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Sandra Thompson
Senior Project Manager
International Accounting Standards
Board (IASB)
30 Cannon Street
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November 14, 2003

RE: Macro-hedging

Dear Ms. Thompson:

UBS AG appreciates the opportunity to comment on the Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement Fair Value Hedge Accounting for a Portfolio of Interest Rate Risk*. We applaud the IASB for proposing a portfolio hedge approach that recognizes that the economic maturities of assets and liabilities often differ from their contractual maturities. Entities risk manage their balance sheets based on this approach and we believe that it is an important step that accounting standards are developed with risk management practices in mind. However, although the IASB has taken a necessary first step, unless the Standard allows an entity to hedge core deposits the proposal provides no relief to the banking industry. Managing core deposits based on economic maturities is integral to managing interest rate risk. The BIS have recognized the importance of taking an economic view for core deposits, as explicitly stated in their May 2001 consultative paper, *Management & Supervision of Interest Rate Risk*, which formulates the appro ach to interest rate risk management that is to be implemented in the second Pillar of the Basel II Accord. We implore the IASB to acknowledge this as well and permit the use of core deposits based on their economic maturities in the macro-hedging model.

Further, we would like to point out that in practice entities view their portfolios on a net basis, and consider natural hedges when assessing their risk management strategies. In keeping with the IASB's proposal to account for portfolios in line with how they are risk managed, we recommend that the Board permit entities to designate a net position as the hedged item. Again, we believe that this would better reflect the economics of the hedging strategy.

As a major retail bank in Switzerland, UBS carries a significant volume and value of core deposits. As with similar organizations, these core deposits provide a significant role in the funding of our balance sheet. While these instruments are fungible the total volume of core deposits has historically been proven to be rather stable. The stable component of the core deposit portfolio can be viewed as long-term fixed rate items with economic maturities that can be replicated into time buckets with reasonable accuracy and are risk managed accordingly. We believe that the IASB should recognize the long-term nature of these products and permit them to be placed in time buckets beyond the shortest period in which the holder can demand repayment.

By denying the inclusion of core deposits in fair value hedging strategies, the proposed macro-hedging changes to IAS 39, provide no relief to the banking industry. UBS believes core demand deposits must be made eligible for fair value hedging, to permit a level playing field to exist for participants in these markets.

We do not believe that the proposed approach for measuring ineffectiveness is consistent with the underlying risk management techniques. The proposal does not consider the dynamics of a macro-hedging approach. On a macro-hedging basis we are managing what is expected on a portfolio level and not what is occurring on an individual basis. The way the entire portfolio behaves is what is being hedged and not the individual items that make up the portfolio. Therefore it is irrelevant how the individual items in a portfolio prepay. If assets prepay slower than expected, there should be no ineffectiveness because the hedged position does not change. Provided the amount hedged does not fall below the amount of the hedging instrument, there are sufficient assets/liabilities in the portfolio to absorb the volatility in the hedging instrument. If there are prepayments earlier than expected which results in an over-hedge, we believe that ineffectiveness must be measured.

We have included our response to the specific questions asked in the Invitation to Comment in Appendix A of this letter.

We very much appreciate the opportunity to comment. If you would like to discuss any comments that we have made, please contact us at your convenience. Your contacts on the subject are Ralph Odermatt, Managing Director (+41-1-236-8410) and John Gallagher, Executive Director (+1-203-719-4212).

Yours sincerely,

UBS AG

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Appendix A

Question 1

Draft paragraph 128A proposes that in a fair value hedge of the interest rate risk associated with a portion of a portfolio of financial assets (or financial liabilities), the hedged item may be designated in terms of an amount of assets (or liabilities) in a maturity time period, rather than as individual assets or liabilities or the overall net position. It also proposes that the entity may hedge a portion of the interest rate risk associated with this designated amount. For example, it may hedge the change in the fair value of the designated amount attributable to changes in interest rates on the basis of expected, rather than contractual, repricing dates.* However, the Board concluded that ineffectiveness arises if these expected repricing dates are revised (eg in the light of recent prepayment experience), or actual repricing dates differ from those expected. Draft paragraph A36 describes how the amount of such ineffectiveness is calculated. Paragraphs BC16-BC27 of the Basis for Conclusions set out alternative methods of designation that the Board considered, their effect on measuring ineffectiveness and the basis for the Board's decisions including why it rejected these alternative methods.

