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Sandra Thompson
International Accounting Standards Board
30 Cannon Street
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21 July , 2004

The Fair Value Option

Dear Ms. Thompson:

UBS appreciates the opportunity to provide comments on the Exposure Draft of Proposed Amendments to IAS 39, *The Fair Value Option*. UBS is a strong supporter of the IASB and its work to develop a comprehensive set of accounting standards. UBS was a very strong advocate of the introduction of the fair value option and believe that it was a positive step by the IASB. UBS adopted revised IAS 39 as of 1 January 2004. The primary reason for our decision to early adopt the revised standard was the inclusion of the fair value designation option. The use of the fair value option has enabled UBS to reduce 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, the fair value option allows us to account for financial instruments in line with how they are managed.

Overall, we do not support the restrictions on the use of the fair value option as proposed in the Exposure Draft. We understand that certain regulators have raised concerns over the potential abuse of the fair value option, citing that valuation is subjective, and use of the option will increase volatility in earnings. As most if not all entities try to reduce volatility in earnings we do not believe that it is a valid concern that any entity would elect to introduce volatility by selectively applying the fair value option. In practice we believe that the fair value option results in less volatility in earnings, greater transparency, and enhanced financial reporting, while at the same time reducing unnecessary operational costs related to separating embedded derivatives, supporting hedge accounting, and entering into external hedging transactions. We strongly urge the IASB not to introduce restrictions on the use of the fair value option, as the proposed restrictions are not an improvement to the existing Standard.

The fair value option was introduced to simplify application of certain onerous requirements in IAS 39, namely bifurcation and hedge accounting. We believe that the proposed amendments will eliminate much of this relief and will add an unnecessary level of complexity to financial reporting. We do not believe that the proposed limitations on designation and the introduction of the concept of verifiability adequately address the regulators' concerns, while preserving the key benefits of the option. We are therefore very concerned with the proposed amendments and the negative impact it may have on the IASB's initiative to address some of the operational complexities associated with IAS 39. The initial proposal to include the fair value option (without restrictions) went through the IASB's due process.

The concerns that the exposure draft intends to address were debated in the original amendments to IAS 39, and the Board concluded not to restrict the use of the fair value option. We question, why the Board has decided to re-open this issue.

Verifiable Criteria

We do not support the introduction of the verifiable concept as it introduces a second definition of fair value. We do not believe that the rationale for introducing this concept is adequately explained, nor do we believe that it addresses the subjectivity concerns raised by the regulators. Valuation, by its nature is subjective, and estimates must be used. If regulators are concerned with the subjectivity of valuations, they should not simply focus their concerns on instruments designated as held at fair value. Introduction of the verifiable criteria for the fair value option will not achieve the goal of eliminating subjectivity from valuation. Estimates are a fundamental part of financial accounting and reporting. The use of estimates is a concept that is accepted and understood by all users of financial statements.

The criteria in the Exposure Draft for when a financial instrument is verifiable are confusing. The introduction of a second, "stricter" concept of fair value undermines the validity of reliable fair values currently reported in financial statements. We believe that investors expect entities to adhere to the highest standards when preparing financial accounts, as such, the implication that one valuation is better or more reliable than another will be confusing for readers of financial statements. Further, the term verifiable is not effective in describing the stricter test than reliable. The examples for when an instrument is verifiable are existing concepts, which are generally applied in practice and are included in the current IAS 39 discussion on valuation. Financial markets have developed to the point where reliable fair values can be obtained for most financial instruments. We believe that reliable valuations are sufficient for designation as held at fair value.

We would like to highlight an issue relating to structured note issuances, which we do not believe has been considered when drafting the verifiable proposal. The verifiability/observability criteria invariably relates to the embedded derivative in a structured product, which is required to be fair valued regardless of designation, as it is a derivative instrument. The valuation inputs for the debt host contract are generally observable in the market, while the valuation inputs for the embedded derivative component may not be observable. The result is that entities will not be permitted to designate the combined instrument as held at fair value. As such, entities will be required to separate the non-verifiable embedded derivative and account for it at fair value, while the verifiable host contract will be accounted for on an accruals basis. We believe this is counter-intuitive. The instrument whose value is in doubt will be measure at fair value regardless of verifiability because it meets the definition of a derivative, and the instrument whose inputs are verifiable will be prohibited from applying fair value. Note that regardless of verifiability, entities will still have the option of applying hedge accounting. Introducing restrictions on the use of the fair value option will not prevent entities from applying fair value accounting. The restrictions will only result in increasing operational cost to achieve this result.

