Committee of European Banking Supervisors

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Dear Madam, dear Sir,

Discussion Paper Credit Risk in Liability Measurement

The Committee of European Banking Supervisors (CEBS), comprised of high level representatives from banking supervisory authorities and central banks of the European Union, welcomes the opportunity to comment on the IASB's Discussion Paper on Credit Risk in Liability Measurement.

Banking supervisory authorities and central banks have a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

CEBS welcomes the efforts of the IASB to improve financial reporting in the area of financial instruments, and in particular the IASB's careful analysis of the phenomenon of 'own credit risk' (OCR).

CEBS accepts that OCR is taken into account at initial recognition, because it is considered in determining the transaction price at inception. However, we believe that for subsequent measurement in many circumstances it is not decision-useful for users to recognise gains and losses on own credit risk in profit or loss. That is partly because the impact can be misleading (gains as an entity's creditworthiness deteriorates, and losses when it improves). Moreover very often such gains cannot be realised.

The comments put forward in this letter and in the related appendix have been coordinated by CEBS's Expert Group on Financial Information (EGFI) chaired by Mr. Didier Elbaum (Deputy Secretary General, Commission Bancaire) - in charge of monitoring any developments in the accounting area and of preparing related CEBS positions - and in particular by its Subgroup on Accounting under the direction of Mr. Ian Michael of the UK FSA. If you have any questions regarding our comments, please feel free to contact Mr. Elbaum (+33.1.4292.5801) or Mr. Michael (+ 44.20.7066.7098).

Yours sincerely,

Giovanni Carosio
Chair, Committee of European Banking Supervisors

Appendix

General Comments

CEBS restricts the scope of its comments on the Discussion Paper Credit Risk in Liability Measurement (DP/2009/2) primarily to financial liabilities. Further, this comment letter is framed in terms of the current IAS 39. We acknowledge that this standard is currently being reviewed. CEBS, however, wants to avoid anticipating or speculating on the outcomes of the revision process.

CEBS recognises that Own Credit Risk (OCR) has to be taken into account at initial recognition as this is a factor considered among others in determining the transaction price by the market in establishing the terms on which a contract is agreed.

However, CEBS considers that the changes in OCR can often be misleading and unhelpful to users of accounts – including investors and depositors. OCR does of course affect values where the measurement attribute is fair value, and for that reason CEBS considers that use of this attribute for liabilities should be kept to a minimum.

CEBS notes that recognising changes in Own Credit Risk (OCR) affects the representation of an institution's capital structure. This may have adverse consequences for claimants that have a contractual relationship with a bank (for example depositors). The adverse effect inherent in recognising OCR becomes particularly manifest when credit standing deteriorates: an institution then recognises a gain at the expense of depositors and debt holders. Wealth transfers like these distort the ranking of claims between owners and debt holders at the expense of the latter and in favour of the former – despite the former being the most junior part of the capital structure. CEBS does not favour a representation that results in such wealth transfers, bearing in mind that liabilities that have to be settled at the contractual amount (notably bank deposits) are a fundamental feature of banking.

More generally, we consider it unhelpful and potentially misleading if changes in OCR lead to a perception of improved performance (and financial condition) when, in fact, an entity's creditworthiness is deteriorating.

This is especially the case for financial liabilities, whose contractual amount needs to be settled, so that gains or losses from OCR may not always be realised.

While in principle financial liabilities could be purchased for their fair value if lower than the (discounted) settlement amount – and some examples of this have been seen during the crisis – this depends on the entity having access to funds to accomplish this. Moreover, over the longer term, the economic gain from a change in OCR may be illusory. If an entity refinances its debt, this is likely to be done at a rate that reflects its reduced creditworthiness, which causes the initial OCR gain to be offset.

We are also concerned that OCR effects could delay assessment of an entity for possible insolvency, in those countries where the solvency of firms is evaluated through a balance sheet test.

