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Sir David Tweedie
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Email: commentletters@iasb.org

1 September 2009

Dear Sir David,

Re: Discussion Paper, *Credit Risk in Liability Measurement*

Deloitte Touche Tohmatsu is pleased to respond to the Discussion Paper, *Credit Risk in Liability Measurement* (the "Discussion Paper"). We support the Board's effort to address this critical topic and believe that future standard setting would benefit if the IASB were to define a consistent set of principles for when credit risk should be reflected in liability measurements.

To assist in the development of such a set of principles, the Board should first define the various potential measurement attributes that could be applied to liabilities as part of Phase C of its Conceptual Measurement project. Below we outline the measurement attributes that we believe the Board should consider. Subsequently, we discuss our proposed set of principles governing when the measurement of a liability should incorporate credit risk.

Measurement Attributes

At this time, we support further consideration of four different measurement attributes for liabilities.

1. *Fair value* – Standard-setters define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, i.e., an exit price.[1] Because fair value, as proposed to be defined by the IASB, is a price in a current market transaction, this measurement attribute reflects the impact of the entity's own credit risk.

[1] The IASB's May 2009 Exposure Draft, *Fair Value Measurement*, and FASB's Accounting Standards Codification Topic 820, *Fair Value Measurements and Disclosures* (formerly FASB Statement No. 157, *Fair Value Measurements*).

2. *Amortised cost.* – For a liability, amortised cost is "the amount at which the ... liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount."[2] Typically, this measurement attribute reflects the entity's own credit risk at initial recognition. For example, when a financial liability is measured at the amount of cash proceeds received, the amount of cash proceeds generally reflects the entity's credit risk. However, subsequent changes in credit risk are not reflected in subsequent measurements.

3. *Current Measurement Using a Frozen Credit Spread* – This measurement attribute uses a present value technique that discounts the expected future cash flows at a current benchmark rate (such as a risk free rate, an interbank benchmark rate, or a bank prime rate) plus (or, in some circumstances, minus) the spread that applied to the liability at initial recognition. Subsequent measurements reflect changes in the benchmark rate; but changes in credit risk are ignored. Similar to amortised cost, this measurement attribute reflects the entity's own credit risk at initial recognition, but subsequent changes in credit risk are not reflected in subsequent measurements.

4. *Current Measurement Using a High Quality Credit Approach* – This measurement attribute uses a present value technique that discounts the expected future cash flows using a current high quality discount rate, for example, the current risk free rate or the current discount rate for high quality corporate bonds. This measurement attribute excludes the effect of the specific credit risk of the issuer both at initial recognition and in subsequent measurements.

Proposed Set of Principles for Choosing a Measurement Attribute

Initial Measurement:
Liabilities arising from exchange transactions in which the obligations are customarily issued or priced at inception on terms that consider the credit risk of the liability should be measured initially at an amount that incorporates the credit risk of the liability. For instance, if an entity borrows cash, the cash proceeds and the interest terms of the liability typically will reflect the credit risk of the liability at initial recognition. Similarly, if an entity receives a non-cash asset (such as a car) in exchange for a promise to pay over a period of time, the terms of the transaction typically will reflect the credit risk of the liability. We strongly believe that the act of borrowing at the prevailing interest rate applicable to the borrower is not an event that gives rise to an immediate gain or loss or an event that results in a reduction in the entity's equity capital.

Additionally, where an entity enters into a derivative liability, while the terms may not include an explicit adjustment for credit risk (e.g., where two swap counterparties have similar credit risk), credit risk would typically be reflected in the terms (e.g., through collateral arrangements or, if credit risk is significant, compensation in the pricing terms). Credit risk should be reflected in the initial measurement of such liabilities.

For liabilities that are incurred in which the counterparty (if identified) does not customarily negotiate terms that consider the credit risk of the liability, we propose that credit risk should not be reflected in the initial measurement (nor subsequent measurement) of the liability. For instance, liabilities that relate to contingent obligations (e.g., litigation), post-employment benefit obligations and decommissioning liabilities are often incurred without terms or conditions from third parties reflecting the specific credit risk of the liability. For such liabilities, the timing and amount of payment are an estimate and without defined terms. These estimates generally do not include credit risk of the entity. We propose that such

[2] Paragraph 9 of IAS 39, *Financial Instruments: Recognition and Measurement.*

liabilities be measured both initially and subsequently using a high quality credit spread approach as described above.