The verifiable requirements appear to be in direct conflict with paragraph 50 which states, "*An entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.*" Observable market transactions and valuation inputs may exist at a specific valuation date, but may no longer exist at another date. As such, the fair value of a financial instrument may be both verifiable and non-verifiable during its life. As designating an item as held at fair value is irrevocable this would imply that an instrument only needs to be verifiable at inception.

Should the IASB decide to include the verifiable criteria in the final standard, we recommend that additional guidance be included on what criteria must be met to prove that an instrument is verifiable, as well as guidance distinguishing verifiable from reliable.

Proposed Limitations

Overall, we do not support any limitations on the use of the fair value option. Most financial instruments will generally meet at least one of the five proposed criterion. As a result, we do not believe that the proposed restrictions will accomplish anything other then introducing volatility into financial statements or reducing business transactions, as entities may decide that the cost of achieving hedge accounting is too great.

The goal of the IASB in introducing the fair value option was to simplify the application of IAS 39. Specific benefits mentioned include the elimination of the need for hedge accounting and the related burden of designating, tracking and analyzing hedge effectiveness, and the elimination of the burden to identify and separate embedded derivative. We believe that the proposed limitations have the potential to result in more onerous accounting than the existing hedge accounting and bifurcation rules. In practice we believe that most entities will use the fair value option to eliminate the need to bifurcate embedded derivatives from structure products and to achieve hedge accounting where it is impractical to achieve it under existing IAS 39.

We have significant concerns over the proposal relating to assets and liabilities whose changes in fair value substantially offset. We question the level of documentation and effectiveness testing that will be required to apply the "substantially offset" provision. We believe that this could be interpreted to require the same documentation and effectiveness testing as the current hedge accounting guidance. For example, as designation is only available at inception of an instrument, entities would be required to enter into the offsetting asset and liability at exactly the same time. Further, would entities have to prove at inception, and throughout the life that the changes in fair value substantially offset? If so, what type of documentation and effectiveness testing is required? Further, what would happen if the entity sold one component of the economic hedge? Since the designation is irrevocable, entities would not be permitted to de-designate the un-hedged instrument, however they would no longer meet the criteria to be considered held at fair value.

We have included responses to the specific questions asked 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).

Best regards,

UBS AG

Ralph Odermatt	John Gallagher
Managing Director	Executive Director
Accounting Policies and Support	Accounting Policies and Support

Appendix A

Question 1
Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

We do not agree with the proposals in the exposure draft. The fair value option is a positive step to simplify complex accounting requirements and bring financial reporting in line with risk management practices. We believe that the fair value option results in less volatility in earnings, greater transparency, and enhanced financial reporting, while at the same time reducing unnecessary operational costs related to separating embedded derivatives, supporting hedge accounting, and entering into external hedging transactions. The proposed amendments introduce an unnecessary level of complexity and have the ability to undue much of the relief provided by the fair value option. We strongly urge the IASB not to place any restrictions on the use of the fair value option.

Question 2
Are you aware of any financial instruments to which entities are applying, or are intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in this Exposure Draft? If so:

(a) please give details of the instrument(s) and why it (they) would not be eligible.
(b) is the fair value of the instrument(s) verifiable (see paragraph 48B) and if not, why not?
(c) how would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?

UBS adopted the fair value option on 1 January 2004. We are currently applying this option to our structured debt portfolio in order to reduce the burden associated with bifurcation of embedded derivatives and applying hedge accounting. As long as the restrictions as proposed do not change we will not be immediately impacted by the proposal, with the possible exception of the verifiability criterion. Until more guidance is provided on verifiability we will not be able to assess its impact to the bank. However, if the Standard only permitted entities to apply the option to structured instruments that have embedded derivatives that are required to be separated from the host under the standard, we would be restricted in our use of the standard.

Entities often manage risk on a dynamic basis. Credit default swaps are often used to economically hedge loans, however this will generally not be a one to one offset. Banks have increased the use of credit derivatives in an effort to reduce credit risk. Under the hedge accounting criteria of IAS 39 it is very difficult to achieve hedge accounting over a loan portfolio when hedging credit risk. Most financial institutions do not apply for hedge accounting and live with the volatility between fair valuing the credit derivative and carrying the loans at cost less permanent impairment. The fair value option would permit companies to reduce this volatility that exists today. Restricting the fair value option for loans will ensure that unnecessary volatility in earnings continues.

Question 3
Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value option so as to address adequately the concerns set out in paragraph BC9? If not, how would you further limit the use of the option and why?

We understand that certain regulators have raised concerns over the potential abuse of the fair value option, citing that valuation is subjective, and use of the option will increase volatility in earnings. We disagree with these concerns. Putting restrictions on the model will have the exact opposite effect.

