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Mr. Wayne Upton,
International Accounting Standard Board
30 Cannon Street
EC4M 6XH
United Kingdom

Re: Comment Letter on Credit Risk in Liability Measurement

Dear Mr. Upton,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),¹ in consultation with its Corporate Disclosure Policy Council (CDPC)², appreciates the opportunity to comment on the IASB - *Credit Risk in Liability Measurement - Discussion Paper (DP)*.

The CFA Institute Centre represents the views of its worldwide members, including portfolio managers, investment analysts, and advisors. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct*.

EXECUTIVE SUMMARY

Background

The discussion paper (DP) on *Credit Risk in Liability Measurement*, relates to the recording of gains on liabilities when an entity's non performance risk, of which own credit risk is a component, increases. The relevance of this component continues to be on the spotlight especially as a number of financial institutions have recently reported gains related to liabilities under deteriorating financial and economic conditions. As noted in the DP, there are polarized views on the usefulness and economic meaning of these gains and it remains one of the most debated aspects of fair value application. The Financial Crisis

¹ The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, Brussels and London, CFA Institute is a global, not-for-profit professional association of more than 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

² The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

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Advisory Group (FCAG) has highlighted this as a necessary area for further standard setter focus and resolution.

Some of the IASB's recent consultative documents³ have at least partially addressed the issue of credit risk in liability measurement, including proposals relating to the accounting for financial instruments, insurance, and fair value measurement. This discussion paper aims to further develop the conceptual considerations around this issue. In order to articulate the reasons for including or excluding own credit risk, the DP seeks financial reporting stakeholder opinion on the following specific issues:

- Whether the inclusion of own credit risk should be extended to all classes of liabilities, i.e. borrowing transactions that involve a cash exchange at initiation as well those that do not (e.g. pension obligations, asset removal and decommissioning, product warranty; and insurance claim liabilities)
- Whether the accounting treatment at initiation of a liability should be applied in subsequent measurement of that same liability
- How the entity-specific credit risk component should be determined
- Alternative measurement approaches to inclusion of credit risk

Implications for Investors

- **Expansion of the reporting of credit risk in liability recognition would increase investors' need to assess asset and earnings quality for gains rooted in credit deterioration.** It would also increase the importance of understanding signals given by credit markets (e.g. credit spreads) about a firm's future creditworthiness.
- **On the other hand curtailing the inclusion of credit risk would perpetuate asymmetrical accounting measurement of assets and liabilities on the balance sheet.** The result would be an asymmetrically greater burden on the investor.

Summary of CFA Institute Positions

In our response, we

- Strongly support the fair value application for all liabilities and this entails the inclusion of credit risk
- Disagree with the view that any approach that excludes the credit risk factor is an acceptable alternative to fair value measurement. While some may view liability gains as being counterintuitive, we agree with the line of reasoning that measuring and reporting own credit risk gains on liabilities conveys information regarding the effective interest rate of borrowings and refinancing requirements. These gains also provide insight on the wealth transfer that has occurred from bondholders to shareholders. In addition, gains may also offset declines in the fair value of assets.

³ For example, credit risk in liability measurement was addressed in *Fair Value Measurement*, issued in May 2009; *Fair Value Measurements*, November 2006; *Preliminary Views on Insurance Contracts*, May 2007; *Preliminary Views on Amendments to IAS 19 Employee Benefits*, March 2008; and *Reducing Complexity in Reporting Financial Instruments*, March 2008.

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- Reiterate our previous proposals for enhanced disclosure and presentation. The reporting of liability gains is a consistent application of fair value and concerns can be alleviated by enhanced disclosure and presentation to facilitate the interpretation of reported amounts

GENERAL COMMENTS

The DP articulates the factors in favor of and those against the recording of credit risk of liability associated gains or losses. We find the arguments in favor of inclusion to be compelling. These include:

Across period consistency: We concur with the view that information that is relevant at inception should be similarly relevant for subsequent measurement purposes. When an entity borrows funds from an unrelated entity: the lender's judgment about the credit paying ability of the borrower is explicitly incorporated in the interest rate charged in the transaction. The same evaluation is applied through the holding period and should be reflected in the valuation of liabilities. Consistency between initial and subsequent measurement yields comparable financial reporting information, a necessary ingredient of decision usefulness.