Subsequent Measurement:
For those liabilities in which the initial measurement incorporates the specific credit risk of the obligation, the subsequent measurement could be fair value, amortised cost, or a current measurement using a frozen credit spread. We believe the Board should establish principles for determining which measurement attribute is most appropriate to the subsequent measurement of a liability based on the characteristics of the liability.

Note that credit risk may not be the only or the primary basis for choosing a subsequent measurement attribute. For example, fair value measurement should continue to be required for derivative liabilities, not only because the measurement incorporates a current credit risk component but because fair value is the most relevant measure for an instrument (a) that may have little or no initial investment and (b) whose value potential changes in significant magnitudes in response to a specified variable(s) (such as an interest rate, commodity price, or equity price index) that is not specific to one of the parties to the contract.

In determining the best subsequent measurement attribute, the board should consider the relevance of changes in the issuers own credit to investors. For example, for most debt obligations, the issuer does not have the practical ability to realise gains associated with decreases in their credit worthiness. They are also not required to absorb losses associated with increases in their credit worthiness in debt obligations. Thus, changes in an issuer's own credit is generally not relevant and should not be incorporated in the subsequent measurement of most debt obligations. This would lead to debt obligations being measured at amortised cost or a current measurement using a frozen credit spread (whether fixed rate debt obligations should be measured using a frozen or current benchmark interest rate is not a topic for this Discussion Paper). Where the issuer could realise changes in value of a liability due to changes in its own credit risk, a measurement attribute incorporating current risk (e.g., fair value) may be appropriate.

Other Issues
In developing a new consistent set of principles, the Board will also need to address certain issues:

Selection of a Discount Rate – For certain obligations, such as, post-employment benefit obligations, decommissioning liabilities, and provisions, where credit risk is not priced into the terms, we propose that the expected cash flows be discounted using a high quality discount rate. The Board would need to clarify how such a discount rate should be selected.

Business Combinations – If the obligation is measured by the acquiree using a technique that excludes the impact of own credit, will the Board provide a scope exception from the measurement requirements of IFRS 3, *Business Combinations*? If not, how would an acquirer account for a "gain" resulting from fair valuing the obligation at the acquisition date (if such an obligation was measured using a higher quality discount rate by the acquiree)? Would the "gain" be included in the calculation of goodwill?

Reclassification – If an entity's assessment of its practical ability to realise gains and losses from credit risk changes, should the measurement attribute change, for example, from a high quality credit approach or frozen credit approach to fair value (or vice versa)?

Derivatives – Although we continue to support fair value for derivatives, in developing a consistent set of principles for credit risk in liability measurement, the Board may wish to consider whether the current measurement of obligations inherent in derivative financial instruments should include own credit risk. We recognise that the terms of non-derivatives

and derivatives are inherently different, however, with respect to own credit risk many derivatives are similar to non-derivatives, for example, they are over-the-counter arrangements where the obligor has limited ability to transfer or settle the obligation outside of its contractual terms at an amount that includes change in the fair value of the obligor's credit risk.

We encourage the Board to coordinate its efforts and any standard setting projects the Board may undertake as a result of this Discussion Paper, with the FASB to help achieve the common goal of convergence between IFRSs and U.S. GAAP.

Our detailed responses to the questions for respondents are included in Appendix A to this letter.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907.

Sincerely,

Ken Wild
Global IFRS Leader

Appendix A: Questions for Respondents

Question 1

When a liability is first recognised, should its measurement (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why?

(a) If the answer is 'sometimes', in what cases should the initial measurement exclude the price of the credit risk inherent in the liability?

(b) If the answer is 'never':

1. ***What interest rate should be used in the measurement?***
2. ***What should be done with the difference between the computed amount and cash proceeds (if any)?***

Response 1

Sometimes.

As discussed in the body of this letter, if the customary third party negotiated terms and conditions of a particular type of liability reflects the credit risk of the arrangement (e.g., bank borrowings and issued debt securities), we believe the liability should initially be measured at an amount that reflects the issuer's credit risk (e.g., the amount of cash proceeds or other consideration received).

