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Sandra Thompson
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International Accounting Standards
Board (IASB)
30 Cannon Street
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January 8, 2004

RE: Fair value hedge accounting

Dear Ms. Thompson:

Previously UBS AG submitted a comment letter on the macro-hedging proposal. Subsequent to our comment letter submission, we analysed what impact the macro-hedging proposal would have on a specific delta-neutral hedging strategy that many corporate treasurers employ to hedge a bond portfolio. We believe that this strategy is highly effective and meets all the criteria for hedge accounting, except for the fact that it is a fair value portfolio hedge of the risk of the cashflows that make up many bonds with different tenors and interest rates. As a result, corporate treasurers are unable to apply hedge accounting due to the portfolio hedging rules. As the IASB is currently focusing on the macro-hedging proposal, we thought that they would find this example of use during their deliberations. The approach we are referring to is a dynamic portfolio hedging concept, whereby assets and liabilities are hedged according to their risk positions. If it would be helpful, we would be happy to meet with you to further discuss this example.

Under the current IAS 39 rules, portfolio hedging is not permitted unless all the instruments in the portfolio effectively have the same maturity. As result of these rules, there is really no practical application of portfolio hedging in existence today. The IASB has recognized this in the macro-hedging proposal, which permits assets to be grouped into narrow maturity buckets based on expected maturity and hedged on a portfolio basis. We suggest that this bucketing approach be extended to risk (rather than just asset maturity), and to the hedging of risk on a portfolio basis in particular buckets or at tenor points. This would provide a commercially useful amendment to IAS 39 and would enable market participants to economically hedge the risk exposures.

In order to remove interest rate risk, entities will enter into swaps to turn 'Available for sale' bond portfolios from fixed rate to floating. Through a practice called swap overlay, entities will use a defined set of vanilla swaps to hedge the interest rate risk of the entire portfolio. This is

accomplished by hedging the sensitivity to swap curve movements at each tenor point along the swap curve. Entities use this method as it is inexpensive and easy to adjust the hedges as bonds are bought or sold. Entities have elected this approach in lieu of individual swaps, as entering into swaps for the entire bond portfolio would result in exposure to the bid-offer spread and result in unwind costs every time a bond is bought or sold. Further, individual swaps are harder to maintain since the entity has to book and monitor one swap for every asset in the portfolios. As such, we would recommend that the IASB consider permitting use of a swap overlay.

Under the recently revised IAS39, market participants could lower P&L volatility by, for example, classifying the portfolio as 'trading', but they would still be left with residual credit volatility passing through P&L. Accommodating the approach outlined above would enable credit volatility to be kept within equity as per the 'Available for sale' treatment.

We propose that the IAS portfolio hedging framework should accommodate such an approach to immunize the interest rate risk of the portfolio in each bucket/tenor point – as this is commercially the most sensible way to hedge a portfolio against interest rate risk.

In Appendix A of this letter we have provided a simple example, based on a one-bond portfolio, however the process is exactly the same for a multi-bond portfolio. The real benefit of a swap overlay comes when there is a portfolio of many bonds that can then be hedged with a handful of swaps.

We would very much appreciate the opportunity to discuss this topic with you in greater detail. We suggest a meeting so that we can present our proposal and discuss any questions or issues that you may have.

Thank you for taking the time to consider our proposal. We hope to hear from you soon.

Yours sincerely,

UBS AG

Ralph Odermatt
Managing Director
Accounting Policies and Support

John Gallagher
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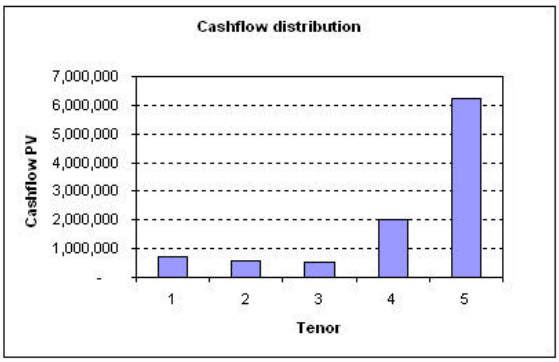
Appendix A

This is an example of how a swap overlay works. In the interests of simplicity and clarity, we have used a one-bond portfolio for the example, however the process is exactly the same when you have multiple bonds. The benefits are also greater when you have many bonds as you can hedge the interest rate sensitivity using a handful of swaps rather than asset swapping each issue.
The bond in the portfolio is €10m Ford 6.125% coupon, maturing 8-Jun-2007.

1. We start by measuring the sensitivity of the cashflows in the portfolio to a 1bp shift of the swap curve, attributed to tenor points. The specific tenor points can be chosen by the treasurer.