Information content: We acknowledge that some users, such as credit analysts whose predominant analytical focus is on contractual cash flows, might not find unrealised gains on liabilities to be useful. However, there is undisputed information content for other classes of users. The inclusion of credit risk yields useful information on the effective interest rate of the liabilities and portrays what would be the likely refinancing requirements at the time of reporting. At the same time, we believe that footnote disclosure should be required of the contractual cash flow amounts due. The liability gains may also indicate that there has been a decline in the fair value of assets, that, implicitly or explicitly provide the collateral for entity's liabilities.

As a general principle, we urge the standard setter to consider why users have differing information needs and to develop standards that serve the needs of the broadest range of users.

Accounting mismatch (supporting argument): The fair value measurement of financial assets, both initially and subsequently, includes the price of credit risk. Although the timing may not be coincident, the recognition of liability gains may offset recognized asset losses and provide a better depiction of aggregate economic reality across the asset-liability portfolio. It effectively dampens the exaggeration of earnings volatility that would arise if only financial assets were accounted for on a fair value measurement basis. It also warns the investor of potentially incorrect measurement (in terms of the amount and timing) of asset quality when significant asset classes are measured at historic cost.

Economic wealth transfer to shareholders: The DP also identifies the wealth transfer from bondholders to shareholders as an economic rationale for inclusion of own credit risk. There is empirical evidence⁴

⁴ Barth, Hodder and Stubben (2008), 'Fair Value Accounting for Liabilities and Own Credit Risk', *The Accounting Review*, Vol.83, No.3, pp 629-664

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that debt moderates the impact of credit quality deterioration on overall share price, that is, that real economic wealth transfer is recognized in the markets.

The DP cites various arguments against including:

- a) Being counter-intuitive;
- b) Realisation difficulties
- c) Creating accounting mismatches

Counterintuitive

Implicit in the counterintuitive characterization is a mindset that investors should use a single performance measure or regulators should apply this measure in a formulaic fashion and with minimal judgment when determining capital adequacy ratios. Users or regulators who focus on a single net income amount are bound to be misled as a single number cannot fully convey firm performance.

Some have also expressed concern that some firms manage earnings to mislead investors on their underlying core profitability and solvency. However, their ability to do so is mitigated when both assets and liabilities are measured at fair value given that the aggregate magnitude of the fair value of liabilities is lower than fair value assets. A study⁵ of S&P 500 companies in the US during 2007 estimated the ratio of liabilities to assets at 1:4. A similar conclusion can be inferred from the breakdown based on the fair value assets and liabilities of European banks (see appendix). Hence, there will be other robust indicators of operating problems.

The concerns about distortion of the reported earnings can be addressed through enhanced presentation and disclosure. If the components of performance measurement are disaggregated, then it is easier for users to process the information content of such recorded gains. This would also be the case for other fair value holding gains or losses. As a general recommendation, we urge the standard setters to include the enhancement of financial statement presentation within each individual standard amendment. We strongly urge the IASB to require gross presentation of individual line items, without netting, using the following categories:

1. gains and losses on assets,
2. gains and losses on liabilities
3. gains and losses on nonfinancial assets
4. gains and losses on nonfinancial liabilities

These items would be presented separately from operating revenues, expenses, interest income, etc.

Overall, we continue to believe that improved presentation of operating cash flows and fair value changes, using a balance sheet-to-balance sheet reconciliation statement and bolstered by robust disclosure, would significantly advance the ability of investors to forecast future cash flows, earnings power, capital adequacy, liquidity and the value of companies in which they invest, and discourage

⁵ Credit Suisse: Focusing on Fair Value-27th June, 2008

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investors and other constituents from focusing on potentially misleading single-point and bottom-line type of numbers.

Realisation difficulties

Opponents of recognition of credit risk changes contend that low tradability and counterparty constraints associated with liabilities make their realization or monetisation unlikely, hence any profit is essentially ‘theoretical’.

However, there is observable market evidence⁶ that discounted liabilities have actually been repurchased and resulted in a gain for the issuer. While it is true that the entity that redeems its liabilities might still need to refinance at a higher cost of borrowing which over future periods would deplete any realized gains, overall an economic gain exists whether realization occurs or not. As stated in the DP realization is not a critical event in the accounting for assets, nor should it be for liabilities. If the entity did not redeem, it is still enjoying a lower cost of funding than would be the case if it were to replace the liability and hence benefits from an economic holding gain. Another reason that realization is not critical is because gains associated with credit risk changes can be effectively realized using credit derivative instruments as opposed to redemption of cash bonds.

