classification of liabilities and equity. We do not believe that developing additional guidance around those classifications in a piecemeal fashion simplifies or improves financial instrument accounting. We encourage the FASB to work with the IASB to develop comprehensive converged guidance in this area.

Question 32: For financial liabilities measured at fair value with all changes in fair value recognized in net income, do you agree that separate presentation of changes in an entity's credit standing (excluding changes in the price of credit) is appropriate, or do you believe that it is more appropriate to recognize the changes in an entity's credit standing (with or without changes in the price of Credit) in other comprehensive income, which would be consistent with the IASB's tentative decisions on financial liabilities measured at fair value under the fair value option? Why?

UBS does not support the classification and measurement of liabilities model in the proposed Update. As it relates to own credit, we believe the approach currently under development by the IASB, such that fair value changes related to own credit on assets for which the fair value option was elected should go through OCI, is a superior model for addressing the accounting for own credit.

As a financial institution with debt instruments classified as at fair value through profit or loss, we have experienced fluctuations in our financial results as own credit inputs for valuing these positions have changed over time. We do not believe that these results are representative of the true economic performance of the bank. Further, UBS's equity analysts have stated that they do not believe that recognizing changes in own credit through profit or loss produces decision-useful information. It is counter-intuitive to recognize gains in periods of declining credit quality and losses in periods of improving credit quality. This is particularly evident in periods of market upheaval when there is significant volatility in own credit risk factors.

Question 33: Appendix B describes two possible methods for determining the change in fair value of a financial liability attributable to a change in the entity's credit standing (excluding the changes in the price of credit). What are the strengths and weaknesses of each method? Would it be appropriate to use either method as long as it was done consistently, or would it be better to use Method 2 for all entities given that some entities are not rated? Alternatively, are there better methods for determining the change in fair value attributable to a change in the entity's credit standing, excluding the price of credit? If so, please explain why those methods would better measure that change.

While UBS notes the theoretical merit to identifying the incremental, entity-specific cost of credit in order to evaluate own credit, we are not convinced that the proposed calculation is an improvement over the far simpler model in IFRS 7. The IFRS 7 model also lends itself to enhanced comparability due to its simplicity and consistency in practice.

Question 38: The proposed guidance would require an entity to recognize a credit impairment immediately in net income when the entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s). The IASB Exposure Draft, *Financial Instruments: Amortised Cost and Impairment* (Exposure Draft on impairment), would require an entity to forecast credit losses upon acquisition and allocate a portion of the initially expected credit losses to each reporting period as a reduction in interest income by using the effective interest rate method. Thus, initially expected credit losses would be recorded over the life of the financial asset as a reduction in interest income. If an entity revises its estimate of cash flows, the entity would adjust the carrying amount (amortized cost) of the financial asset and immediately recognize the amount of the adjustment in net income as an impairment gain or loss. Do you believe that an entity should immediately recognize a credit impairment in net income when an entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s) as proposed in this Update, or do you believe that an entity should recognize initially expected credit losses over the life of the financial instrument as a reduction in interest income, as proposed in the IASB Exposure Draft on impairment?

UBS supports the recognition of initial expected credit losses over the term of the portfolio as that is the expected loss realization horizon for those financial assets and the yield on the instrument that will be recognized over its life necessarily reflects that expectation. We do not believe that the recognition of losses should be limited to historical experience and loss events, but should be based on the credit expectations of the portfolio over its life. We are concerned about the deepening divergence between IFRS and US GAAP, particularly as it relates to recognition and measurement, derecognition and impairment. We acknowledge that convergence for the sake of convergence is not a solution. However, with regard to such an important issue as impairment, we believe that it is essential that the Boards resolve their differences and reach a converged standard. As such, we do not support the divergent approach that the Boards have taken with regard to impairment. We remain supportive of exploring an expected loss concept in a joint convergence project.

Question 39: Do you agree that a credit impairment should not result from a decline in cash flows expected to be collected due to changes in foreign exchange rates, changes in expected prepayments, or changes in a variable interest rate? If not, why?

Yes, UBS agrees that changes in cash flows that are not attributable to the borrower's ability to make payment in agreement with the contractual terms of the instrument are not credit losses.