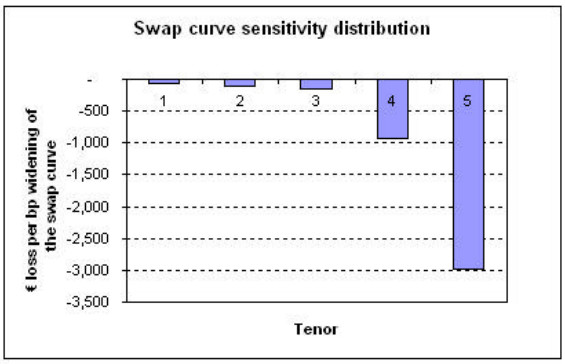
Note: we are using *tenor points* as a more accurate way of breaking down the cashflows, as opposed to *maturity bands*. Tenors enable us to see the actual cashflow at each point such that the total PV and other characteristics of the portfolio are maintained, this contrasts with maturity bands where cashflows are said to be within a range (eg. 2yr to 3yr), which therefore has less accuracy for measuring risk.

Cashflow distribution		
Tenor	PV	PV %
1yr	716,489	7.13
2yr	558,741	5.56
3yr	523,415	5.21
4yr	2,027,774	20.18
5yr	6,218,477	61.88
Total	*10,044,896*	



The cashflows comprise all the coupon payments and maturity of the bond and are discounted down individual issuer curves to come to the PV of the position. The distribution of cashflows can be attributed to any series of tenor points chosen by the treasurer. As such, they do not have to match the actual distribution of underlying cashflows. The process used in attributing cashflows ensures that all characteristics of the portfolio are maintained.

Swap curve sensitivity	
Tenor	Sensitivity (€)
1yr	- 69
2yr	- 111
3yr	- 157
4yr	- 933
5yr	- 2,981
Total	*- 4,251*



Changes in interest rates are reflected in the swap curve. The graph above shows the sensitivity of the portfolio to a 1bp increase in swap rates. This is done for the cashflows at each tenor point. Eg. For a parallel 1bp increase in the swap curve, you will lose €4,251. If just the 1 year point increases by 1bp, you will lose €69, and so on…

2. The sensitivity to changes in interest rates can be hedged using a set of standard swaps.
Standard interest rate Swaps can be used to hedge the portfolio against movements in interest rates. Using the sensitivity to swap curve movements at each tenor, we can calculate the rate and notional of each swap required such that the hedge has a sensitivity equal but opposite to that of the portfolio – Portfolio swap curve sensitivity is the same but opposite as hedge swap curve sensitivity. The swap maturities do not need to coincide with the maturity of the cashflows.

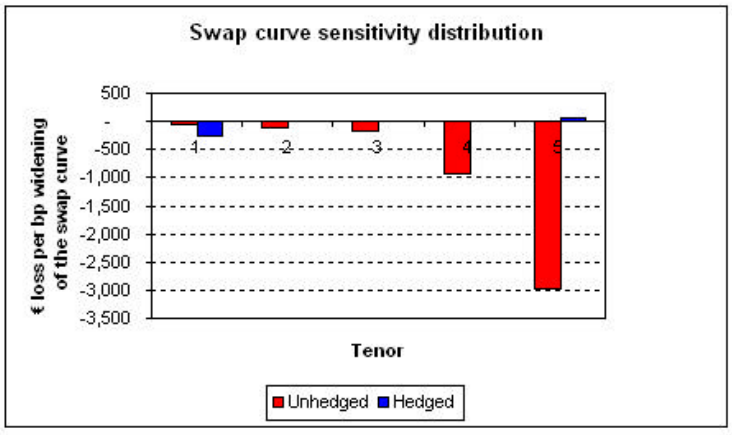
Swap hedge							
Tenor	Maturity	Portfolio swap curve sensitivity	Fixed leg	Par swap rate	Swap hedge nominal	Hedge swap curve sensitivity	Residual sensitivity
1yr	02-Sep-03	-69	Pay	3.334	236,506	69	0
2yr	02-Sep-04	-111	Pay	3.535	195,966	111	0
3yr	02-Sep-05	-157	Pay	3.773	189,919	157	0
4yr	02-Sep-06	-933	Pay	3.971	2,380,896	933	0
5yr	02-Sep-07	-2981	Pay	4.139	7,157,052	2981	0

3. Interest rate sensitivity is hedged:

- Interest rate sensitivity is neutralised (down from - €4,251 to - €196, the residual is attributable to fixing risk as with all floating instruments.
- Duration is down from 3.97yrs to 0.1yr and volatility attributable to Swap curve movement is down from 3.16% to 0.1%.