The main focus should be on providing information that is relevant⁷ to users and the usefulness of information should not be confined to amounts that will result in cash flows to the entity (i.e. settlement value). The transfer value of liabilities is relevant because it provides information on the replacement value and effective borrowing cost of liabilities.

Accounting mismatch (opposing argument)

The principal argument about accounting mismatch is that certain intangible assets are not recognized and this leads to asymmetrical accounting. Intangible assets could for instance arise when a company has secured low-cost funding, that is significant material information for investors to understand as it most likely signals a strong business and competitive advantage. It could also arise for core deposits intangible when interest rates rise. Or when interest rates fall and the volume of securitization and securitization gains increases offsetting changes in the value of mortgage servicing rights.

The primary question should be what is the right accounting for liabilities? And the answer should not be constrained by sub-optimal accounting (i.e. mixed measurement attribute) for assets or omission of some assets, such as intangible assets. The solution should be to work towards recognizing omitted assets and improving their disclosures so as to redress any situation of investors being misled on the asset and liability management effectiveness, rather than perpetuating ‘symmetrical’ off balance sheet accounting.

⁶ Over the past year, Royal Bank of Scotland, Standard Chartered and UBS bought back bonds- Risk Magazine- 5th August 2009. The DP staff paper also cites various examples of realisation

⁷ On the asset side, for example, entities often carry on their balance sheet American style options that have a fair value much higher than their settlement value (i.e. intrinsic value). No one is arguing that if the company were to exercise the option today it would not recover the time value of the option. The fair value is simply a **more relevant** measure.

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In addition, there is a view that the corresponding asset value adjustment is not influenced by entity specific credit risk to the extent that liabilities are. In other words, portfolio effect is more evident on financial assets held as there is effective minimization of credit spreads at a portfolio level. Hence asset related credit spreads might not widen to the same extent that entity specific liability related credit spreads would. This in itself is indicative of an economic mismatch and the accounting information should simply reflect that. However, we believe the overriding consideration of accounting information should be to provide relevant information on liabilities rather being a device of masking any resulting economic mismatches. As stated previously, preparers should expand disclosures to enable users to fully understand the underlying asset and liability management effectiveness.

As we have indicated in previous letters, we believe that the fair value of all financial assets and liabilities should capture all elements of market price changes. If management would like to provide its view on the values of financial assets and liabilities, such input best belongs in a management commentary rather than in the financial statements. The fair value of liabilities can be excellent inputs into analyzing the strength of a company as well as liquidity and cost of borrowing.

Fair value option and accounting mismatch

We do not support an accounting model that allows companies have the choice whether to fair value, and even then, only for certain individual financial liabilities (i.e. fair value option). Anecdotally, companies appear to elect to fair value certain liabilities in order to opportunistically post gains to offset losses in the near-term post adoption; put differently, the fair value option is elected for certain liabilities to reduce accounting mismatches. The mismatches of concern at election are those relating to assets recognized at fair value. Cherry-picked application of accounting measurements substantially reduces the usefulness, accentuates accounting asymmetry and lack of comparability of financial reports to investors.

The standards should therefore not allow the on and off application of the fair value option, as would be the case if the Board was to curtail the application due to concerns of some banks that realize that they will have to record related losses when credit spreads tighten.

SPECIFIC COMMENTS

Application across all liability categories at initiation and subsequent measurement

The DP seeks specific views on whether credit risk should be included for all or some or none of the liabilities at initiation and subsequent measurement.

We believe that the impact of entity specific credit risk should be reflected in the measurement of **all** liabilities. We believe all liabilities (i.e. derivatives, borrowings and other obligations) should be measured at fair value and fair value by definition includes the credit risk of the entity. All of these

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liabilities are subject to entity specific non performance risk and there is no conceptual basis for excluding credit risk for any liability that is measured at fair value.