Do you agree with the proposed designation and the resulting effect on measuring ineffectiveness? If not,

(a) in your view how should the hedged item be designated and why?

(b) would your approach meet the principle underlying IAS 39 that all material ineffectiveness (arising from both over- and under-hedging) should be identified and recognised in profit or loss?

(c) under your approach, how and when would amounts that are presented in the balance sheet line items referred to in paragraph 154 be removed from the balance sheet?

We do not agree with the proposed method for designating a gross asset or liability position as the hedged item and the resulting effect on measuring ineffectiveness. We strongly support the IASB's move to develop accounting standards that reflect the way a business is managed. We believe that the draft standard is a good first step, but does not go far enough to represent the true economics of portfolio management. The current proposal recognizes that entities manage their portfolios on a net basis, however it requires hedge designation on a gross basis. We believe that this approach results in a significant disconnect between risk management and accounting. Entities do not view their portfolios on a gross basis. Rather they recognize that certain positions offset the risks of others and therefore manage portfolios based on the net risk position. Permitting designation on a net basis will better align the reporting with the economics of the hedging strategy.

We do not support the proposed method of testing ineffectiveness. We do not agree that in a portfolio hedge that ineffectiveness arises when an entity under-hedges a position. We believe that the proposal does not consider the dynamics of a macro-hedging approach. On a macro-hedging basis we are managing what is expected on a portfolio level and not what is occurring on an individual basis. Entities replicate their portfolios by estimating, based on historical evidence, prepayment trends and then risk manage the net open positions based on this estimate. As such, the way the entire portfolio behaves is what is being hedged and not the individual items that make up the portfolio. Therefore it is irrelevant how the individual items in a portfolio prepay. If assets prepay slower than expected, there should be no ineffectiveness because the hedged position does not change. Provided the assets/liabilities in the portfolio do not fall below the amount of the hedging instrument, there are sufficient assets/liabilities to absorb the volatility in the hedging instrument. If there are prepayments earlier than expected which results in an over-hedge, we believe that ineffectiveness must be measured.

We believe that of the four methods proposed for measuring ineffectiveness that Approach C is the most appropriate, as it is consistent with IGC 121. We recognize the IASB's concern expressed in paragraph BC23 that an arbitrary rule would need to be introduced to prevent the 'cushion' from becoming too large. For example, where an entity designates the entire gross asset or liability position as the hedged item and therefore no ineffectiveness would occur. However if entities were required to designate the hedged item based on the net position this issue would be resolved, as the amount that entities could designate as the hedged item would be limited to the net open risk position.

a. We believe that the hedged item should be designated as the net open risk position for the reasons stated above. Ineffectiveness should only arise when a position is over-hedged.

b. Yes, we believe that our proposed method would support the principal that all material ineffectiveness should be recognized in the income statement. However, we disagree with the IASB that both over and under-hedging produces ineffectiveness. We believe in a portfolio hedge that only over-hedging can lead to ineffectiveness. A macro-hedging concept is based on the notion that no single transaction is identified as the hedged item. We do not believe that it is necessary that a portfolio hedge concept apply the same effectiveness provisions as an individual hedge.

c. Balance sheet amounts relating to the hedged item should be removed when the time bucket expires.

Question 2

Draft paragraph A30(b) proposes that all of the assets (or liabilities) from which the hedged amount is drawn must be items that could have qualified for fair value hedge accounting if they had been designated individually. It follows that a financial liability that the counterparty can redeem on demand (ie demand deposits and some time deposits) cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment. Paragraphs BC13-BC15 of the Basis for Conclusions set out the reasons for this proposal.

Do you agree that a financial liability that the counterparty can redeem on demand cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment? If not,

(a) do you agree with the Board's decision (which confirms an existing requirement in IAS 32) that the fair value of such a financial liability is not less than the amount payable on demand? If not, why not?