Some argue that creditworthiness does not fall for no reason, and that in practice the impact of OCR on liabilities measured at fair value would be offset by a decline in asset values. However, there is no obvious reason why the offset would be complete. On the whole, we are not convinced by the rationale for linking the decline of the value of the asset to the OCR of liabilities. Considering our previous comments, we see no objection in principle to recognising one and not the other.

In view of these points, CEBS considers that fair value should be applied to liabilities at initial recognition, but subsequently only in cases where it is essential to provide useful and relevant information.

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':

- **(i) what interest rate should be used in the measurement?**
- **(ii) what should be done with the difference between the computed amount and cash proceeds (if any)?**

CEBS considers that for financial liabilities own credit risk should be taken into account at initial recognition, when the market would clearly consider OCR.

The same would be true for non-financial liabilities if they are measured on a market consistent basis. However, such a basis may not be appropriate or meaningful, if for instance there is little market depth in the relevant liabilities (e.g. certain environmental decommissioning liabilities such as oil rigs or nuclear power plants).

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?

Regarding subsequent measurement, CEBS believes that, given the significance for financial liabilities of the contractual amount owed, the use of fair value should be limited to cases where this is essential in order to provide useful and relevant information.

Where fair value is used, banking supervisors within CEBS have adopted a prudential filter to eliminate the element of own credit risk from regulatory capital measures. Therefore, any credit risk related gains or losses on liabilities at fair value through profit or loss are excluded from regulatory own funds. In an EU context this is stipulated in article 64.4 of Directive 2006/48/EC (the so-called 'Capital Requirements Directive'). This exclusion is motivated by a desire to avoid undue volatility of regulatory capital and by a concern that the related gains or losses are not immediately available for unrestricted and immediate use to cover risks and losses as soon as they occur.

Although CEBS notes that prudential and accounting frameworks have different objectives, we believe, in line with our prudential approach, that only gains due to own credit risk that are demonstrably capable of being realised by the entity should be admissible within accounts. We have some doubts as to whether banks are always able to effectively realise gains even on traded liabilities or derivatives. Therefore, following our May 2007 letter on the Fair Value Measurement Discussion Paper, we remain unconvinced that, in general, own credit risk should be recognised when valuing liabilities.

However, from an accounting point of view, it could be argued that fair value may provide useful and relevant information where entities can demonstrate that they are in a position to realise gains due to own-credit risk. This may be the case for some actively traded instruments and derivatives.

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?

CEBS does not have a view on specific methods of measurement. However, we are aware that there are a range of possible techniques, and that these can give materially different results.

However, banks' accounts tend to provide limited information on measurement methods. The disclosure requirements in IFRS 7, paragraph 10 should be increased such that: (i) they cover all liabilities measured at fair value; and (ii) they require banks to explain the way in which they measure own credit risk.

In particular, it should be clarified what "own credit risk" includes. In the DP it is assumed that OCR is the spread over the "risk-free rate". However, IFRS 7 proposes to measure it as the spread over a "benchmark interest rate" (see IFRS 7. B4). This "benchmark interest rate" could, in turn, include a "market" spread over the "risk-free rate".

In its June 2009 Follow-up review of banks' transparency in their 2008 audited annual reports, CEBS noted that "[i]n some cases the level of detail of disclosures regarding the methodology used to determine the impact of credit spreads on own liabilities could improve. In addition CEBS would welcome, in line with the IASB Expert Advisory Panel guidance on measuring and disclosing fair value of financial instruments in markets that are no longer active (October 2008), disclosure of the sources of inputs used in the valuation. Indeed, the IASB Expert Advisory panel notes: "given the scrutiny applied to the movements in the fair value of liabilities due to changes in an entity's own credit risk, in addition to the required disclosures of how the amount was calculated, disclosing the source of inputs used to calculate the movement provides transparency about the uncertainty of that amount".

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?

CEBS does not consider substitution of the risk-free rate (or any other non-transaction related rate) at initial recognition to be appropriate, as this would set aside the 'facts' of the transaction and may introduce undesirable incentives.

We see some attraction in use of a 'frozen spread', as set out in Illustration 4. However, it is hard to conceive of this as a satisfactory measure where liabilities are classified as held for trading.