Question 40: For a financial asset evaluated in a pool, the proposed guidance does not specify a particular methodology to be applied by individual entities for determining historical loss rates. Should a specific method be prescribed for determining historical loss rates? If yes, what specific method would you recommend and why?

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UBS supports permitting flexibility in the determination of historical loss rates as different entities may approach the determination differently and their systems may be developed to accommodate a specific methodology. We do not believe the potential cost of standardizing the approach is warranted if the end result is appropriate.

Question 41: Do you agree that if an entity subsequently expects to collect more cash flows than originally expected to be collected for a purchased financial asset, the entity should recognize no immediate gain in net income but should adjust the effective interest rate so that the additional cash flows are recognized as an increase in interest income over the remaining life of the financial asset? If not, why?

UBS supports consistent subsequent recognition for financial instruments. Consistency improves understandability and simplifies the accounting. In order to achieve consistency as it relates to financial instruments not at fair value through profit or loss, improvements and deteriorations in credit should have similar effects in earnings. If subsequent deteriorations in credit are to be reflected immediately in profit or loss, then subsequent improvements should also be reflected immediately in profit or loss as well.

Question 42: If a financial asset that is evaluated for impairment on an individual basis has no indicators of being individually impaired, the proposed guidance would require an entity to determine whether assessing the financial asset together with other financial assets that have similar characteristics indicates that a credit impairment exists. The amount of the credit impairment, if any, would be measured by applying the historical loss rate (adjusted for existing economic factors and conditions) applicable to the group of similar financial assets to the individual financial asset. Do you agree with this requirement? If not, why?

UBS supports the collective evaluation of credit loss in the absence of indicators of individual impairment. The collective loss is intended to ensure that credit losses are accrued to reflect the economic experience of the institution in the absence of explicit information confirming a specific loss.

Question 46: The proposed guidance would require that in determining whether a credit impairment exists, an entity consider all available information relating to past events and existing conditions and their implications for the collectibility of the cash flows attributable to the financial asset(s) at the date of the financial statements. An entity would assume that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset(s) and would not forecast future events or economic conditions that did not exist at the reporting date. In contrast, the IASB Exposure Draft on Impairment proposes an expected loss approach and would require an entity to estimate credit losses on basis of probability-weighted possible outcomes. Do you agree that an entity should assume that economic conditions existing at the reporting date would remain unchanged in determining whether a credit impairment exists, or do you believe that an expected loss approach that would include forecasting future events or economic conditions that did not exist at the end of the reporting period would be more appropriate? Are both methods operational? If not, why?

We believe that forecasting future events is the most economically faithful representation and provides the most decision-useful information to users as to future economic value. We believe that either method can be made operational with additional consideration.

Question 49: Do you agree that the difference in the amount of interest contractually due that exceeds interest accrued on the basis of an entity's current estimate of cash flows expected to be collected for financial assets should be recognized as an increase to the allowance for credit losses? If not, why?

UBS agrees with the proposed treatment.

Question 50: The proposed guidance would permit, but would not require, separate presentation of interest income on the statement of comprehensive income for financial assets measured at fair value with all changes in fair value recognized in net income. If an entity chooses to present separately interest income for those financial assets, the proposed guidance does not specify a particular method for determining the amount of interest income to be recognized on the face of the statement of comprehensive income. Do you believe that the interest income recognition guidance should be the same for all financial assets?

UBS supports consistent recognition guidance for financial instruments that share the same classification and measurement. This improves comparability and simplifies the accounting for users.

Question 56: Do you believe that modifying the effectiveness threshold from *highly effective* to *reasonably effective* is appropriate? Why or why not?

We support the removal of the purely quantitative assessment of hedge effectiveness currently present in Topic 815, the easing the of the qualification threshold to better reflect the economic decision motivating the hedging, and the adoption of a more qualitative approach to assess effectiveness. These changes would reduce complexity in applying the hedge accounting rules. We believe there is a risk that in the absence of additional guidance clarifying the application of the qualitative assessment, auditors may look to preparers to provide quantitative proof of effectiveness, thereby eliminating the benefit of permitting qualitative effectiveness evaluations. This has been our experience with previous guidance, for instance FIN 46(R).

However, we are concerned that practical issues will arise, such as the ability of companies to operationally comply with the "long haul" calculations prescribed in Topic 815.

Question 57: Should no effectiveness evaluation be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term? Why or why not?