(b) would your view result in such a liability being recognised initially at less than the amount received from the depositor, thus potentially giving rise to a gain on initial recognition? If not, why not? If you do not agree that the situation outlined in (b) is the result, how would you characterise the change in value of the hedged item?

No, we do not agree with the Board's conclusion that liabilities with a demand feature cannot qualify for hedge accounting. The Board concluded in BC9 of the ED to "permit the scheduling that is used for risk management purposes, i.e. on the basis of expected repayment dates, to be used as a basis for the designation necessary for hedge accounting." The stable component of the core deposit portfolio can be viewed as long-term fixed rate items with economic maturities that can be replicated into time buckets with reasonable accuracy and are risk managed accordingly. The replication process involves transforming the bank's retail banking products, (e.g. Core deposits) into predicted fixed term transactions and is aimed at minimizing the volatility of the resulting interest margin. Financial Institutions manage interest rate risk of core deposits on a pooled basis through a "replication portfolio". The replication portfolio is a portfolio of revolving transactions between an originating business unit and the treasury function at market rates designed to approximate the average cash flow and repricing behavior of the pooled client transactions. The structure and parameters of the replication portfolios are set in accordance with long-term observations of market and client behavior and are reviewed periodically. As a result of this process, the originating business units are immunized as far as possible against interest rate movements, but retain the product margin, while the treasury function acquires market interest rate based positions, which can be managed by entering into external transactions. We believe that it is inconsistent for the IASB to recognize the economic maturities of assets with a prepayment feature and not liabilities. We believe the rules should apply equally to both assets and liabilities, which are risk managed within a unified strategy. Permitting macro-hedging for both assets and liabilities with prepayment/demand features will ensure that the accounting reflects the underlying economic substance of the entire portfolio.

We have reviewed the Basis for Conclusions and note that although the IASB is aware of many of the arguments in support of fair value hedging of core deposits, they have concluded that the arguments against are more compelling. We believe that the arguments in BC-13 for including core deposits in a fair value hedge based on expected repayment dates are persuasive and better reflect the risk management activity employed by financial institutions. Below we set forth our view to the arguments made by the IASB in paragraph BC-14.

BC-14(a) - The IASB has concluded that core deposits cannot qualify for fair value hedge accounting because the specific deposits are unlikely to be outstanding for an extended period. While we agree that deposits may be withdrawn and replenished we would like to point out that on average banks maintain a very stable level of deposits, whose replicated maturities can be predicted with relative accuracy. The current macro-hedging proposal recognizes that tracking specific instruments is difficult and therefore permits in paragraph A29 the allocation of a percentage of the portfolio, rather than individual items to each time period. As cash is fungible we do not believe that it is relevant to designate which specific deposits in the portfolio will remain on hand over a designated time period. Further a bank's exposure does not relate to any specific deposit, but to the entire portfolio. As such, any hedging strategy will be based upon the expected economic behaviour of the portfolio, which is consistent with the technique proposed for prepayable assets.

BC-14(b) - The IASB concludes that the use of core deposits should be prohibited, as they are similar to trade payables. We disagree with this conclusion, as a trade payable is a liability as a result of a specific transaction, the terms of which require repayment within a set period of time. Core deposits are not created as a result of a service that was performed or a transaction and there is no set period established for repayment.

BC-14(c) - It is not our intention to recognize any profit or loss upon inception of a hedge of core deposits. It should be recognized that the individual deposits are not being adjusted. These items are viewed on a dynamic overall portfolio basis for the purpose of achieving hedge accounting, which is not the same as recognizing an individual liability at less than the amount received by the depositor. The valuation adjustment, subsequent to initial recognition would not be equal to that of an overnight deposit and a longer-term fixed rate instrument. Rather, the adjustment would reflect the impact of movements in interest rates.

BC-14 (d) – We agree that an individual deposit's fair value does not change with movements in interest rates. However, in a macro-hedging approach we are not hedging individual assets or liabilities. It is the risk of the net open risk position that is being managed. We believe it is appropriate to acknowledge that these deposits behave as long-term fixed rate liabilities.