If the customary terms and conditions of a particular type of liability do not consider the credit risk associated with the liability (e.g., decommissioning liabilities and contingent obligations for litigation), credit risk should not be reflected in the measurement of the liability. Instead such a liability should be measured using a high quality credit approach.

Question 2

Should current measurements following initial recognition (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why? If the answer is 'sometimes', in what cases should subsequent current measurements exclude the price of the credit risk inherent in the liability?

Response 2

Sometimes.

As discussed in the body of this letter, we continue to support fair value measurement of derivatives. Credit risk may also be reflected in the subsequent measurement of a liability if the entity has the practical ability to realise gains or losses associated with changes in credit risk in the ordinary course of business.

Changes in credit risk should not be reflected in the subsequent measurement of non-derivative liabilities whose contractual cash flows are fixed or fluctuate solely based on a market interest rate (including non-leveraged inflation) and are not managed on a fair value basis. Similarly, changes in credit risk should not be reflected in the subsequent measurement of non-derivative liabilities where the entity does not have the **practical** ability to **realise**

gains or losses associated with changes in own credit in the ordinary course of business (i.e., other than in bankruptcy, liquidation or default) [emphasis added]. If such a liability has variable cash flows (e.g., payment terms based on earnings), a frozen spread approach is applied.

Moreover, credit risk should not be reflected in the initial or subsequent measurement of liabilities that are incurred on terms or conditions that do not consider the credit risk associated with the liability. Instead such a liability should be measured using a high quality credit approach.

Question 3

How should the amount of a change in market interest rates attributable to the price of the credit risk inherent in the liability be determined?

Response 3

The separation of credit risk from other changes in value will often be arbitrary and rely on practical conventions. However, one approach that can be used and is being currently applied in practice in determining the change attributable to the credit risk inherent in the liability is outlined in paragraph IG11 of IFRS 7. This approach freezes the credit spread at the beginning of each period.

Further, another approach, a variant of the approach in paragraph IG 11 of IFRS 7, would be to freeze the credit spread at initial recognition rather than at the beginning of each reporting period.

Entities may also use information derived from data about credit default swap spreads, when available as another alternative.

Regardless of the approach used, we believe that the Board should clarify whether credit risk includes or excludes sector spreads (i.e., is the price of credit risk determined based on the issuer's credit spread relative to the overall market benchmark rate or to the prevailing rate for a particular sector?).

Question 4

The paper describes three categories of approaches to liability measurement and credit standing. Which of the approaches do you prefer, and why? Are there other alternatives that have not been identified?

Response 4

We do not support the "borrowing penalty" or the "shareholder put" approach as described in paragraphs 62(a) and 62(b), respectively, of the Discussion Paper. However, we encourage the Board to further explore the "frozen spread" approach as described in paragraph 62(c) of the Discussion Paper in certain circumstances. Discussed below are our reasons for our position noted above.

Borrowing penalty approach – As discussed in the body of our letter and in our response to questions 1 and 2 above, we believe that if a liability is issued for cash consideration, the

liability typically should be measured initially at the amount of consideration received. The act of borrowing at the prevailing interest rate is not an event that gives rise to an immediate gain or loss, which would be recognised under the borrowing penalty approach.

Shareholder put approach - We believe that the act of borrowing at the prevailing interest rate is not an event that results in a reduction in the entity's equity capital (e.g., as an imputed distribution of equity to the entity's owners). Instead a liability issued in exchange for cash consideration typically should be measured initially at the amount of consideration received. Further, even if the Board were to conclude that the amount attributed to the "shareholder put" should be initially recognised in equity, it would be inappropriate to amortise the amount to expense, because contracts properly classified in equity do not affect net income.

Frozen spread approach - We support further consideration of the "frozen spread" approach as an alternative to amortised cost or fair value for non-derivative liabilities with variable cash flows for which the terms and conditions initially reflect credit risk, but the issuer does not have the practical ability to realise gains or losses from changes in its own credit risk. We note, however, that this approach can result in complex "layering issues" for liabilities that arise over a period of time, since different components of the liability would be measured using different credit spreads. Additionally, as discussed in the body of this letter, we support further consideration of a "high quality credit approach" for liabilities that have terms and conditions that do not consider the credit risk associated with the liability.