UBS believes it would be prudent to maintain limited continuing eligibility requirements after inception of an accounting hedge. We suggest limiting the required re-evaluation of eligibility to circumstances in which the terms of the hedged or hedging instruments are modified.

We acknowledge that forecasts are inherently imperfect and unforeseen events may cause currently correlated relationships to diverge in future periods. However, we believe that entities would generally seek to economically limit hedge ineffectiveness if and when it arises in the future. As ineffectiveness will be reflected in current income, accounting and risk objectives are already aligned. The requirement to continue or discontinue a hedge should thus be taken solely as a risk-management decision; not through accounting rules. As discussed further in Q.63., we believe that entities should be permitted to de-designate a hedging relationship at their discretion. Thus, if and when management needs to re-balance, re-calibrate or simply to eliminate a current hedge relationship in response to factors arising after the inception of the hedge, it will not be artificially constrained by accounting rules.

Question 58: Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? Why or why not?

We believe that if the FASB decides to continue to permit de-designation as currently provided for in Topic 815 (see Q.63. below), companies will naturally discontinue or adjust hedges as circumstances dictate. To the extent companies choose to continue to run an open risk in the event hedge effectiveness begins to decay, such a decision will transparently manifest itself in earnings volatility.

Question 59: Do you believe that a hedge accounting model that recognizes in net income changes in the fair value and changes in the cash flows of the risk being hedged along with changes in fair value of the hedging instrument provides decision-useful information? If yes, how would that information be used? If not, why?

We note that the IASB has tentatively decided to move to a single hedge accounting presentation whose mechanics are generally consistent with the current "cash flow" hedge. We believe that this re-designed approach would result in both simplification and usefulness, as multiple models are difficult to apply and present in an understandable fashion. Further, the IASB's tentative approach would eliminate artificial volatility in equity by requiring that the effective portion of the change in fair value of hedging derivatives be recorded as a separate line item on the balance sheet rather than in equity. We consider that to be an important improvement over the current cash flow hedge presentation.

Question 60: Do you believe that the proposed changes to the hedge accounting model will provide more transparent and consistent information about hedging activities? If yes, why and how would you use the information provided? If not, what changes do you disagree with and why?

Although the ED would allow more hedges to qualify for hedge accounting and relax certain current demands to qualify for hedge accounting, some valid and effective hedges would result in significant income statement volatility without the ability to define the hedged risk associated with a nonfinancial contract in a manner that reflects the economic risk being hedged. As a consequence, unless the FASB reconsiders the types of risks that can be hedged for accounting purposes, many companies may find limited practical benefit from the ED.

We believe that the presently proposed guidance falls somewhat short of achieving practical utility for both users and preparers. Specifically, we suggest the FASB consider the following three important issues:

1. Companies often manage interest rate risk on a net portfolio or macro basis. US GAAP currently prohibits entities from designating the combination of financial instruments as a single hedged item, not in a fair value hedge nor in a cash flow hedge, unless those individual instruments are expected to respond similarly to changes in the hedged risk. It also prohibits aggregating a combination of financial assets and financial liabilities to be a hedged item. This requires companies that are looking to hedge their net interest rate risk exposure to define the hedged item as either an individual asset or liability, or groups of similar assets or liabilities, which often requires frequent

dedesignation/redesignation of the hedge relationship as the net risk exposure within the portfolio changes.

At recent Board meetings, where the hedge accounting project was debated, the IASB decided to expand the existing hedging approach in IAS 39 and considered permitting a net position to qualify as hedged item by changing how the hedged item can be defined. The decisions of the IASB would permit the hedged item to include a financial company's net interest rate exposure comprised of financial assets, financial liabilities and derivatives, which will ease the burden associated with hedging a company's net interest rate exposure. While the FASB has not formally deliberated the merits of "macro hedging" under its Financial Instruments project, the FASB should consider incorporating the IASB decisions in this area for inclusion in the final standard on hedge accounting, resulting in further convergence of accounting, while improving the accounting standards on hedge accounting.