We do not believe that the introduction of the verifiable concept addresses the subjectivity concerns raised by the regulators. Valuation, by its nature is subjective, and estimates must be used. If regulators are concerned with the subjectivity of valuations, they should not simply focus their concerns on instruments designated as held at fair value. Valuation of certain instruments that are required to be measured at fair value, most notably embedded derivatives are no less subjective than the valuation of instruments that would be fair valued under the option or for instruments such as loans, whose carrying value is also subjective. Introduction of the verifiable criteria for the fair value option will not achieve the goal of eliminating subjectivity from valuation. Estimates are a fundamental part of financial accounting and reporting. The use of estimates is a concept that is accepted and understood by users of financial statements.

The second concern stated in BC9 is that the option might increase volatility if an entity would apply this option to only one part of a matched position. We do not see this as a valid concern. Entities view earnings volatility as something to avoid and as a result, we do not see this option being used to increase volatility. In practice entities will use this option to reduce volatility by applying it to financial instruments where it is presently impractical to achieve hedge accounting.

Further, we are uncertain why a standard setter is concerned with earnings volatility. We believe that accounting standard setters should address the relevant and reliable representation of the financial position of an entity. If the true position of an entity is that they have volatile earnings, then this should be represented in the financial statements.

Question 4

Paragraph 9(b)(i) proposes that the fair value option could be used for a financial asset or financial liability that contains one or more embedded derivatives, whether or not paragraph 11 of IAS 39 requires the embedded derivative to be separated. The Board proposes this category for the reasons set out in paragraphs BC6(a) and BC16-BC18 of the Basis for Conclusions on this Exposure Draft. However, the Board recognises that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial number of financial assets and financial liabilities would qualify for the fair value option under this proposal. Is the proposal in paragraph 9(b)(i) appropriate? If not, should this category be limited to a financial asset or financial liability containing one or more embedded derivatives that paragraph 11 of IAS 39 requires to be separated?

UBS does not support any limitation on use of the fair value option. As such, we would not support a further limitation to permit only instruments with separable embedded derivatives to be designated as held at fair value. As the goal of the fair value option was to simplify the current requirements related to embedded derivatives, we question the Board's logic in considering a further limitation. If the Board limited fair value designation to those instruments with embedded derivatives that require separation, entities would be required to first evaluate the instrument to determine if it has an embedded derivative, and if so further analyze for potential separation. This will negate any operational and cost benefits obtained from the introduction of the fair value option.

Under IAS 39 financial institutions that issue structured notes with embedded derivatives that are not required to be separated under paragraph 11 generally do not apply hedge accounting. Hedge accounting is not applied as the cost of doing an external layoff of the derivative instrument would be too expensive. As a result financial institutions will either need to cease issuing these instruments, or bear unnecessary P&L volatility, as they will economically hedge the structure even though they are unable to achieve hedge accounting. The fair value option was a welcome relief to many financial institutions as this option permitted companies to present the substance of the transactions while reducing volatility in earnings. Restricting the option will bring back this volatility.

Question 5

Paragraph 103A proposes that an entity that adopts early the December 2003 version of IAS 39 may change the financial assets and financial liabilities designated as at fair value through profit or loss from the beginning of the first period for which it adopts the amendments in this Exposure Draft. It also proposes that in the case of a financial asset or financial liability that was previously designated as at fair value through profit or loss but is no longer so designated:

(a) if the financial asset or financial liability is subsequently measured at cost or amortised cost, its fair value at the beginning of the period for which it ceases to be designated as at fair value through profit or loss is deemed to be its cost or amortised cost.
(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognised in profit or loss shall not be reclassified into the separate component of equity in which gains and losses on available-for-sale assets are recognised.

However, in the case of a financial asset or financial liability that was not previously designated as at fair value through profit or loss, the entity shall restate the financial asset or financial liability using the new designation in the comparative financial statements.

Finally, this paragraph proposes that the entity shall disclose:

(a) for financial assets and financial liabilities newly designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the previous financial statements.
(a) for financial assets and financial liabilities no longer designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the current financial statements.

Are these proposed transitional requirements appropriate? If not, what changes do you propose and why? Specifically, should all changes to the measurement basis of a financial asset or financial liability that result from adopting the amendments proposed in this Exposure Draft be applied retrospectively by restating the comparative financial statements?

We are concerned that entities that have previously applied the fair value option as a result of early adoption in 2004 will encounter significant difficulties if they wish to re-establish hedge accounting. As a result, we would recommend that institutions are provided an option to apply the revised requirements on a fully retrospective basis.