Unhedged portfolio	
Swap curve sensitivity	
Tenor	Sensitivity (€)
1yr	- 69
2yr	- 111
3yr	- 157
4yr	- 933
5yr	- 2,981
Total	**-** ***4,251***
Duration	3.97
Swap curve vol	3.16

Hedged portfolio	
Swap curve sensitivity	
Tenor	Sensitivity (€)
1yr	- 259
2yr	1
3yr	1
4yr	13
5yr	48
Total	**-** ***196***
Duration	0.10
Swap curve vol	0.10



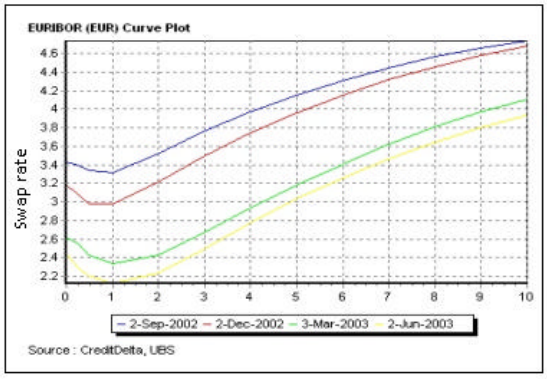
The Libor sensitivity is hedged away. The residual LiborDelta D1 sensitivity is your 'fixing risk' following the setting of your quarterly rate (as with FRNs)

4. Monitoring the hedge effectiveness

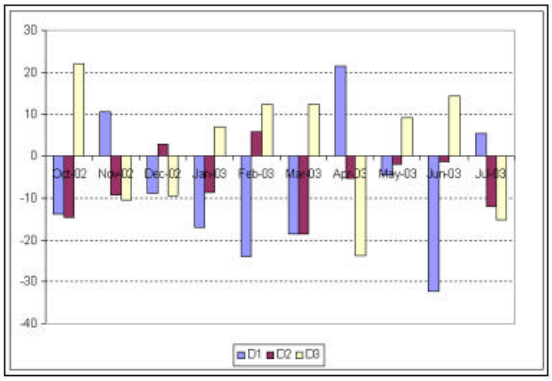
Changes in three factors - level, slope and curvature (D1, D2, D3) - can capture almost all of the movements of the swap curve over time.

By measuring the sensitivities of the portfolio and the swap hedge to these three factors, we can calculate the change in portfolio value due to swap curve movement. Using this we can assess the effectiveness of the hedge over a period of time.

0-10yr Euro swap curve from Sep 02 to Jun-03 at 3 month intervals



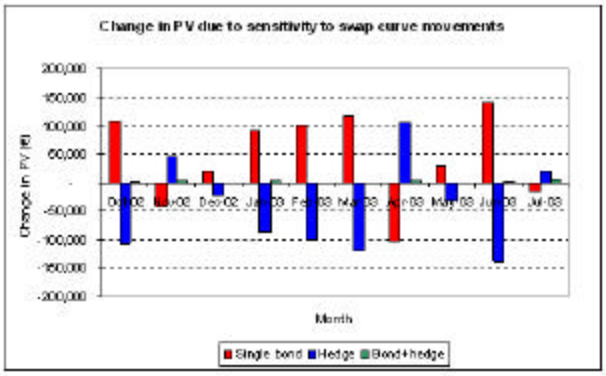
Monthly changes in level, slope and curvature - D1, D2 and D3



Taking the D1, D2 and D3 sensitivities of the portfolio and hedge, together with the observed D1, D2 and D3 changes, we can calculate the effect of swap curve movement on the value of the portfolio.

The graph on the right shows the combined impact of D1, D2 and D3 movements each month on the portfolio, hedge and hedged portfolio.

For movements in the Swap curve, the value of the *hedge* changes in an approximately equal but opposite amount to the change in the value of the *bond*. The net change in value of the *hedged portfolio* is therefore very small.



Under current IAS 39 rules, for a hedge to be effective it must hedge between 80% and 125% of the target (this may or may not remain). The effectiveness of the swap overlay in this example is very high such that the accumulated PV of the hedged portfolio is low. And during this example the percentage effectiveness has hovered between 94% and 99%.

	Effectiveness	Accumulated PV change		Monthly PV change		
		Bond+hedge	Single bond	Bond+hedge	Single bond	Hedge
02-Sep-02						
02-Oct-02	99%	1,440	107,399	1,440	107,399	-105,959
04-Nov-02	94%	4,239	65,763	2,799	- 41,636	44,435
02-Dec-02	95%	3,966	86,237	- 273	20,474	-20,747
02-Jan-03	96%	7,064	175,831	3,098	89,594	-86,495
03-Feb-03	98%	6,802	277,120	- 262	101,289	-101,552
03-Mar-03	99%	5,621	394,035	- 1,180	116,915	-118,095
02-Apr-03	97%	8,271	292,016	2,650	- 102,019	104,668
02-May-03	98%	6,814	321,356	- 1,458	29,340	-30,798
02-Jun-03	98%	8,708	463,037	1,895	141,681	-139,786
02-Jul-03	97%	13,161	446,904	4,452	- 16,133	20,585

The example above shows that the effectiveness of the hedge is very high and therefore the portfolio will have low interest rate-based volatility