2. Although the elimination of the "short-cut" approach will eliminate preparer concerns regarding the consequences of unintentionally misapplying the attendant restrictive guidelines, we believe that alternative "long-haul" approach is still overly complex for practical application, specifically in respect to fair value hedges of interest rate risk. We urge the Board to simplify the current hedge accounting model by allowing hedges of a portion of a financial instrument's contractual cash flows (e.g. the LIBOR component of a fixed-rate bond), similar to current IFRS rules. Such an approach substantially simplifies the determination of ineffectiveness, thus reducing the potential for error. Furthermore, it more faithfully reflects the economic risk being hedged in the financial statements.

   Alternatively, if the Board chooses not to incorporate such an approach, we suggest that it consider adopting the "hypothetical derivative" approach presently used for cash flow hedges of interest rate risk.

3. In addition, the ED should expand the current bifurcation-by-risk approach population to allow hedges of other identifiable and reliably measurable/observable interest rate risk exposures such as the Federal Funds Rate, the Prime Rate, inflation indexes, etc. This would ease preparers' concerns with performing the complex "long haul" calculations and would achieve convergence with current IASB decisions.

Question 61: Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for cash flow hedging relationships? If yes, what constraints do you foresee and how would you alleviate them?

We note that the ED contains a proposed change in cash flow hedge accounting to recognize ineffectiveness from over-hedging and under-hedging in profit and loss. We oppose the proposed inclusion of recognizing ineffectiveness arising from under-hedging in earnings for cash flow hedge accounting. This would conflict with the logic of cash flow hedge accounting since the hedged transactions (or forecast cash flows) are not currently recognised on the financial statements (i.e. they are highly probable, but not presently existing forecast transaction and cash flows) and hence it would not be appropriate to recognize such ineffectiveness (cumulative fair value of hedged items greater than hedging instruments).

Question 62: Do you foresee any significant operational concerns or constraints in creating processes that will determine when changes in circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness at each reporting period? If yes, what constraints do you foresee and how would you alleviate them?

No. We expect that current risk and financial management controls should generally be sufficient to identify such circumstances.

Question 63: Do you foresee any significant operational concerns or constraints arising from the inability to discontinue fair value hedge accounting or cash flow hedge accounting by simply dedesignating the hedging relationship? If yes, what constraints do you foresee and how would you alleviate them?

We disagree with the proposal to prohibit the voluntary dedesignation of a hedge accounting relationship currently permitted in Topic 815. In addition, UBS considers the proposed guidance on effective terminations to be nonoperational and cost prohibitive. Companies commonly add new economic hedge relationships and remove, or de-designate, existing hedge relationships as changes occur in the risk profile of the hedged risk exposure. As a result, we find the FASB's basis for conclusions regarding dedesignation to be flawed and inaccurate as such risk management strategies are prudent and appropriate. We do not understand how an entity could accomplish earnings management through a decision to dedesignate, as hedge accounting designations must be made in advance of market movements. The FASB's concerns can be addressed by enhanced disclosure about why companies re-designate or de-designate hedging relationships.

Question 64: Do you foresee any significant operational concerns or constraints arising from the required concurrent documentation of the effective termination of a hedging derivative attributable to the entity's entering into an offsetting derivative instrument? If yes, what constraints do you foresee and how would you alleviate them?

We expect that the implementation and maintenance of the proposed requirements will be resource-consuming. However, we do not believe it to be an unreasonable requirement.

Question 65: Do you agree with the proposed disclosure requirements? If not, which disclosure requirement do you believe should not be required and why?

UBS encourages the FASB to work with the IASB to develop converged disclosures related to financial instruments in order to improve comparability.

Question 68: Do you agree with the transition provision in this proposed Update? If not, why?

UBS supports the transitions relief provided by requiring a cumulative catch-up adjustment rather than requiring a full retrospective application. This approach significantly simplifies the adoption process and reduces the accounting risk associated with restating prior period information.

Question 70: How much time do you believe is needed to implement the proposed guidance?

UBS supports the inclusion of a long lead time in order to allow for significant system adaptations necessary to comply with the new rules. For our purposes, the effective date should not be less than 2 fiscal years following the publication of the final requirements. Given the current review of IFRS by the SEC for domestic registrants, we believe it may be in the best interest of FASB's constituents and users to provide a sufficiently long-dated effective date such that they may adopt IFRS if accepted by the SEC rather than be required to adopt the final FASB standard and then later adopt IFRS.

Question 71: Do you believe the proposed transition provision is operational? If not, why?

Yes, UBS believes the proposed transition guidance is operational given sufficient lead time.