We acknowledge that liabilities measured at fulfillment or settlement value (e.g. pension obligation and insurance claims) may present some measurement difficulties. However, difficulty in measurement is not a sufficient reason for omitting relevant information. The thrust of opposition seems to revolve around usefulness of information and measurement difficulties. But, as we have argued the liability gains enables some users to derive key information on the effective cost of borrowing as well as, in some cases, the deterioration of asset values. A disaggregated presentation and disclosure should help guide the interpretation of reported amounts.

As earlier stated, we also believe that there should be consistent treatment at the initiation and subsequent measurement of liabilities. This will yield comparable and more decision useful information.

Determination of credit risk

The DP notes that an observed interest rate has many risk components including entity specific, idiosyncratic own credit risk, systematic credit risk, the impact of the specific liability credit enhancement and liquidity risk. The DP seeks views on how the amount of a change in market interest rates attributable to the price of the credit risk inherent in the liability should be determined.

We support the identification and disclosure of the components of changes in fair value. The ability to differentiate own credit risk changes from other market price changes certainly must exist since opponents of including own credit risk believe that change should be isolated and excluded. The determination should factor instrument-specific credit enhancements, such as 3rd party guarantees. Even a with-and-without analysis, which would likely include many subjective assessments, could provide useful information if a consistent analysis was performed in each period.

There is also a need to define a robust framework of disclosure of the methodologies that are used to determine the valuation impact of entity specific credit risk. This will facilitate the consistent disclosure across period and across company practices and bolster financial reporting comparability.

Proposed alternatives to accounting for credit risk

The DP seeks views on three alternatives to accounting for credit risk. These are

Alternative 1: Measure all liabilities using the risk-free interest rate and expected future cash flows, excluding default expectations. The difference between the measurement and cash proceeds goes through income immediately.

Alternative 2: Measure all liabilities using the risk-free interest rate and expected future cash flows, excluding default expectations. The difference between the measurement and cash proceeds goes through equity and is amortized over the life of the liability.

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Alternative 3: Measure borrowings and other liabilities that result from an exchange for cash at the amount of cash proceeds. A liability not resulting in an exchange of cash is measured at the present value of expected future cash flows, discounted at market rates excluding the effect of credit risk. Subsequent current measurements include changes in market interest rates, excluding changes from an entity's credit quality or the price of its credit.

We do not believe any of the 3 approaches provides a suitable substitute for fair value as they all exclude own credit risk factor. We have articulated why the credit risk factor is an integral and necessary part of fair value reporting of liabilities and thus cannot see how it can be meaningful to exclude it. The first two approaches would suggest that the entity is a risk free entity and these proposals would result in less relevant information being provided.

Disclosure requirements

To mitigate the concerns of misinterpretation of gains related to liabilities, we recommend the disclosure of contractual cash flows of all liabilities recorded at fair value. This should be by class of liability and preferably in the form of a roll forward. This could be as outlined in Equation 1:

Equation 1

Opening balance
+ Amounts incurred
- Amounts settled
+/- entity changes (acquisitions/divestitures)
+/- foreign currency effect, if any +/- credit risk adjustment
= Closing balance

CLOSING REMARKS

If you, other board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, CFA, by phone at +44.207.531.0763, or by e-mail at vincent.papa@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht
Kurt N. Schacht, CFA
Managing Director
CFA Centre For Financial
Market Integrity

/s/ Gerald I. White
Gerald I. White, CFA
Chair, Corporate Disclosure
Policy Council

Cc: Corporate Disclosure Policy
Council

APPENDIX

Table 1: Application of Fair Value by US and European Banks, 2007. This table shows that there should be corresponding offsetting information on financial assets to allay concerns about gains on fair value liabilities

Financial Institutions	Assets at Fair Value on a Recurring Basis	Liabilities at Fair Value on a Recurring Basis
JP Morgan Chase	41	16
Citigroup	39	22
Bank of America	27	6
Goldman Sachs	64	43
Lehman Brother	42	22
Merrill Lynch	44	33
Morgan Stanley	44	27
Credit Suisse	64	39
Societe Generale	46	32
Royal Bank of Scotland	45	31
BNP Paribas	65	55
Deutsche Bank	75	48
UBS	54	35
HSBC	40	25
Barclays	52	39
Credit Agricole	44	24

Source: IMF October 2008 report on 'Fair value and Procyclicality'-Chapter 3